The Art and Science of Valuing Oilfield Equipment and Service Companies

In the first of a series of white papers, Founders Investment Banking will address valuation in the context of oilfield equipment and service companies. Because valuation is based on multiple factors, there is never a silver bullet that can be used to arrive at an exact number. Instead, an array of factors is used to produce a range of likely values. In the end, however, the value of a company is what someone is willing to pay based on their own conclusions on multiple factors. For that reason, finding the highest value for a company is dependent upon finding the right buyer, which is why a reputable investment bank is able to provide outsized value to its clients. Investment banks are adept at identifying the most likely buyers and providing them with relevant information that presents a company in the best light, maximizing value relative to expectations. This leads to a competitive, efficient market process that ends with a higher valuation, better terms for the seller, and a higher probability of close. In the following white paper, we will walk through the common valuation methods that buyers use to arrive at a value. Additionally, we will walk you through the range of factors impacting these valuation methods.

Valuation Methodologies Used to Value Middle Market Companies

There are numerous methods of valuing a company's cash flows and assets. Each of these methods takes a different approach and will produce varying results. Though many valuation methods exist, when it comes to valuing middle-market private companies, precedent transactions, public comparables, discounted cash flow, and leveraged buyout approaches are most relevant. These methods can be lumped into two categories: relative valuation and intrinsic valuation. In general, relative valuation arrives at a value for a company by looking at recent transactions or current public data as a proxy to determine how the market values a similar company. On the other hand, intrinsic valuation looks to the future cash flows of the actual company being analyzed in order to determine its present enterprise value. Relative valuation includes two methodologies from above: precedent transaction analysis and public comparables. Likewise, intrinsic valuation includes the discounted cash flow and leveraged buyout methods.

Examples of Valuation Methodologies	
▪ Economic Value of Assets	▪ Public Comparables
▪ Capitalization of Income Stream	▪ Discounted Cash Flow
▪ Book Value	▪ Replacement Cost
▪ Precedent Transactions	▪ Excess Earnings Method
▪ Ability to Pay	▪ Leveraged Buyout

Using Multiple Valuation Methods

Relative and intrinsic valuation methodologies have distinct differences, which highlights the importance of using multiple valuation methods to value a company.

Defining the Art and Science of Middle Market Valuation Methodologies

Relative Valuation Methods

Comparable Public Companies: Comparable company analysis is the comparison of trading multiples, such as Enterprise Value/EBITDA, to a company's peer groups to determine a valuation range. The art of the analysis is determining the discount to apply, as comparable public company multiples trade higher than private middle market companies due to size and liquidity.

Precedent Transactions: Previous transaction analysis is the comparison of recent transactions involving similar companies to determine comparable sales data. The art of precedent transaction analysis is finding a similar company that has been sold with similar attributes including size, market, growth rate, management quality, tenure in business, and customer base.

