Art'o'val Advisors

True Art of Valuation

Valuation Series

10 – Valuation of Private Companies

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What is Private Company Valuation?

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Private Company Valuation

- Private company valuation is the process of determining the economic value or worth of a privately held company, taking into account factors such as financial performance, growth prospects, industry dynamics, and risk factors.

Public Company Vs Private Company

Public Company

- Large number of shareholders, and their shares are publicly traded on stock exchanges, making ownership open to general public.
- More complex decision-making process due to larger number of shareholders and regulatory requirements.
- Access to wider range of capital sources, including issuing stocks and bonds to public.
- Transparency with financial performance, making financial statements and reports available to public.
- Adhere to strict regulatory compliances, including regular financial reporting, adherence to securities laws and more.

Private Company

- Ownership is typically held by small group of individuals, founder or family. Shares are not publicly traded on stock exchange.
- Greater decision-making autonomy since ownership is concentrated among a smaller group.
- Typically, have limited options to raise capital relying on private investors, bank loan, or venture capital.
- Advantage of maintaining greater financial privacy since their financial information is not publicly disclosed.
- Fewer disclosure requirements and face less scrutiny from regulatory bodies.

Why is Valuation Important?

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Why is valuation important?

A company's valuation is a test to understand how much the company is worth and has grown over a period of time.

1. Private companies have a smaller group of owners and are not publicly traded, while public companies have numerous shareholders and trade on stock exchanges.
2. The value derived from the various methodologies forms a basis on which many decisions are made by the founders and the investors.
3. Private company valuations are typically performed for three reasons: transactions, compliance (financial or tax reporting), or litigation.
4. In India, valuation of private company may be required for issue/transfer of shares, M&A, impairment testing, etc. under various laws such as Companies Act, Income Tax Act, FEMA, IBC.
5. Factors influencing private company valuations include financial performance, industry and market conditions, growth prospects, intellectual property, and customer base. Challenges in private company valuations are limited transparency, illiquid shares, influence of controlling shareholders, and subjective assumptions.

Factors Influencing Private Company Valuation

Financial Performance	The financial performance of a private company is crucial for its valuation. Assessing revenue growth, profitability, and cash flow generation through historical statements and projections determines its ability to sustain earnings.
Industry and Market Conditions	The industry in which the private company operates, and the overall market conditions can affect its valuation. Factors such as market growth potential, competitive landscape, and barriers to entry are considered to evaluate the company's position within its industry.
Growth Prospects	The growth potential of a private company is key to its valuation. Factors like innovation, market expansion, and business scalability are assessed to gauge future revenue and earnings potential
Intellectual Property and Assets	Intellectual property, proprietary technology, patents, and other valuable assets owned by the private company can contribute to its valuation. These assets can provide a competitive advantage and create barriers to entry for potential competitors.
Customer Base and Relationships	Customer base factors impact a private company's value. Considerations include size, loyalty, diversification, long-term relationships, recurring revenue, and a robust sales pipeline
Risk Factors	Evaluating risks is vital in valuing a private company. Factors like regulatory compliance, market volatility, operational risks, and dependence on key customers or suppliers are considered to assess the company's risk profile
Comparable Transactions	Analyzing comparable transactions in the industry can provide valuable insights into the valuation of a private company. Examining recent mergers, acquisitions, or financing rounds involving similar companies can help establish a benchmark for valuation multiples.

Challenges in Private Company Valuations

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Lack of market data	• Private companies operate outside the realm of public markets, where pricing and valuation data are readily available. The absence of comparable transactions and market indicators can make it challenging to determine an accurate valuation.
Limited financial disclosure	• Private companies' limited obligation to publicly disclose financial information leads to a lack of comprehensive data for analysis. Investors and valuation professionals often rely on limited financial statements, which may not offer a complete picture of the company's performance
Subjectivity in assumptions	• Valuing private companies often involves making assumptions about future performance, growth prospects, and market conditions. These assumptions can be subjective and vary among different stakeholders, leading to divergent valuations
Illiquidity and lack of exit options	• Private company shares are typically illiquid and not easily traded on public exchanges. The absence of a liquid market can impact the valuation process and make it more challenging for investors to determine an appropriate value.
Influence of controlling shareholders	• In many private companies, a single or a few controlling shareholders hold significant influence over the company's operations and decision-making. This concentrated ownership can introduce complexities in assessing the fair value of minority stakes

Key Consideration

Liquidity discount

- The illiquidity discount is the discount applied to the valuation of an assets, as compensation for the reduced marketability.
- It stems from liquidity risk, which is the incurred loss in asset value from the inability to easily liquidate the position.
- Measures of how quickly an asset can be sold in the open market without requiring a significant discount

Discount for lack of marketability

- Discounts for lack of marketability (DLOM) refer to the method used to help calculate the value of closely held and restricted shares.
- The theory behind DLOM is that a valuation discount exists between a stock that is publicly traded and thus has a market, and the market for privately held stock, which often has little if any marketplace.

Size premium

- The size premium is the additional return that investors require for the risks of investing in small businesses.
- The size premium can be observed in earnings multiples of listed companies, with large companies trading on higher multiples than small companies, all else being equal.

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Thank You

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