# FLIGHT PLAN

## Introduction

Flightplan was conceived by AngelNews and its partners in spring 2006 to provide a no-nonsense guide with the answers to all the key questions asked by both entrepreneurs and their investors.

The first edition of Flightplan will be issued as a series during 2006 and 2007, with each Chapter covering a different question. The first question is "what is my business worth?", which we understand is the first one asked by people when they approach our partners. Expert contributors have each provided the answer they would give if asked the question, including a detailed explanation of why. Thus we have Charles Stanley Securities addressing it from the point of view of flotation, Vantis Corporate Finance from the point of view of a trade sale, Sovereign Capital in the context of an MBO or venture capital backed deal and Kemp Little on the basis of using IP as collateral to secure debt financing. This Chapter, as with all future Chapters, has an introduction from our resident expert angel investor, Gabriel who has provided his own pithy and unique thoughts on the question.

AngelNews hopes you enjoy Flightplan and that it will become your reference work of choice as you plan, launch, fly and land your business.

Modwena Rees-Mogg

Editor, AngelNews

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## Question — What is my business worth?

## According to Gabriel

Turnover less than £1m and you are worth less than a million"- that's what I say. Too many companies these days overestimate their value and simply don't see the risks that we investors take when we back them. I am always (well nearly always) looking at a deal that even a bank won't touch (come to that, the bank probably will back it if I do, so that means something doesn't it?), so I need to be compensated for this. I want to get 10x my money if I can and to avoid losing it if I can't. Therefore, entrepreneurs need to do their valuation sums based on that understanding. If they really believe they can get me a 10x return in a sensible time – 5-7 years by my diary - and then convince me then I will go with them on value, but usually when I challenge them and threaten performance milestones they quickly come around to my way of thinking. Only one team has ever assured me they could do this and, sure as heck, they met every budget set, so I backed a good one there.

Remember, I have made my money the hard way. I have done the long days and nights, weekends and the spare time in between. I can help you do it too, but that makes me valuable to you, so I deserve a good stake in your business.

I look at what a company is worth today – not what it might be worth in the future, though. As I said – turnover less than a million…., but I will be argued up. What's worth money to me today? Three major things – the management team (good and complete is worth a lot to me, and I will pay for that both in valuation and in salary), patents – strong and issued ones mind - which I might say are worth £500k or so and revenues – my favourite of all. I prick my ears up when I hear the word revenue especially from loads of customers who matter.

I'm not interested in new fangled multiples of nonsense numbers. If you can't show me a record of steady trading over at least five years, the only thing I know is that whatever happens you won't hit Excel's wonder results – you will either be above (perhaps) or below (probably). This is because you don't yet have any idea about how hard it is to make sales and to then keep making sales. I do. I reckon it takes a salesman 6-9 months just to come on stream. Go back to your spreadsheets after you have read this and keep all overheads the same, but delay sales by 6 months + another 1 or 2 to take account for the fact that hardly anybody these days pays on delivery. When you have seen how this decimates your cashflow, come back to me. I understand and will help.

## Question What is my business worth?

### According to Gabriel

About those "City" valuation techniques. They have their place and will be VERY useful when you and I come to sell our business. If you are in the B2C game don't forget that we will also be thinking up other new "measures" - % of household penetration or mobile phone users, applying a price per unit and multiplying by the actual numbers you have, so go out get that growth for me please. We may not need profits to sell profitably – wish I had backed Skype by the way.

Back to why I am worth something to you. I have nous, I have an address book, I have suppliers and customers for you. I will also roll my sleeves up if necessary and come and get your book-keeping sorted out, help you employ your staff and write those tricky contracts that stop nasty unfair dismissal claims later on.

Forget EIS. This is none of your business. Its my relief if I choose to use it. Its not an excuse for you to put up the price of the shares in your company. Likewise, if we need to mix up the equity investment with a little bit of convertible debt, remember that is my way of protecting my position. I will use it because it is a way to make you think hard about delivering against the targets we have agreed. It gives me a chance for some jam. It also helps me if a new vc investor comes on board to stop myself being diluted like gin in a teetotaller's tonic. By the way, I wouldn't mind a director's loan account, so that you can roll up my salary and expenses into it. I don't want the cash back now, but I do want a record of the work I have done.

