Weighing in on the Market Approach: What Holds Water?

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When valuing a privately held company, a market approach using guideline public companies (GPC) is one method the IHS Markit Private Capital Markets’ team considers to determine the enterprise value of an entity (applicable in both Topic 820 and 409A reports). This approach relies on a subject company’s available information including historical financials over the last twelve months leading up to a valuation date and also considers projected financials that encompass the next twelve months’ performance past a valuation date. Once the subject company has begun recognizing significant revenue and a market approach can be considered, the GPC approach applies multiples derived from comparable public companies to the subject’s financial metrics to reach an enterprise value. The multiples in the GPC approach are applied to revenue and EBITDA, and weighting for each indication is separated between these two data points. Typically, weighting is also separated by historical versus projected figures. Significant revenue can be reached at different levels based on the subject company’s operating sector and overall stage of development, but a good rule of thumb is around the $7.5 - $10 million mark.

The metrics that should be examined in a GPC approach as of a valuation date include:

- Revenue
- EBITDA (referred to as cash flows for this discussion)
- Cash balance
- Outstanding debt balance
- Any additional circumstances unique to the entity that may influence the company’s business

But how should weight be distributed among the available information to retrieve a value reflective of the subject company?

According to the AICPA’s Accounting and Valuation Guide for Valuation of Privately-Held-Company Equity Securities issued in 2013, each report requires the analyst, “to select the financial metrics that are applicable to the enterprise valuation, given the enterprise’s stage of development, industry, growth, profitability and other relevant factors”. Inspection of a company’s financial statements is only scratching the surface to determine the proper procedure for this type of valuation. Given the state of a subject company as of a specified valuation date, if no positive cash flows have been recognized over the last twelve months, then of course all historical weight will need to be placed on revenue. If the subject company has begun recognizing positive cash flows for less than six months, then it is still appropriate to only weight revenue as initial positive cash flows for a young company can sometimes become unsteady. If positive cash flows have been consistent, then a majority weight (75%) can be placed on EBITDA figures. This depends on the uncertainty of continuing operations while maintaining positive EBITDA, and details should be discussed...
with the subject company’s management team to determine the probability of meeting
milestones and projections. The comparison of available cash versus outstanding debt
balance will lend some perspective to the company’s ability to recognize positive cash
flows in the future as well.

While considering probability of maintaining historical performance through the next
twelve month period, another question is raised: how much weight should be placed on
projected performance in the next twelve month time frame? In Qval, a standard weight
that is assumed while compiling broad strokes prior to discussions with management
is placing the majority of weight (75%) on the next twelve months revenue or EBITDA as
applicable. This is a standard weighting used due to the level of growth and high volatility
of venture stage companies, assuming the subject company does not have stable, positive
EBITDA. Traditionally, the value in these companies is better represented by where they
expect to be in the next twelve months versus where they were in the past twelve months.
However, evidence provided by management that may bring into question the validity
of projections such as setbacks in production/prototypes or imminent hardships within
the industry that should be taken into consideration as well. These factors could lead to
less weight placed on projected figures. Conversely, if items are brought to the analyst's
attention such as exceeded expectations for bookings in the following year, confirmed
FDA approval (in case of a healthcare company), or other contributions to positive growth
moving forward, then more weight can be applied to projected performance.

Other questions to keep in mind when assigning weight to the subject company’s
financials during the analysis include but are not limited to:

- If EBITDA is positive, how long does the company predict these cash flows will
  continue? What accounting methods are being used to calculate EBITDA?

- Are there peak sessions in the business model where revenue is inconsistent
  throughout the year? Are the projected figures reasonable given management’s
  commentary and perceived growth over the next twelve months?

- What milestones are responsible for the subject company’s projected performance?
  What is the probability of meeting these milestones?

- How has the company historically performed? Have the projections been met in
  the past? (This can include income statement figures as well as individual product
  launches and milestones.)

- How much competition is present in the respective industry sector? Are there
  significant barriers to entry? How difficult is it for the subject company to maintain
  operations and performance at its current rate?

- What risks are present (if any) when taking geographical location into consideration
  for prospective revenue and EBITDA growth?

Based on the circumstances of each subject company being valued, there are a myriad of
blended weightings that can be assigned to properly reflect the company’s value through
a GPC market approach. Support for weight assignment in this type of market approach
is accomplished through a thorough inspection of the subject company’s historical and
future projected performance as well as perceived risk regarding growth and operations
overall. This can be easily achieved through a collaborative effort with the subject
company’s management team to present a clear picture on the company’s past, present
and future. These guidelines are a good starting point when completing a report for a
privately held company; however all of the underlying details and qualitative information
unique to each company must be considered when determining the best representation of
compny value.

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