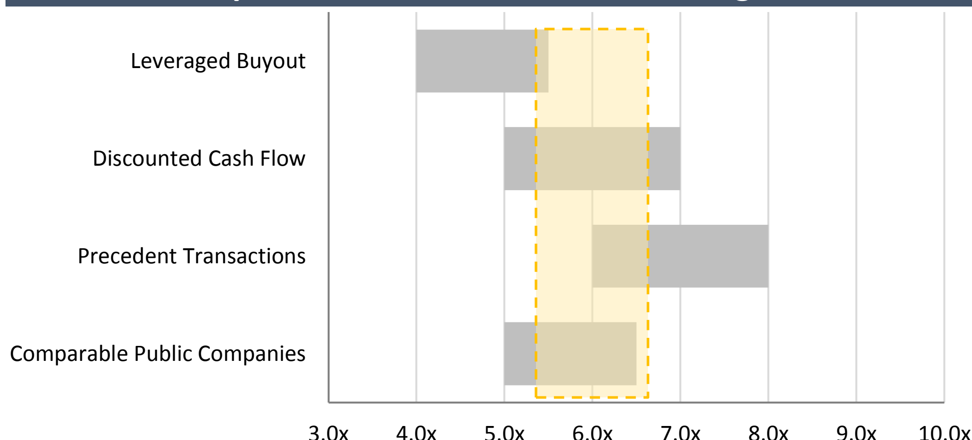
Intrinsic Valuation Methods

Discounted Cash Flow: Discounted cash flow estimates the present value of a business or asset by projecting future cash flows and discounting them based on the firm's cost of capital. The art of discounted cash flow is forecasting future cash flows as estimates are based on multiple assumptions such as revenue growth, margins, and the cost of capital.

Leveraged Buyout: Leveraged buyout is an analysis of returns, usually for a private equity firm if they were to buy a company. A valuation range can be determined by using common return benchmarks for private equity firms.

First, relative valuation is perceived to be a more straight forward method because it uses multiples as a function of revenue and/or EBITDA (EBITDA is earnings before interest, tax, depreciation and amortization. In the financial industry, EBITDA is a shortcut to measure cash flow of a business) as a proxy of comparison for similar businesses. The challenge in this method is that no two companies are created equal; therefore, an experienced professional should be sought for advice. Intrinsic valuation, on the other hand, relies on a variety of quantitative inputs, making it more than a back of the napkin calculation.

Second, the methodologies differ in the degree to which they reflect current market perception. Since relative valuation looks at recent transactions or current public data, it reflects what the market is willing to pay for a similar company. However, this can lead to inflated valuations during a bubble or market driven event. Conversely, intrinsic valuation does not take current market perception into account unless incorporated into an input such as the cost of capital. Instead, intrinsic valuation uses academic theory to derive a valuation based on the probability of obtaining estimated future cash flows.



Pros and Cons of Relative Valuation

Pros

- Easy to calculate and relate to
- Reflects current market conditions and perception
- The future earnings potential of the industry is typically priced into public comparable data

Cons

- Does not take into account the future earnings potential of the specific company
- Relies on accurate comparisons but is still skewed due to differences between companies
- Relevant comparables may be mispriced because of a bubble or a market driven event

Pros and Cons of Intrinsic Valuation

Pros

- Measure of intrinsic value backed by theory
- Independent of current market perception
- Works best for businesses with predictable revenue streams
- Relies on Free Cash Flow as a measure of earnings

Cons

- Relies on and highly variable to a variety of inputs such as future earnings, discount rate, and perpetuity growth rates
- Valuation results are sensitive to terminal value assumption, perpetuity growth rates, and discount rate

Each method will result in various ranges of value. Therefore, it is important not to rely on a simple formula or industry "rule of thumb" to value your company; rather, multiple valuation methods should be used to triangulate a range of values.

The level of analysis involved in these methodologies can be extensive and highly nuanced; therefore, hiring a reputable investment banker to perform this particular analysis and give an opinion on valuation is important.

> "It is important not to rely on a simple formula or industry "rule of thumb" to value your company"

Building Blocks of Valuation

A buyer arrives at the value of an asset by measuring how much future economic benefit they can expect to receive and the probability or associated risk of receiving it. In a basic sense, the willingness of a buyer to pay for an asset or a company is the surety of the future cash flows. Future cash flows is the first component to valuing a company. In order to quantify future cash flows, buyers typically look at the company's historical growth rates and certain factors called valuation drivers. Valuation drivers are those factors that will affect the sustainability and/or change the growth outlook from its historic trend.

The second component buyers look at when calculating valuation is risk. First, risk measures the confidence one has about achieving the projected cash flows based on the internal and external valuation drivers. Second, risk measures the buyer's opportunity cost. The buyer must ask themselves what amount of return should they expect if they invest in a similar company with a similar risk profile.