I suppose I had better confess that I can be a bit of a pussycat. If I love your idea, but so does everyone else, I might just pay a tad over the odds so that I can grab it for myself. I will also pay more if you already have good investors who I would like to hang out with. Also, more than likely I will be there for you with my cheque book and real help when the chips are down …. in about four months time and then six months later and then…. I love you entrepreneurs and I don't want to own or run your business – if I wanted that I would do another one for myself, but I do want to make shed loads of cash so help me to help you to do that. That's what your business is worth to me.

*If you want to contact me, please email: Gabriel@angelnews.co.uk.*

**Question** **What is my business worth?**

## On flotation

## Tim Davies, Charles Stanley Securities

Against the backdrop of the increasing popularity of the Alternative Investment Market (AIM – *the* public market for smaller and growing companies, with 1,426 constituent companies with a collective value of £65 billion*), one of the most commonly asked questions by management teams of privately owned businesses is what might our business be worth if we were to float it on AIM?

At a simplistic level, businesses are typically valued on the key metrics of multiples of Price to Earnings (P/E ratio); Earnings Before Interest, Taxation, Depreciation and Amortisation (EBITDA); or, in the case of asset-backed businesses, such as property companies, on Net Asset Value (NAV).

As P/E implies, this measure is for profitable companies and reflects anticipated earnings in the current and following years. EBITDA is widely used by companies that, based on headline numbers, would otherwise appear unprofitable. Again, importance is attached to current and subsequent year expectations.

But these are headline numbers only and should be treated as such: behind their calculation lie other considerations, both objective and subjective. Furthermore, these considerations will not necessarily apply to any two similar companies. Confused? Read on…

With P/Es, for example, it does not follow that a company will automatically be valued in line with its perceived peers, or even on a 'sector' rating. The reality is that even if there were two companies that are identical apart from one having been listed on the stockmarket for several years and generating say, twice the sales and profits of the other, recently floated, smaller company, the newer company is likely to be valued at a discount to the other due to a) its comparative lack of stockmarket track record; and b) its relative size.

At flotation, valuation reflects a blend of:

- The nature of the business, the potential for its products or services and growth expectations for the markets it addresses, together with analysis of its competitive environment
- The anticipated levels of growth and profitability (of the company and in comparison to comparable businesses)

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•The perceived quality, ability, ambition and track record(s) of the management team, including non-executive directors (it is understood that for the majority of companies, management teams will have little or no 'City' experience; typically, this is where non-executive directors can add value). Equally, if there is likely to be management succession as a part of the process, the path must be clearly defined.
•Company strategy and the likely 'end game' alternatives for it i.e. is it destined to remain independent or is there a likelihood of it becoming an acquisition target?
•The investment proposition: organic growth only, organic growth and acquisitions, or 'buy and build'
•Risk factors, be they human, economic or trading-related (over-reliance on key individuals, one product, or a small number of customers)
•The financial characteristics (specifically balance sheet management, cash generation and debt profiles)
•Vendor shareholder dilution at the time of IPO (the trade off being how many they want or need to sell to raise funds, versus how many new shares will be issued versus the issue price - or, put another way, achieving the optimal float price with minimal dilution)
•Liquidity of the quoted shares: incoming investors will be reassured by more liquid shares and cautious of the more thinly traded, on the basis they will be able to get in, but not necessarily out, when they want to
•Prevailing stockmarket sentiment as it affects fund raisings or the company or sector in question (like any, it is a cyclical market!)
•The timing of IPO: would the company achieve a higher valuation if, for example, it floated a year later, based on the business having achieved particular milestones, or being that much bigger or more profitable?
•The reason for the IPO. Most common is for existing shareholders to realise some gains and, simultaneously, for the company to issue and sell new shares. Typically, funds raised are used to provide working capital to expand the business, or capital for acquisitions. A listing also provides a liquid market for the company's shares, a valuation for share options and generally enhanced corporate status

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### On flotation

The ambition held by the management team to use the company's stockmarket listing to raise further new funds in order to facilitate growth. One other very important consideration is the expected stockmarket valuation, or market capitalisation, of the company at flotation. Broadly speaking, the larger the company, the wider the range of (institutional) shareholders it is likely to attract; conversely, the smaller the company, the harder it will be to attract institutional investors. Institutional support is important, as if the company performs well, institutions tend to be long term holders and are likely to support future fund raisings.

