Management Buyout and Leadership Succession – the Question of Valuation

Management buyout (MBO) and leadership succession transactions are options for owners that seek to exit. In my first blog I overviewed these transactions and pointed out four common features.

One feature I outlined was to urge not getting stuck on a valuation number. Valuation is simply that, valuation. A single number that stands like a light seeking to be truth. It is very important to get a common focus on what drives a valuation. First is the forecast earnings before interest tax and depreciation (EBITDA), which is the measure of earnings quantum. Second there is the multiplier which is the measure of earnings quality (or measure of certainty that earnings will be repeated in the future, or risk that earnings will not be repeated). Vendors often get a valuation that assumes perfect transition, purchasers see transition risk in large letters. MBO / succession transactions are more collaborative than positional. A valuation is essential yes. However it is the negotiation that occurs around each parties view of what drives each of earnings quantum and earnings quality that creates the transaction.

So, here is a headline overview of the four basic valuation building blocks.

First earnings quantum. An estimate of <u>future</u> maintainable earnings, the standard being a number called EBITDA being earnings before interest and depreciation. Future being the key. Historical earnings are relevant to the extent they point to future earnings. A measure of earnings quantum is however by no means a view backwards into history. Remember the value of an asset is its future earnings.

Second earnings quality. This is expressed as a multiplier. This is a measure of risk. If there was absolutely no risk then the multiplier would be very large representing the risk free rate of return. Of course in the world of business valuations there is risk to achieving the assessed future earnings quantum. You often see reference to multipliers, and there are some publications that have useful information of current multipliers by industry and deal size. A multiplier of 3.5 is a bit like a standard flat white. Not the assured drink preference of a group in a café, but everyone would recognise it.

Third enterprise valuation. This is a number calculated as future earnings (EBITDA) multiplied by the multiplier. This produces the enterprise valuation, so the value of all of the assets of the enterprise that are required to generate the forecast earnings quantum.

Fourth value of the business or shares. This is where use of the enterprise valuation branches into two separate streams, and where I see the most valuation confusion. First, a transaction where there is a sale and purchase of a

business will (or should) start and pretty much finish with the enterprise valuation number. There may be tweaks to asset numbers, or an adjustment to allow for vendor liabilities assumed, but that is pretty much it. Second however is the transaction where there is an acquisition of shares. This requires two pieces of additional work after the enterprise valuation is calculated – dis aggregate the enterprise valuation into tangible and intangible assets (subtract tangible assets at market value from enterprise valuation and derive intangible assets), and then insert into the Statement of Financial Position the value of unrecorded intangible assets and any changes to bring tangible asset values to market value. This Statement of Financial Position then shows a derived value of all the shares in the company.

Of course there are a myriad of nuances, such as how to properly estimate earnings quantum, particularly to mark transactions to market (normalise), what to do when market value of tangible assets exceeds enterprise valuation, minority interests, nature of intellectual property, mixed businesses bundled in one company, co dependant companies, pre transaction dividends, thin capitalisation, excess working capital. The list does go on.

I will deal with some of these nuances in a future blog.

Now to ***words*** and their ***meaning.*** Last time I left you to go check out **know** and **knowing**.

Well, the Mirriam Webster dictionary definition of know is a transitive verb (1) to perceive directly, have direct cognition of, to have understanding of importance of knowing oneself, to recognize the nature of (2) to recognize as being the same as something previously known, to be acquainted or familiar with, to have experience of. As an intransitive verb, to have knowledge, to be or become cognizant.

Lets go to the Hebrew. The Hebrew root yada, translated "know"/"knowledge, " appears countless times in the Bible. It has a wider sweep than the English word "know, " including perceiving, learning, understanding, willing, performing, and experiencing. To know is not to be intellectually informed about some abstract principle, but to apprehend and experience reality. Knowledge is not the possession of information, but rather its exercise or actualization.

Sir Kenneth Robinson in his iconic and profoundly insightful 2014 Ted Talk quipped in relation to knowledge that the pursuit of it (at the expense of knowing) was creating humans with bodies that simply conveyed our heads to meetings.

Brought to you by

Anthony Harris, email anthony@anthonyharris.co.nz phone 021 937 973, www.anthonyharris.co.nz ,

PO Box 251 Nelson 7040

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