Scientific pricing: Valuation

Would you buy a second hand company from this lad?

Valuation of the company in merger and acquisition situation is easy, very easy. If the seller and the buyer are happy, the price is correct.

The valuation is technically very simple when we are talking about public companies. It goes roughly this way:

- pick a date for the stock exchange price
- define which one is the buyer, usually it is the company in worse financial situation
- define the premium which is given to the target company's owners

Simple.

Small (or bit bigger) problem here is, that from stock exchange you will get the price of the company, not the value and there can be a big difference. But that is the name of the game.

For non-listed companies the story is different. It can be quite complicated challenge. How to get the market price? You can use external expert who's makes it as a business or if you have the courage, you can do it yourself.

It is done very often based on P&L and Balance sheets from previous 3 to 5 years. Taking in account EBIT, operating margin, debts, substance value etc. But Houston, we have a problem. Those numbers are history. Who wants to buy history? Those figures are telling mainly that the patient can breath and has potential to walk or even run. Buyer is targetting for the future, solid and profitable one. Now it is time to phone a friend whose name is Excel (or LibreOffice Calc when talking Linux).

We all know that the prophecy is difficult especially when talking about the future. We are talking about the future income value type of calculations. One has to build at least three scenarios about the company's future business: conservative, optimistic and pessimistic. Finding out (guess, hopefully an educated guess) what is the possible way for future you will need all of the available knowledge of your business area to find out what is possible scenario for the future. Very important issue is that how current strategy affects to the future's figures. When you agree the scenario with all of the parties involved the rest is only mathematics. Just remember that the excel-sheets are only educated guesses, they are not the truth.

When talking about M&A valuation is just a part of the story. Yes, quite core part but still… And the devil is in details. Very often more important issues is that how the possible obligations of the sellers are handled in the deal.

One lesson of this story is that when you are looking Annual Reports of a public company the important part is not the P&L and Balance sheet. It is the management's view of the future. Unfortunately it is not always very detailed because it is a business secret.

The 2nd lesson. Although simulation will get you a nice bunch of figures and calculations, they are just ballpark figures and usually you end up back to square one, find a figure what makes buyer and seller happy keeping in mind check the heartbeat from the history and mindset ready for the future.

