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How to understand the value of your private business

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While most investors are familiar with the ins and outs of equity and debt financing of publicly traded companies, few are equally informed about their privately held counterparts. Private companies make up a large proportion of businesses in Canada and across the globe; however, the average investor most likely cannot tell you how to assign a value to a company that does not trade its shares publicly. This article is an introduction to placing a value on a private company and the factors that can affect that value.

Private and public firms

The most obvious difference between privately held companies and publicly traded companies is that public firms have sold at least a portion of the company to the public during an initial public offering (IPO). Large private companies, on the other hand, have decided not to access the public markets (small companies generally do not have the ability to be public) for financing and therefore ownership in their businesses remains in the hands of a select few private investors. The list of owners typically includes the companies' founders, along with initial investors such as friends and family (angel investors).

The biggest advantage of going public is the ability to tap the public financial markets for capital by issuing public shares or corporate bonds. Having access to such capital can allow public companies to raise funds to take on new projects or expand the business. The main disadvantage of being a publicly traded company is that the various regulatory bodies require such firms to post numerous filings, such as quarterly earnings reports and notices of insider stock sales and purchases. Private companies are not bound by such stringent regulations, allowing management to conduct business without having to be so concerned about regulatory policy and public shareholder perception. This is the primary reason why private companies choose to remain private rather than to enter the public domain.

Establishing business value

Establishing an understanding of how to value your business is required at an early stage in succession planning. This knowledge is not only a key factor that affects the timing and viability of succession, but it is also required for tax, estate, and insurance planning. Most importantly, working through a valuation exercise helps to identify the value drivers and detractors of the business. Valuation drivers are characteristics of the business that have a material-enhancing effect on the value of the business and, conversely, value detractors have negative implications on value.

Important value drivers are:

- Stable or growing cash flow trends that are supported by consistent profit margins
- Being an industry leader
- Diversified customer base, ideally with long-term contracts at decent margins
- Strong and balanced management team
- Customer/sales relationships that are shared among the management team
- Key differentiators such as branding, reputation, and technology – competitive advantages
- Minimal staff turnover
- Producing and/or selling a scalable product that is adaptable to changing industry conditions

Common detractors of value are:

- Poor and unreliable reporting capabilities (systems and personnel)
- Excessive occurrence of lawsuits
- Dependency or concentration on a few customers and suppliers
- Active family members with poor communication skills and objectives (dysfunctional behaviour)
- Key customer/sales relationships reside with the owner of the business and not shared throughout management
- Disorganized and unprofessional working environment

It is often said, and it is partially true, that business valuation is more of an art than a science. There is a certain amount of professional judgment required to analyze many of the aspects noted above, but to develop the proper basis for that judgment relies on mathematical skills and business logic. The actual specifics involved in assigning value to a private business will be explored in a follow-up article, but to put it simply, valuation is about predicting future cash flow –based on historical cash flow– and assessing the risks that could impede the business from generating future cash flow.

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