Considerations of a Financial Analyst in the Sale of Business

May 2021

When it comes to valuation and the value of an enterprise, applying a multiple to Normalized EBITDA ("Earnings Before Interest Taxes Depreciation & Amortization") is an approach often used to value a company for the purposes of a sale, merger or acquisition. The value of a company is based on the risk of achieving future cash-flows, future growth opportunities, and capital requirements to maintain and grow the business.

This article outlines some of the topics that a financial analyst focuses on in the context of a sale, merger, or acquisition of a company. The topics discussed herein are not exhaustive and are always dependent on the specific deal type, company, industry and size.

Pro-forma adjustments

Pro-forma adjustments are often referred to as "what-if" scenario adjustments, such as quantifying the financial impact of closing a facility, eliminating redundant costs (e.g., payroll, overhead expenses, etc.), acquiring new customers or business, or significant changes expected in operating terms (i.e., pricing, costing, discounts, etc.). Historically, pro-forma adjustments were often not factored into quantifying Normalized EBITDA for the purposes of arriving at a valuation. Instead, pro-forma adjustments were often considered and viewed as another consideration by buyers and sellers. There has been a marked expansion in the nature and extent of pro-forma adjustments advocated on behalf of the advisors of buyers and sellers. Because of this marked expansion and area of focus, pro-forma adjustments are now vetted thoroughly by analysts on the basis of the adjustment, assumptions and data used.

Depending on the extent and nature of pro-forma adjustments that may apply in a given scenario, financial modelling and data analytic techniques may be required to identify and quantify such aforementioned adjustments. To the extent that you have proof of these adjustments, the buyer will view them as being more credible and less risky.

Human capital

Understanding the human capital of a company is another area of focus for financial analysts. Human capital has been traditionally viewed as an operating expense (i.e., an income statement caption) rather than a revenue producing/contributing capital asset on the balance sheet. As such, a focus on the company's existing human capital structure is a key area of focus, especially for those businesses that are service-based and labour intensive. Understanding the roles and responsibilities of all personnel (whether they are key personnel or not), in addition to the turnover of employees, availability of skilled labor in the region and employee demographics is key.

Working capital

When you are selling or acquiring a business, imbedded in the purchase price (i.e., enterprise value) is an understanding that a specific normal level of working capital will be delivered by the seller to the buyer at closing. Defining and quantifying a normal level of working capital that is expected to be delivered post-acquisition is often contentious and is a highly negotiated term of agreement by business advisors on both sides. As such, understanding and determining an appropriate level of working capital that is required to sustain the existing level of operations is a critical area of focus for buyers and sellers. The basis of adjustments used for normalizing working capital is also vetted thoroughly by financial analysts to ensure that it, and the assumptions used are reasonable.

Capital expenditures

Capital expenditures can be classified as either maintenance or growth-related expenditures. Maintenance expenditures are defined as those required in maintaining and sustaining the existing level of operations. Financial analysts will often want to review a detailed list of the nature, amount and frequency of maintenance-related expenditures incurred by the company. If the seller is unable to provide sufficient proof that normal maintenance-related capital expenditures have been incurred, the buyer will likely negotiate a purchase price reduction for the shortfall of what was incurred versus expected.

Understanding and documenting what is a normal level of maintenance-related capital expenditures a company will incur is a key consideration in transaction scenarios.

Growth-related capital expenditures include those incurred by the company to grow the business. These are often significant expenditures incurred by a seller (e.g., expanding a company's facilities, occupancy infrastructure or technology investments), where the company will not realize the incoming cash flows or benefits until later in the future once they are complete or have been proven or materialized. Growth capital expenditures are an important area of focus by analysts because these often relate to commitments (e.g., build-outs, construction and expansion contracts with vendors) that a potential buyer will be liable for in the future. The buyer may not necessarily agree with the strategic objective or efforts undertaken by a seller for these growth-related items, which may lead to the seller not getting credit, and often being liable for any break fees to discontinue these efforts. Similarly, the seller may have incurred significant growth capital expenditures that may have not yet materialized in the company's earnings, for which the buyer will get credit for in the future, post acquisition. As a seller, you should document the level of growth-related capital expenditures incurred and ensure this is factored into and considered as part of the proposed purchase price contemplated by the buyer.

Seek advice

Whether you are contemplating the sale of your company in the short-term or some time in the future, consider the potential advantages of addressing the Normalized EBITDA in relation to the business valuation and potential operational accretive decisions. A BMO Business Advisory and Transition Planning Specialist can assist with understanding Normalized EBITDA and the potential impacts on the valuation of your business when you are considering selling your business.

For more information, speak with your BMO financial professional.

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ID3956 03/21-0631