
EVALUATING A BUSINESS
WITH VOLATILE EARNINGS
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Evaluating a business with volatile earnings

One of the hardest situations to evaluate a business is when it has volatile earnings. Evaluation multiples will evaluate the company at a specific time and in cases where there is consistent growth or decline these can be factored in, but when the earnings are erratic these figures are very subjective at best or completely erroneous at worst.

Erratic earnings can be caused by external changes in the market or internal factors of the business. The impact of these changes on the business needs to be analyzed if there is any hope of finding some sort of prediction of the future earnings and therefore arrive at a meaningful evaluation.

So what are some of the external factors on a business? Small as well as large economic changes in the target market can have a big affect on the smaller business. There may be a change in the competition nearby or changes in the environment affecting the location of the company. There could also be a fluctuation in business because of losing or gaining a big customer.

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Some business sectors are prone to more volatility as they are affected by events in the business world or even global events. Some of the more volatile industries are those in technology, oil and gas and healthcare/pharmaceuticals.

Some of the internal factors that could cause erratic earnings may include a change in products and services or the pricing of the products and services, the attaining of new equipment, increase or decrease in the workforce, especially of key workers, or maybe a change in location. There may also be a discrepancy between changes in the cost of production compared to the pricing.

In order to assess these factors it is necessary to have a good knowledge of appropriate accounting methods and a thorough knowledge of the industry in which the business is working. Account needs to be taken of the stage of growth also. Some factors will seem negative and a reason to believe that future earnings will be reduced, whilst others will be positive and when taken account of will give reason to believe that future earnings will increase. Once the analysis has taken place a new multiple can be worked out by making predictions on the earnings based on these analyses.

There may be cases where the earnings still remain unpredictable. This makes the company a very high risk to any buyer. One solution to this, in order to get some sort of reasonable price for the business, a deal may need to be agreed that includes earn out.

In summary, mid market businesses can be prone to erratic earnings making them very difficult to evaluate fairly. Analysis needs to be done to work out what is causing the erratic earnings and the multiple adjusted so that it is based on predictable earnings. If this is not possible the business will seem very high risk to any buyer and will consequently be sold at a lower price. One of the ways to help get the price deserved is to include an earn out in the deal.

Our M&A Process

TARGET APPRAISAL	APPROACH	DUE DILIGENCE	NEGOTIATION & CLOSE	POST MERGER INTEGRATION (PMI)
Key Areas				
▪ Target & market analysis; ▪ Initial assessment of synergies & value drivers; ▪ Indicative valuation; ▪ Go or No-Go decision; ▪ Preparation of transaction documents (NDA – Non-disclosure Agreement/LOI-Letter of Intent); ▪ Select Transaction team; ▪ Appoint advisors; ▪ Consider funding ability.	▪ Initial approach letter; ▪ Signing of NDA; ▪ Prepare & share initial information requests; ▪ Formulation of LOI (Letter of Intent) & possible negotiations; ▪ Initial meeting and Q&A; ▪ Circulate information on the Target to the Transaction team.	▪ Set scope of due diligence; ▪ Set up VDR (virtual data room); ▪ Coordinating of due diligence, further meetings and Q&A sessions; ▪ Consider points relevant to the Post-Merger (PMI) phase;	▪ Revisit indicative valuation & prepare detailed valuation based on due diligence findings; ▪ SPA negotiations with the seller; ▪ Development of final structure (share/asset deal) and final valuation; ▪ Approvals; ▪ Signing of SPA & Close.	▪ Consider the extent of integration; ▪ Development of 100 Day PMI Plan; ▪ Consider short & long term objectives; ▪ Estimate requirements to capture synergies; ▪ Determine resource needs & optimal allocation.
Parties Involved				
▪ CFO; ▪ Head of M&A; ▪ Accountants; ▪ Corporate finance advisors; ▪ Consultants.	▪ Senior management; ▪ CEO, CFO, CTO; ▪ Strategy director; ▪ Head of M&A; ▪ Head of Business Development; ▪ Consultants.		▪ Company general counsel; ▪ Lawyers; ▪ Senior management.	▪ Company general counsel; ▪ Lawyers; ▪ Senior management/HR.


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