Similarly, Venture Capital Trusts (often also managed by the mainstream smaller company institutional investors referred to above) are also important. Companies with Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) clearance will be of appeal to investors in this type of business, although there are restrictions: with effect from 6 April 2006, companies qualifying for VCT investment must have gross assets, pre any new money, of no more than £7 million and £8 million after.

Estimates vary as to the ideal market capitalisation at float. Our view is that assuming all of the factors outlined above can be satisfied, a company starting public life should be valued at a minimum of £15 - £20 million. At this size, the company should attract support from an initial range of small cap. institutional investors. That is not say it cannot be achieved at lower levels: it just makes it a lot harder!

So valuing a business for IPO is not necessarily straightforward, but from the stockmarket practitioner's perspective is a relatively simple and quick process.

*Charles Stanley Securities specialises in smaller and growing UK-listed companies. It also works closely with companies moving towards a listing. Contact Tim on 020 7953 2412 or via email at tim.davis@csysecurities.com*

*source: London Stock Exchange AIM Market Statistics, February 2006

## Question — What is my business worth?

## On a trade sale — Tony Lindsay, Vantis Corporate Finance

The most common method used to estimate the value of a business in a trade sale is the "earnings multiplier" method.

This method requires an assessment of the current earnings of the business, together with an estimation of an appropriate capitalisation multiple for that particular business.

It is most readily applied when the historical earnings pattern of a business is sufficiently stable and indicative of the earnings that can be expected in future, or where other factors such as available forecasts or other indicators of likely future results are considered sufficiently reliable to allow reasonable estimates of future earnings to be made.

The two components of this valuation method are considered in turn below.

*Assessing the Appropriate Capitalisation Multiple*

The appropriate capitalisation multiple can be assessed:
•by observing multiples at which other businesses in similar industries are trading on stock exchanges; or
•by reference to the pricing multiples implied in transactions involving companies that are sufficiently comparable to the one being valued.

These multiples may need to be adjusted to take account of differences between the listed company, or the company that was acquired, and the company being valued. Factors to consider when adjusting the observed multiples include differences in:
•size (in terms of turnover and profits);
•profit margins and returns on assets and capital;
•growth prospects;
•liquidity/marketability (shares in private companies are less marketable than shares traded on recognised exchanges, and hence would price at a discount); and
•control (all else equal, a controlling interest in a company would attract a premium relative to a minority interest).

## Question What is my business worth?

### On a trade sale

*Capitalising the Appropriate Measure of Profitability*

When adopting the earnings multiplier method, an appropriate multiple may be applied to either:
- sales;
- earnings before interest and tax (the EBIT multiple);
- earnings before interest, tax, depreciation and amortisation (the EBITDA multiple); or
- profit after tax ("PAT") (the price earnings ("P/E") multiple).

The EBIT multiple approach is more common in valuing businesses for acquisition purposes as it eliminates the effect of gearing and tax which are driven by an entity's capital structure under the control of the acquirer. It also eliminates any distortions arising from the tax position of the business. Where non-cash expenses such as depreciation and amortisation distort the differences between businesses it may be more appropriate to consider EBITDA multiples as this avoids errors from differences in accounting methodology.

Where sales, EBIT or EBITDA is capitalised, a deduction must be made from the gross business value determined for interest bearing debt (net of surplus cash) to arrive at a net value for the owner's equity. If PAT is the preferred earnings measure, the resulting capitalised value will represent the equity value.

Earnings should be normalised and should not include non-recurring revenue or expense items or items attributable to surplus or non-operating assets not required in the business. Any surplus assets should be added to the resulting enterprise value to arrive at a total value.

As is evident from the above, estimating the value of a business in the context of a trade sale is a difficult and subjective exercise.

*Vantis Corporate Finance helps people acquire, sell and raise capital for companies typically valued from £2-100m. Specifically, we provide corporate finance advisory and transaction support (financial investigation and reporting) services and have many years experience in valuing businesses in a commercial context. If you require any valuation or other corporate finance advice, contact Tony Lindsay on 020 7549 2443.*

*Vantis Corporate Finance Limited is authorised and regulated by the Financial Services Authority.*

**Question** What is my business worth?

## In an MBO or Venture capital deal

## Philip Conboy, Sovereign Capital

### 1. Introduction

Valuation, valuation, valuation... is it an art or a science? No matter how limited the information or how early in the process, investors will always try to ascribe a value to a target investment. Very little has been done in recent years to sophisticate or create new valuation techniques. MBO valuation methods are still the same today as they have been for many years and are no different from those used for other businesses: discounted cash flows, profit multiples and asset values.