Valuation drivers can be separated into two categories: internal and external. Internal drivers focus on the environment in the company itself, while the external drivers focus on the uncontrollable environment outside of the company. These drivers are extremely important to consider if you own a business whether you are considering selling in the near term or in the future. As the confidence in the valuation drivers increases the perceived risk decreases, causing an overall increase in value.

Company Value

Internal Valuation Drivers

- Financial systems
- Management quality
- Strong historical financial performance
- Customer relationships
- Geographic diversification (multi-basin and/or international footprint)
- Service diversification
- Contract length/recurring revenue
- Competitive positioning
- Growth opportunities
- IP/Proprietary Technology

External Valuation Drivers

- Macroeconomic Environment
- Regulatory Environment
- Market Size
- Market Evolution
- Market Growth Outlook
- Market Drivers
- Capital Markets
- Investment Trends
- Public Markets
- Precedent Transactions
- Oil Prices

In Summary

Valuation is not a simple task, it takes experience and education to accurately place a range of value on a company. Because of the level of experience required, a M&A advisory firm can be highly valuable to a company looking to sell now, or thinking about selling in the future. An experienced investment banker can help find the right buyer with the right synergies in order to drive the sale price to the higher end of the valuation range. According to a recent University study[1], companies sold in a professional process have a higher probability of closing and are sold at higher valuations than those using a limited process without a professional.

1. University of Alabama Research Paper, "Does Hiring M&A Advisers Matter for Private Sellers?"

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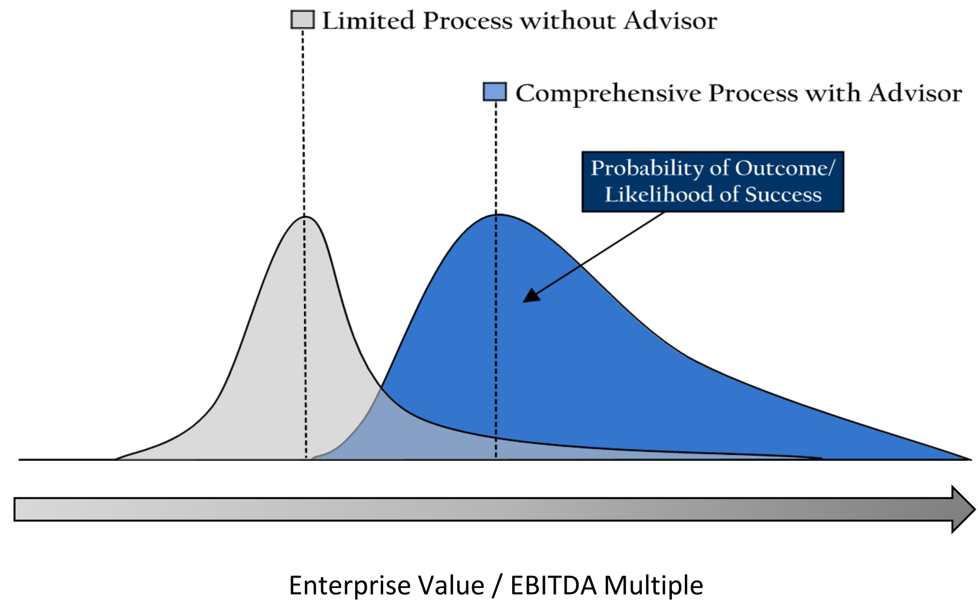

Enterprise Value / EBITDA Multiple

About Founders

Founders Investment Banking is a merger and acquisition advisory firm based in Birmingham, Alabama. Its team's proven expertise and process-based solutions help companies and business owners access capital and prepare for and execute liquidity events to achieve specific financial goals. The firm focuses on the following industries: oil and gas, industrial, healthcare, internet & digital media, and technology. For more information, visit www.foundersib.com. In order to assist Founders Investment Banking with securities related transactions its Principals are registered investment banking agents of M&A Securities Group, Inc., member FINRA/SiPC. M&A Securities and Founders are not affiliated entities. The testimonial presented herein does not guarantee future performance or success.

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