Banque de développement du Canada
Business Development Bank of Canada

How to evaluate a proposed acquisition

There's nothing simple about estimating the value of a business you wish to acquire. You must not rely solely on the judgement of your chartered accountant or the seller. You would, in fact, be well advised to seek out the services of an expert who specializes in business valuations and have him or her produce an independent report. (While this is an unregulated field, the Canadian Institute of Chartered Business Valuators (CICBV) does provide guidelines and a code of ethics.)

There are few instances where you will be able to compare yourself with other market transactions. Not only is information on such transactions relatively rare, but little may be known about the specific conditions. Lastly, the terms may be too closely related to the particular sector to prove useful.

3 degrees of assurance

According to the CICBV, there are three types of reports, which differ in terms of scope of the work done, the assurance they provide, and obviously the price. Following is a list of these reports, from the most general to the most detailed:

1. Calculation report, which provides an approximate valuation for initial planning.
2. Assessment report, which is ideal for preliminary negotiations, succession planning, and situations involving important issues subject to budgetary constraints.
3. Opinion report, which is appropriate in situations that involve high risks, important issues, or when there are legal proceedings.

To prepare their reports, evaluators look at the facts and financial data, formulate a conclusion, add a disclaimer regarding the scope of the mandate (which varies with the quality of the report provided - see below), and the possible impacts on the estimated value.

The work required

The work required to produce a **calculation** report involves a review and analysis of the financial information and may occasionally include meetings with management.

The **assessment** report takes the same approach but is not as exhaustive. The difference between the two is a matter of the valuator's professional judgement.

The **opinion** report requires significantly more work:

- Review of the letters patent, bylaws, and shareholder agreements;
- Research on the business' economic situation and sector;
- Research on market conditions and the competition;
- Review of the clientele (contracts, backlog of orders);
- Review of suppliers (contracts, commitments);
- Visit to the business;
- Review of financial, historical and financial, historical and forecast data;
- Rationale for the choice of discount and capitalization rates using accepted financial models.

Basic valuation principles

The first step in the process of establishing a price consists of determining the fair market value of the business. The three main valuation principles are:

1. Value is dependent on expectations;
2. Value is dependent on future cash flows;
3. Value is dependent on tangible capital assets.

Valuation methods and techniques

There are two basic ways of determining the value of a business:

1. Liquidation value, which assumes that the business sells all its assets, pays off all its debts, including taxes, and distributes the surplus to its shareholders.
2. Going concern value, which assumes, on the contrary, that the business continues to operate.

This value can be calculated in different ways, the most common being:

- **Capitalization of typical net earnings:** this approach assumes that a value can be attributed to future earnings resulting from the acquisition. To obtain the going concern value, a capitalization multiple is applied to these earnings and non-operating assets are added.
- **Capitalization of typical cash flows:** this approach is the same as that for capitalization of typical net earnings, with the exception that cash flows, rather than the earnings, are capitalized.
- **Discounting of expected future cash flows:** this method consists of determining the most likely future cash flows and discounting them at the valuation date.
- **Determination of adjusted net assets:** according to this method, liabilities are subtracted from the determined fair market value of the assets. It is used for businesses such as those in the real estate sector, whose value is asset-related rather than operations-related.

For more information, consult the appendix **Take a Closer Look - Valuation Methods Explained** in the Show Your Investment Potential guide included on the Strategis site.

Other rules

There are some sectors in the service industry where the value of a business is based on a multiple of revenues. For example, an insurance brokerage firm is worth 1 to 1.5 times the commissions received over a given period, determined by negotiation.

Valuating businesses is not a simple exercise, nor is it an exact science. It simply provides a theoretical value that will give you an idea of the fair price to pay for a business. In the final analysis, purchase conditions and the final price paid will be determined during the course of negotiations that you hold with the vendor.