It is widely accepted that valuing a business is more of an art than a science. However, this does not mean that valuation techniques should be discarded. The experienced investor will use these methods (when appropriate) and interpret the "real" meaning of the numbers.
We don't to give a compressive list of valuation techniques nor explain in detail their application in this article. Its purpose is to discuss the valuation approach commonly used by professional investors when assessing Management Buy Out (MBO) opportunities in the UK mid-market. Please note that we will use the term MBO to refer to Management Buy In, Buy In and Management Buy Out (BIMBO), Institutional Buy Out (IBO) or any other type of later stage private equity deal i.e. not early stage companies.

### 2. Background

When assessing an opportunity, all methods in some way or another, are used. Different techniques should be used in particular stages of the deal execution process, according to the quantity and quality of information gathered and the timeframe. It is very important not only to use the appropriate techniques, but also to be able to interpret the results. The purpose of using valuation techniques is not to come out with an absolute number, but with a range of values that will give an idea of the real value of the target. This range of results will depend on the assumptions used by the investors. Therefore understanding the rationale behind the assumptions is key to obtaining a fully informed result.

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## In an MBO or venture capital deal

*"Price is what you pay and value is what you get"*
*Warren Buffet*

From the investor perspective, overvaluing or undervaluing an asset can be equally dangerous. Overvaluation can lead to overpayment for the asset, making it difficult for the investor to obtain their return or in extremis jeopardizing its investment. Undervaluation can make the seller choose another investor or even decide not to do anything! For obvious reasons, sensible valuation is as important when buying as it is when selling.

The three most commonly use methods are:
•Multiples of profit
•Asset values
•Discounted cashflows

Each method has pros and cons. It is impossible to say which method is better in absolute terms, it depends upon the circumstances involving the process, the characteristics of the company, the industry, the market, the sellers, the buyers, the number of players involved and the financial structure.

**3. Multiples**
At an early stage in the process, valuation using multiples is typically the only choice. The investor will search for comparable and recent transactions in the same industry or sector to try to find the appropriate multiple. Of course this could be complicated if there are no comparable transactions of privately held companies. An alternative are the multiples obtained from quoted companies (that share the same characteristics). Due to the public nature of these quoted companies, obtaining information is easier, however extrapolating the multiples to a privately owned company is not straight forward. Typically discounts linked to relative size of the quoted company and for liquidity are applied.

Since MBOs will typically involve a change in the capital structure of the company, PE investors will try to calculate the value of the assets of the company regardless of the level of debt i.e. the enterprise value (EV). Therefore, the investor will use the appropriate multiple in that industry to calculate the company value on a debt-free and cash-free basis.

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### In an MBO or venture capital deal

*Example 1*
Company X is a high street clothing retailer with great brand awareness and shops in many of the major cities across the UK. It competes for the consumer pound with GUS, House of Fraser, M&S and Next. Since these companies share the same business model and market we can use them to value our target.

P/E ratios can be downloaded from the FT http://news.ft.com/markets/equities. On 5th May 2006 the P/Es were: GUS 18.2x, House of Fraser 15.8x, M&S 16.3x, Next 13.1x. The average of these is 15.8 x.
P/E is share price divided by earnings per share after tax (EAT); this number represents the value of the equity since earnings have been already reduced by the debt service or interest charge.
However we cannot use this multiple straight away. These are large, national companies, listed in a quoted market. Our target has a lower level of liquidity and a higher level or risk; therefore we need to “discount” the multiple. Investors typically will discount the comparable quoted multiple by 10% to 50%. In this case we will use 40%:
15.8 x (1-40%) = 9.5
Company X EBIT is £6m and, assuming zero debt, EAT is £4.2m. Thus, the valuation of this company would be circa £39.9m.

Finding the comparable
The multiples approach is typically mistaken as straight forward. It appears to be very simple to apply the comparable multiple to the target. However, finding the right comparables and applying the proper discount is challenging. Investors will need to judge which companies represent appropriate comparables and justify their decision. Proper comparables could be competitors, companies that share the same business model or companies from similar industries.

