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Risk—The Other Side of the Valuation Equation

Risk factors are difficult to quantify but have a direct impact on value.

by Jay Schembs

Business owners know two factors when it comes to valuing their business – cash flow (or more specifically, the shorthand proxy, "EBITDA") and the multiple. As we have discussed in many articles in IN$IGHT, valuation isn't just based on one year's EBITDA, but expectations of cash flow over a long period. The multiple (see "What's in a Multiple?", IN$IGHT Summer 2014) is a function of many factors, most importantly the expected rate of growth of cash flow and the rate by which future cash flows will be discounted. This discount rate, also known as cost of capital, is a quantification of risk that acknowledges the potential variability of expected future cash flows.

The impact of these risks helps determine an appropriate discount rate to apply to projected cash flows. Certain risks create intractable situations where investors will not consider an acquisition, regardless of price.

The academic approach to valuing privately held businesses adds a "small business" risk premium to general equity and industry risk factors. In some cases, the amount of this risk premium is larger than all other components combined. For example, the risk of general equities is in the range of 7%, while the small business risk premium could be an additional 10%. Substantially higher discount rates help to explain why smaller companies are often valued much lower than their larger counterparts.

The small business risk premium is real, but not always clearly identified or understood. Since our firm's founding in 1991, we have encountered a wide range of risks prevalent in privately held companies that contribute to the risk premium of smaller businesses. These are risks that many times can be mitigated and, whether being evaluated by bankers, investors, or acquirers, can have a meaningful impact on the value when it comes time to sell the business.

Future cash flow estimates need to be discounted not only for the time value of money, but also for the risks that cash flows will deviate meaningfully from the forecast. Investors typically handicap myriad risk factors when evaluating a business. The impact of these risks helps determine an appropriate discount rate to apply to projected cash flows. Certain risks create intractable situations where investors will not consider an acquisition, regardless of price. For example, significant customer concentration, weak management depth, or historical spats with organized labor could all be non-starters for certain investors, even for businesses with phenomenal growth and cash flow profiles.

PRODUCT AND/OR SERVICE OFFERING

What does the company sell? Is it unique or differentiated from competitive offerings? The level and stability of a company's gross margins offer clues, but sometimes more qualitative factors are at play. For example, we've sold cold storage businesses with facilities in remote locations near major customers. For competitors to make the significant investment to build a competing facility would be foolhardy, and thus investors viewed much of that company's revenue as relatively low risk.

For product companies, are there patents and other intellectual property that serves as a competitive barrier? What is the company's ongoing R&D and product development pipeline? Patents do not always provide the best protection, as we've worked with companies providing such a unique product or service that patenting would put the "secret sauce in public view." In contrast, companies manufacturing largely commoditized products that compete on price will face higher perceived risk resulting from high levels of competition.

CUSTOMERS AND SUPPLIERS

Owners often drastically underestimate the risks associated with their customers and suppliers. For many investors, excessive customer concentration will preclude them from even considering an investment. For others, such concentration will result in a significantly higher discount rate (in other words, a lower multiple).

Customer stability and consistency are secondary, but similarly important factors. Stability and consistency lower acquisition costs, and convey a sense of value received by a company's customers over time.

Contractual arrangements with large customers will strengthen a prospective buyer's view of relationship stability – even if the arrangement provides various termination provisions. For buyers, these relationships are new and unfamiliar, and anything that can be done to document the arrangements will provide comfort to prospective buyers assessing the risk to future cash flows.

Supplier concentration of key inputs is the other side of the coin and just as important as customer relationships. Documented agreements that commit resources and frame pricing will help to mitigate the perceived risk of vital supply relationship interruption.

MANAGEMENT AND EMPLOYEES

Small businesses are generally more reliant on fewer people, a delicate balance that can be susceptible to disruption. Businesses driven by a founder who is now looking to exit can expect a significant discount due to the uncertainty of success under a new leader. A deep bench of capable managers that a new owner can rely upon will yield substantial benefits when time comes to transfer ownership.

Risk is always in the eye of the beholder. Even though many of these risk factors are difficult to quantify, buyers form an opinion on each.

Heavy reliance on particular people (i.e. one salesperson who maintains the relationships with major customers) can also result in a discounted valuation. For important individuals, we always recommend negotiating employment agreements in advance of a sale that include non-competition language to help assuage fears associated with their potential departure.

Lastly, labor is the life-blood of many busi-

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nesses. Disruption of that critical resource as a result of unions, competitive labor markets, and shortages of credentialed skills can affect the price and supply of labor. Documenting smooth labor relations, low turnover, and/or consistent access to qualified candidates help to mitigate concerns regarding disruption (unions and turnover) or a company's ability to grow (general labor pool).

INDUSTRY DYNAMICS

Owners, of course, are less able to control the risks related to industry dynamics, but a few points are worth making here. First, an industry in decline generally elicits caution, with most "surprises" expected to come on the downside. Second, risks attributable to competition can be a double-edged sword – a highly competitive market may indicate a lack of differentiation, while a business owning a lion's share of the market offers the risk that further market share gains will be increasingly difficult. Lastly, excessive government regulation can be a non-starter, particularly for investors without significant direct experience in the industry. Addressing industry issues up front by way of a thorough study of the issues can help to mitigate perceptions of risk.

Risk is always in the eye of the beholder. Even though many of these risk factors are difficult to quantify, buyers form an opinion on each. The amalgamation of those opinions will determine a "go or no-go" decision as well as a discount rate, which will translate into a valuation multiple. Accordingly, sellers that can demonstrate that the business has taken steps to contain each of these risks will meaningfully improve any outcome involving third-party providers of capital – lenders, investors, or prospective buyers. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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