Jon Moulton's Diary

Enterprise valuation — is it a science or something less precise?

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

If you were able to go back to the early years of my career, shares in UK public companies were largely valued on the dividend yield and on the ratio of post-tax profits to dividends paid — dividend cover — and these were the primary ratios used in valuation. The higher the cover, the higher the multiple of dividend (and the lower the yield) used to arrive at a share price.

There was a simple logic in this. Shares were principally viewed as sources of income and the safer the income the lower the yield required. Stockbrokers were not mathematical geniuses, and they happily used yield and cover to generate a price target for shares.

The defects in this simple model are rather obvious to a modern reader.

What about growth?

Notably, growth is not explicitly considered. Clearly a growing business will be more likely to be able to increase dividends to shareholders. However, in recent years we have seen a marked tendency for growing businesses to be valued on revenue multiples — this is arguably at least as lacking in logic as the share valuation methods of my youth. If it costs £1,000 to capture a customer who will generate revenues of £2,000 and £700 in gross margin over the lifetime of the customer relationship then you have a cash negative business into eternity, which is truly worth nothing.

Unless of course you can find a believer (aka "mug") in revenue multiples that you can unload your shares on...

Modern theory for valuation is generally some form of discounted cash flow (DCF or deceit by computer forecast). The problem with DCF is not the intellectual basis but rather the unknowable future whose prediction is inevitably dreadfully imprecise and the use of discount rates that are judgemental. And I have hardly ever seen a DCF that was not biased strongly to the optimistic.

The most common valuation basis in the private equity world is to multiply a past or future Ebitda (earnings before taxes, depreciation and amortisation). This is supposedly using an earnings figure that can be less manipulated than accounting profits.

'Adjusted Ebitda is often quoted with adjustments that are a testament to the creativity of the PE industry'

In practice "adjusted Ebitda" is often quoted with adjustments (if they are explained at all) that are a testament to the creativity of the private equity industry. Quite often I have seen adjusted numbers that are inexplicably different from numbers filed at Companies House — PE firms would like to show their clever buying of a company by inflating the profits they bought. Alternatively, they could show lower entry profits to show how clever they are at improving business performance. Tough choice! Amusingly, it is not unknown in secondary buyouts to get one view of the exit Ebitda multiple paid from the PE seller and another from the PE buyer.

Right multiple

The other large problem is fixing the right multiple to use — rationally that is all about future performance, which is always judgemental. In practice, the multiple is a market norm based largely on recent deals in the industry area.

The most irritating thing I find is that after arriving at a rough and ready enterprise value by the machinations above we then have to arrive at a share value by adjusting for cash or debt. This at least ought to be easy — but with fees in sight the accountants have decided to complicate matters. The concept of "debt-like" items is wheeled out. The concept is awful — arguments arise over whether or not seasonal movements matter or whether creditors are stretched or if future contracts represent a risk or leases are operating leases or financing leases or ad nauseum.

This debate lacks clarity and often adds an unpleasant argument well into a deal. It certainly adds cost.

As a seller, I am only interested in the price for my shares. It is up to the bidder to decide how he values the enterprise and adjust that to a price per share reflecting the balance sheet they are buying. This saves complexity and disagreements.

Above all – never believe that valuation is a precise science. I wish it was.

Finding the right valuation for a company can sometimes appear to be a bit of a game

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