**Question** | **What is my business worth?**

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*Discounting the multiple*
In the same way, the investor needs to define whether the comparable multiple should be discounted and by how much. Typical discounts from quoted multiples range from 10% to 50%, thus this could significantly impact the valuation. Differences in size and liquidity are, among other things, factors used to define the discount.

Which multiple?
As mentioned before, multiples of profits are commonly used when valuing companies. However, multiples of sales, cashflows or other indicators could be used in some industries. Furthermore choosing which profit line is important. The investors not only need to choose from EBIT, EBITDA, EBT and EAT but also from historic, prospective or run rate figures. Historic figures represent the past financial results of the company, while prospective are the forecasted returns. Run rate refers to the level of profit that the company is producing at the time of the deal (on an annualised basis). The most frequently used techniques to calculate run rate are either to annualize the last month's result or to calculate the level of profit from the last 12 months to date.

Run rate in fashion
In the early 90's most investors used multiples of historic (delivered) EBITDA. These investors would be shocked if they were asked to buy a company base on unrealized profits.
Today, competition has put pressure on asset prices and thus it is not uncommon to find investors justifying higher valuations based on run rate or prospective figures, which are by definition unaudited, not yet achieved profits.
Experienced investors should be able to identify the level of risk associated with their projections and incorporate this into the valuation.

**4. Asset value**
If the private equity investor manages to advance in the process of executing a deal, he will get more information about the company. This will include the characteristics of the company, its operation and the composition of the balance sheet.

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For some companies, the next logical step is to calculate the value of the company using the Asset Value or Balance Sheet methods. However these calculations rarely match the price expectations of the vendor and are not relevant for companies without significant fixed assets.

The Asset Value methods attempt to calculate the value of the underlying assets of the business as recorded in its Balance Sheet. This is a bottom up method, so its accuracy depends on: 1) how similar the accounting value is to the market value; and, 2) how clearly the value of the whole represents the sum of the parts.

Multiples and DCF calculate the value of the business as an ongoing concern, whilst the asset approach provides a value should the business be wound up. Although a business may not be bought with the intention to winding it up, the asset valuation can provide a measure of the downside risk.

The three most common applications are:
•Book value
•Adjusted book value
•Liquidation value

*Book Value*
This is the simplest technique whereby the assets minus the liabilities on the balance are calculated. In most cases the book value will not reflect the real value of the company. Therefore its use is limited and rarely determines the final price of the target.

*Adjusted Book Value*
This method tries to reconcile the accounting value with the real value, accounting for the cost of replacing the value of each element in the balance sheet so that the company can continue its operations. Appraisals provide the estimates of the real value. However these appraisals represent time and money that sometimes do not justify the benefits of having an accurate valuation. Therefore it is common to use rough estimates of the replacement cost of the assets and liabilities in the balance sheet using the practitioner's best judgment.

## Question What is my business worth?

### In an MBO or venture capital deal

*Liquidation Value*
Liquidation value assumes that the company will stop its operations and the assets are sold. The usefulness of this method is limited given most investor would like to continue operating the business. Nevertheless, this method provides a downside scenario for the investor.

**5. Discounted Cashflows (DCF)**
If the investor manages to get to a late stage of the deal execution process, he will have an idea of the real value of the company and how much he would need to pay for the asset. In a MBO, the level of cashflow is key to the value of the company; it determines to a great extent the debt capacity of the business and in turn with the overall value of the business.
The theory behind the DCF is that the current value of the business is equal to the value of the future cashflows discounted at an appropriate rate. It is very difficult to disagree with this reasoning, however estimating the cashflows and finding the appropriate discount rate are challenging. Despite the fact that academics have come out with robust DCF methodologies, such as Weighted Average Cost of Capital (WACC) and Adjusted Present Value (APV), their use in Private Equity transactions is limited.

Nonetheless, a cashflow model must be constructed when executing MBO transactions. However, the acquisition price in these models is typically an input rather than an output. Cashflow models in the Private Equity world, try rather to predict the "appropriate discount rate", that is, in this case, the Internal Rate of Return (IRR). Experienced investors will know the characteristics of the target, including their risk profile and leverage capacity, therefore they will be able to determine the appropriate discount rate of the company. In other words, the investors will have a target IRR for their investment, therefore applying this IRR to the cashflows will provide the maximum price that he will be able to pay.

