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Public vs. Private Company Valuations: What's the Difference?

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Business owners are often puzzled as to why their private companies are valued less than similar public companies in the same industry. However, because a number of factors affect the valuation of public and private companies differently, it is difficult to compare the two.

Market Liquidity

An important factor contributing to private companies' discount in value is market liquidity. In public companies, investments can easily be bought, sold or traded, but the absence of a market makes trading stock in private companies more difficult. This lack of market liquidity reduces a private company's value.

Profitability Definition

Profitability is every business owner's highest concern, but the way companies report their profits affect the way business appraisers value a company. In most public companies, the primary goal is to keep shareholders happy by generating high profits. However, private companies have few, if any, shareholders besides the owners themselves, and they can therefore fill financial statements with unnecessary expenses to reduce their tax liability. This practice of reducing

profits will reduce taxes, but it makes it hard to measure the company's profitability. Even though these discretionary expenses can be added back to create a more accurate depiction of the company's performance, they still negatively affects the value of the company.

More importantly, the difference between public and private companies' profitability is the difference in definitions. A public company's measurement of PE (price to earnings) does not measure profitability in the same terms as a private company's measurement of an EBITDA ratio. The price in a PE multiple is derived from the aggregate population's belief of the public company's value. This value is larger because public companies tend to be larger and have other benefits related to size. Private companies will never have a PE ratio because they will never have a publicly derived market price or value.

Size & Infrastructure

When comparing private and public companies, private companies are usually smaller. Large public companies typically have greater infrastructures comprised of broader management teams with more diversity and greater input into the decision making process. This size advantage

allows public companies to have stronger brand equity and to operate at greater economies of scale, which makes them more efficient and able to provide the same product or service to customers at a lower cost.

Economic Risk

Economic downturns tend to hit private companies a bit harder in terms of performance and market position, making them more vulnerable to systematic or market risk. During difficult economic times, public companies rely on public equity and debt markets for financial support, but private companies do not have the same level of protection. As a result, private companies are more sensitive to economic market conditions, reducing their values.

Operational Control

Another factor that influences the value of both private and public companies is the amount of operational control a buyer would have. In a private company, the buyer usually purchases the majority interest in the company, which grants him the power to make all major decisions. However, in public companies, investors are usually owners of minority shares and lack the

authority to make any significant decisions. This lack of control decreases the value of public companies and increases the value of private companies

Conclusion

To accommodate the factors that forge a difference between the values of private and public company, appraisers employ different valuation methodologies. For example, because past stock transactions are not available for private companies, valuation reports typically refer to market transactions of similar private companies instead. Appraisers also circumvent the difficulty in calculating a private company's cost of capital by building up each cost individually to create a discount rate. However, without a weighted cost of capital, including costs to equity and debt holders, it is difficult to determine if the private company is making true economic profits or simply accounting profits.

As this article has shown, many factors create differences between the derived value of a private company and the derived value of a public company. To compare the value of the two, despite their possible similarities, is much like comparing apples to oranges.