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Valuing a food and beverage business

There are a number of varying methodologies used when valuing a business. However, no secret recipe offers the 'correct' answer. Below we cover some of the more commonly used methods. It is also worth remembering that any model used for valuation purposes is only as good as the assumptions that are put into it; typically such assumptions, if provided by the selling party, tend to err on the side of optimism. Thus, understanding the key drivers of a business is also a critical element of a valuation process.

Comparative Valuation

Comparative valuation is perhaps one of the more easily accessible methods of valuing a business. Historic transaction multiples, or current trading multiples of quoted companies, can be used as a comparison against the earnings of a target company. Thus, if the average price of a transaction in the food sector over the last few years was 0.8x consideration to sales or 7.0x EBITDA (earnings before interest, tax, depreciation and amortisation) or, say 9.0x earnings per share then, these multiples could be applied to the target business to calculate a valuation.

However, there are some shortcomings to this technique, the most recurrent of which we list below.

1) How comparative is the data. When comparing a multiple applied to a recent transaction or the multiple for a quoted company, it is worth asking the question: what does the data refer to? Does it refer to 'adjusted' earnings and if so, what are the adjustments? Is the multiple a reference to historic figures or prospective figures? If the numbers refer to the current valuation for a quoted company, expect a 'take-out' multiple to be higher reflecting a control premium.

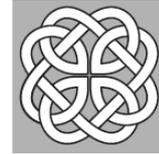
2) How comparative are the companies? Aggregate multiples for transactions are likely to include a wide variety of companies in different sub-sectors of the food or beverage industries. Such companies may have differing financial measures such as margin levels, profit and sales growth. They may also have differing business and customer profiles which could materially affect the branded and private-label mix.

Thus, whilst the comparative valuation technique offers a guide for a range of possible valuations, it is important to ensure that one is comparing like -with - like.

Discounted Cash-flow (DCF)

The DCF method applies forecasts of cash-flows generated by a target company and projects them out for a period of years. A terminal growth rate is then ascribed to the business. These cash-flows are then discounted back to arrive at a current value.

Perceived weaknesses of this approach are that the valuation is a function of the quality of the 'inputs'; namely, the forecasts; the accuracy of the assumption behind the terminal growth rate as well as the level used for the discount rate.



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Cashflow and pay-back period

Under this method, a cashflow model is constructed for the target company with adjustments including, aside from the usual sales and profitability, working capital, capital expenditure and financing costs. The annual cash-flows are then calculated for the required pay-back period, typically between 3-5 years. The aggregate of the cash-flows for the pay-back period are then calculated and a valuation derived. Again, like the DCF model the quality of the forecasts will have a direct influence on the quality of the valuation.

An additional adjustment to the above could be the inclusion of any potential synergies (production and/or sales related) into the calculation. Often, however, the acquirer may retain these savings rather than 'pay them away' through increasing the offer price.

Return on invested Capital (ROIC) vs Weighted Average Cost of Capital (WACC)

A variation on the cash-flow technique is to measure the accumulated cash-flows against the cost of producing those cash-flows. The 'return on invested capital' is calculated by dividing the consideration paid for the business by the projected 10 year cash-flows. This calculation will generate a percentage return for each year which should typically increase annually (assuming the forecasts are for growth in the business). This 'return' or ROIC is then compared with the weighted average cost of capital (WACC) of the acquiring business.

The WACC is the theoretical funding cost of the business. This is a calculation based on the interest rate adjusted for risk. In other words, when you invest money in a business you would expect a return at least comparable with the current market, such as bank deposit rates. However, to allow for the related risk of making the investment, an extra payment or 'cost' is usually demanded. The combination of the two is termed the weighted average cost of capital or WACC.

An acquisition may then be deemed good value when the ROIC meets at least the WACC – this may be set at a pre-determined year post acquisition. It is usual for 'returns' to exceed 'costs' in year 4 or 5 after the date of acquisition or investment. Buying a business, therefore, for a ROIC below WACC dilutes returns of the overall business, above WACC, enhances overall returns.

Put more simply, buying a business with a ROIC below WACC is not rewarding the investor for the risks they are taking.

Assets and Goodwill

Often small and medium-sized company owners view the value of their businesses as a combination of net asset value plus goodwill. The methodologies above offer in effect the procedure for working out the goodwill element. Given that the above valuation methods calculate the 'total value' of a business, then by deducting the net asset value, a figure for goodwill is revealed.

In a further article we will examine the factors that can impact valuation.