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The main steps of a DCF are:
•Projecting the cashflows
•Calculating an exit price
•Discounting the cashflows
•Projecting the cashflows

As stated above, projecting the cashflows is key for any MBO transaction. The investors will spend a lot of their time and due diligence forecasting the company's cashflows. The investors will typically construct a model projecting the financial statements of the company. This model will contain a detailed balance sheet, profit and loss and cashflows statements. Of course, assumption regarding sales, margins, additional investment required, capital structure, etc should be made.
In an early stage of the process, a cashflow analysis could be constructed in a simpler way using the following formula:
Total Free Cash Flow = EBITDA – Taxes – Capex - Changes in Working Capital[1]

Calculating the exit price
The investors also need to make assumptions about when they will sell the company and how much they will get for it. The exit value is typically calculated using multiples. Prudent investors would use the same entry multiple paid applied to future earnings. Alternatively, the investors will expand or compress the multiple given expected company or market conditions.

Discounting the cashflows
As mentioned before, methods such as WACC are not very common in this market. Instead of making assumptions to calculate the discount rate, the investor will input into the model the expected selling price of the company today and on exit, and then he will run the model to calculate the IRR. Alternatively, Investors that have a very solid understanding of what the IRR should be will run the model using this IRR in order to calculate the maximum price they could pay for the target.

[1] Change in working capital could be negative or positive. In the same way, Capex could be positive if the company expects to sell some fixed assets that would be replaced by cheaper assets or would not be needed to sustain the operation of the company.

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*Example 2*
Company X forecasts are outlined below. The investor expects to sell the company in year 5 on the same multiple paid for the business (9.5x taxed EBIT). Therefore, using the IRR function in Excel, the internal rate of return is 18%. Alternatively, the investor could calculate the entry value by changing the target IRR e.g. for and IRR of 20% the entry price should be £37m ceteris paribus.

| £m | Yr 0 (Entry) | Yr 1 | Yr 2 | Yr 3 | Yr 4 | Yr 5 (Exit) |
|---|---|---|---|---|---|---|
| EBIT | 6.0 | 6.4 | 6.9 | 7.4 | 7.9 | 8.4 |
| DA | | 1 | 1 | 1 | 1 | 1 |
| Change in Working Capital & Capex | | -1.1 | -1.1 | -1.2 | -1.2 | -1.3 |
| Tax | | -1.9 | -2.1 | -2.2 | -2.4 | -2.5 |
| Operative Cashflow | | 4.4 | 4.7 | 5.0 | 5.3 | 5.6 |
| | | | | | | |
| Ent. Value | 39.9 | | | | | 56.0 |
| | | | | | | |
| Investors | -39.9 | 4.4 | 4.7 | 5.0 | 5.3 | 61.6 |
| IRR | 18% | | | | | |

**Question** **What is my business worth?**

## In an MBO or venture capital deal

*Example 3 – the value of debt*
Company X has stable cashflows and the bank is willing to finance 55% of the acquisition. Therefore the investor just needs to finance the rest. In most MBOs the management will also invest in the company, however their shareholding will not necessarily be proportional to their investment (in order to properly incentivise the management team).

| £m | Sources | Percent. | Share-holding | Interest |
|---|---|---|---|---|
| Bank debt | 21.9 | 55% | 0% | 6.75% |
| Investor | 17.4 | 43% | 90% | Na |
| Manage-ment | 0.6 | 2% | 10% | Na |
| TOTAL FUNDING | 39.9 | 100% | 100% | |

Using debt not only reduces the original investor investment, but also increases the operating cashflow i.e. interest reduce taxable income and hence taxes.

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### In an MBO or venture capital deal

| £m | Yr 0 (Entry) | Yr 1 | Yr 2 | Yr 3 | Yr 4 | Yr 5 (Exit) |
|---|---|---|---|---|---|---|
| Bank debt ending balance | -21.9 | -18.6 | -14.7 | -10.5 | -5.7 | -0.4 |
| EBIT | 6.0 | 6.4 | 6.9 | 7.4 | 7.9 | 8.4 |
| DA | | 1 | 1 | 1 | 1 | 1 |
| Change in Working Capital & Capex | | -1.1 | -1.1 | -1.2 | -1.2 | -1.3 |
| Tax | | -1.5 | -1.3 | -1.0 | -0.7 | -0.4 |
| Operative Cashflow | | 4.9 | 5.1 | 5.3 | 5.5 | 5.7 |
| Debt interest | | -1.5 | -1.3 | -1.0 | -0.7 | -0.4 |
| Bank repayment | | -3.4 | -3.8 | -4.3 | -4.8 | -5.3 |
| Ent. Value | 39.9 | | | | | 56.0 |
| Bank debt | | | | | | -0.4 |
| Equity value | | | | | | 55.6 |
| Investor share (90%) | | | | | | 50.0 |
| Investor cashflow | -17.4 | | | | | 50.0 |
| IRR | 24% | | | | | |

