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Analysing, Planning and Valuing Private Firms

New Approaches to Corporate Finance

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Introduction

Every asset and firm has a value. One of the goals of corporate finance is to analyze and value companies and their assets. Corporate finance textbooks usually focus on the valuation of firms and assets traded in public markets. However, over the past decade, the number of private companies and the amount of private investments have risen, while the number of public listed firms has been falling since 1997 (Gupta and Van Nieuwerburgh, 2021). As the fraction of wealth in the form of private investments is growing, the importance of developing and applying appropriate valuation techniques is increasing. This book aims to provide a framework for the valuation of private corporations. Starting from the analysis of financial statements to understand where value comes from, to the application of valuation methods, this book tries to provide a list of tools and techniques to solve practical application drawbacks. Regarding the financial statement analysis, despite the consolidated use of financial ratios and scores, sometimes it is difficult to provide a complete picture of the company's economic, financial, and strategic dynamics. The process of valuing private companies is not different from the process of valuing public companies. The present value is computed by discounting future cash flows with a proper rate that reflects the riskiness of the cash flows. However, when applying valuation techniques to private companies, there are two standard problems to overcome: the financial statements for private firms are likely to go back fewer years and have less detail; there is no market value for either debt or equity. In this book, we try to overcome these two criticalities by proposing some approaches to (1) forecast revenues, margins, and cash flows; (2) estimate the cost of capital for private corporations. Then we also provide a framework on how to use relative valuation techniques (multiple) that despite their simplicity hide some pitfalls in the application.

The structure of the book is as follows. The first chapter is devoted to financial analysis through ratios and cash flows. The key to successfully investing and managing a business lies in understanding the sources of value. Financial analysis is the key to this aim. We focus our attention on how to organize financial statements, and how to analyze a company's economic, financial, and strategic situation. In doing so, we provide a different configuration of the monetary cycle which is better able to catch the financial needs dynamics. We also provide a way to organize and conduct ratio and cash flow analysis properly.

The estimation of future cash flows is one of the key ingredients in the valuation process. The second chapter is related to forecasting techniques. More in detail, we provide a different way to plan future firm/investment projects operating revenues by exploiting the concept of the financial break-even. The second key input in any valuation process is the cost of capital. The estimation of this input is difficult in the case of private companies. In the third chapter, we present a novel way to estimate the cost of capital of private corporations, which is based on some practical steps and on credit scoring systems.

Relative valuation techniques allow us to avoid some shortcomings in the application of traditional valuation methods on private companies. For this reason, the private equity industry and many practitioners largely use this approach. While a multiple approach is a convenient valuation method, it has many common pitfalls. In chapter four, we explore the mechanics of multiples, when and how to use different types of multiples, and we present a way on how to adjust the comparable firm value to properly adapt the risk-return profile of comparable companies to the firm under valuation.

The last chapter wraps up the notions provided in the four main chapters of the book by providing an application of the methods in the context of start-up valuation.

We believe that the tools provided in this book can be useful for practitioners and for stimulating the debate among academics on the topic.

Reference

Gupta, A., & Van Nieuwerburgh, S. (2021). Valuing private equity investments strip by strip. *The Journal of Finance, 76*(6), 3255–3307.

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CHAPTER 1

Corporate Financial Analysis

Abstract This chapter is devoted to financial analysis through financial ratios and cash flows. The first part of the chapter reports the reorganization of the balance sheet and the income statement, which represents key preparatory steps to perform a proper financial ratio and cash flow analysis. In the second part of the chapter, we propose a novel methodology for monitoring the monetary cycle and an organized assessment of financial ratio analysis. Finally, in the last part of the chapter, we focus on how to calculate cash flow and how to interpret them for different purposes: valuation and debt sustainability analysis.

Keywords Balance sheet · Income statement · Cash flow statement · Monetary cycle

1.1 Introduction

Aim of financial statement analysis. Financial statements—the income statement, balance sheet, and statement of cash flows—do not promote easy insights into firm operating performance and value. The balance sheet mixes together operating and nonoperating assets and different sources of financing. In a similar way, the income statement combines operating profits, nonoperating profits, amortization and depreciation

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