**Question** **What is my business worth?**

**In an MBO or venture capital deal**

The new leveraged structure presents a better return. Nonetheless, this structure is riskier than the all-equity one. The experienced investor will define case by case the ideal structure for each company trying to maximise the expected return without jeopardizing the sustainability of the business. Please note that in this example a very aggressive bank repayment schedule has been used i.e. 100% of the free cash flow is reducing the debt. Some Private Equity houses invest not only in equity instruments but also in subordinated debt. This reduces the company's capacity to repay its senior (bank) debt, but augments its flexibility. This could be particularly important if there are changes in the original investment plan e.g. additional investment opportunities. The investor will be willing to change the terms of the subordinated debt if this increases the expected value of the equity and hence his overall returns.

**6. Conclusion**

The asset valuation method can be straight forward and can give a tangible value of the business; however, it is useless for businesses without significant assets. For some companies, this analysis can provide a downside case for the investor.

Forecasting and evaluating the cashflows is essential for a MBO. Cashflows determine to a great extent the real value of the business and the leverage capacity. This is a forward looking methodology; however its implementation is complex and based on projections. In reality, cashflow analysis will always be used, but DCF methodologies such as WACC and APV are not applied in this industry.

Multiples are the most common methodology; they represent the market's view and can be used with limited information. Multiples also capture the essence of the other two methodologies; the multiple of the company will be influenced by the asset value and the expected growth.

**Question** **What is my business worth?**

**In an MBO or venture capital deal**

Gearing can increase not only the expected return and valuation, but also the risk and price paid. Higher valuations can translate into higher prices and hence neutralising the positive effect of gearing.
When executing a transaction, assumptions about projections, comparables, discounts, etc should be made. Therefore, the experienced investor must be in touch with the market and have the sensitivity to apply reasonable assumptions and be able to identify the main drivers behind each assumption.

*Sovereign Capital is a successful UK lower mid-market private equity investor. Independent, we invest £5-20m of equity in proven management teams, committed to growing their businesses. Contact Philip Conboy on 020 7828 6944 or via email at philipconboy@sovereigncapital.co.uk*

## Question What is my business worth?

## Using IP as collateral

### Charles Claisse, Kemp Little LLP

With interest rates so low, companies have increasingly been turning to debt for finance. As ever, before making a loan, a finance provider will undertake due diligence on a company's asset base to determine if there exists suitable collateral for secured lending purposes. For companies across all industry sectors the collateral available will include their intangible assets [1] .

Intangibles are a significant part of any company's asset base. Any supply side enterprise will have goodwill and trademarks in relation to its brand, copyright in its marketing materials, database rights in its customer lists and rights of confidence in relation to its know how [2] . An intangible can be a company's most valuable asset: in Business Week recently, Interbrand included the Coca-Cola ® brand in its table of "The World's 10 Most Valuable Brands" at a value of US$69.6 billion.

If intangible assets are a substantial part of the collateral to be offered, two of the key challenges for a company will be: (i) their valuation [3] ; and (ii) satisfying the finance provider that effective security can be taken over such assets.

Valuation itself is an art more than a science and will involve a number of disciplines including law, accounting and finance and a consideration of industry/sector norms. The difficulties in undertaking a valuation have, traditionally, been compounded by scepticism as to whether intangible assets can be reliably valued. In essence, the value of an intangible asset will bring together the legal concept of rights and the economic concept of value.

Set out below is a 'route map' for any company thinking about undertaking this exercise.

**Question** **What is my business worth?**

## Using IP as collateral

**Stage 1: Identification**
The first step will be to identify the intangible assets owned and used by the business (and the nature of the ownership interest or right). Legally, this process is complicated by the fact each asset has its own peculiarities. Certain intellectual property rights need to be registered (e.g. patents), others are creatures of law, not statute (e.g. rights of confidence) and their lifetimes vary [4] .

Given these peculiarities, in identifying the intangible assets, it is helpful to split them into two groups, registered rights (e.g. patents) and unregistered rights (e.g. copyright). A further group will be the rights used under a licence from a third party.

As positive steps are required to acquire registered rights, accurate information should be available on them including as to their ownership, geographical spread, term and the existence of any third party interest. This exercise can be supplemented by third party searches.

Identifying unregistered rights is likely to be more problematic as no positive steps are required to create them. Parsing out the ownership interests in a copyright work can be complex: copyright is itself a bundle of rights, including the rights to copy, adapt, distribute, etc and each of these rights can in many instances be dealt with – by licensing or outright assignment – separately. In the case of a song for example, separate copyrights will subsist in the music (composer), lyrics (author), music as published (publisher) and the recording (record company) of the song. In the case of computer software, the software itself attracts copyright as a literary work, and there will be separate copyrights in the technical and user documentation; using the software to create further works gives rise to yet further copyrights. The movie, broadcasting, publishing and interactive industries all have their own increasingly complex sector specific patterns and practices about copyright ownership.

**Question** **What is my business worth?**

## Using IP as collateral

**Stage 2: Analysis**
Once the rights owned and used by the business have been identified, they will need to be evaluated against a series of questions including the term, nature and scope of the rights (e.g. do they provide a monopoly (e.g. a patent), is the registration sufficiently wide), whether there exist aspects which might affect the validity of the rights (e.g. a failure to pay registration fees), the extent to which there are third party interests and if there have been any challenges or infringements of the rights and, if so, an analysis of how these have been prosecuted by the company.
If an intangible asset is used under licence, sensitivities include the ability to assign (transfer outright) it, the scope of the licence and (in the current market) the solvency risk in respect of the counterparty (e.g. insolvency is likely to lead to failure to provide required support and the risk of the licence being disclaimed by a liquidator).

**Stage 3: Valuation and nature of the security interest**
Once stage 2 and an economic valuation have completed, a value will be given to the intangible assets. As a practical matter, the valuation given by a finance provider is likely to be significantly lower than the company's valuation as it will build into its valuation model an assumption there will be a default in repayment of the loan.

Linked to the valuation will be an analysis of whether the intangible assets are capable of forming the subject matter of an effective security interest and, if so, the nature of this interest. Legally, with the exception of know how (which is not the type of right which gives a good basis for security on its own), a stand alone security interest can be taken over most intangibles. The effectiveness of the security will depend on the legal form of security offered and whether the intangible asset in question can be independently exploited or sold post default.

## Question What is my business worth?

### Using IP as collateral

By way of example, if security is to be taken over a patent or trademark the 'safest' form of security interest that may be taken is a legal mortgage (which will involve a transfer of ownership to the finance provider with an exclusive licence back to the company). The upside of a legal mortgage for the finance provider is the fact that title is obtained from the outset and that it will be able to police enforcement; the downside being its potential exposure to an infringement action and ensuring registration fees are paid. Similarly, the finance provider will need to satisfy itself that, post default, the asset can be independently exploited (e.g. by licensing it to a third party) or sold. This can be particularly problematic if the subject matter of the security interest is a trademark of the company's name as it may prove difficult to resell or licence it to a third party.

Intangible assets now play an important role in providing collateral and can affect a borrower's financial profile for lending purposes. Any company offering its intangible asset base as a substantial part of the collateral should be sensitive to the requirements of the finance provider and the due diligence that will be undertaken to determine its value and suitability for secured lending purposes. Careful management of such assets can increase the attractiveness of a company to a finance provider and reduce the cost of the due diligence process.

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[1] A company's intangible assets will comprise intellectual property rights such as copyright, patents, trademarks, designs, database rights and trade secrets and related rights such as goodwill. This Short Lines focuses on intellectual property rights.
[2] There are also sector specific rights e.g. a technology or pharmaceutical company may have patent protection in respect of their products.
[3] The valuation may have a knock on effect for the company on the price of its equity, balance sheet recognition of its intangible assets and risk management.
[4] A UK patent has a lifetime of 20 years whereas copyright, typically, has a lifetime of 70 years from the death of the author.

## Notes

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