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## Cash Flow is King, But…

"Cash Flow is King." This is a popular saying among those in the valuation community and similar fields such as private equity and M&A advisory, based on a fundamental finance principle that the value of an investment is driven by its ability to provide a future return to that investor (… otherwise, why would they invest?). This principle forms the basis for various valuation approaches (i.e., discounted cash flow or dividend discount models) but also extends to various "rules of thumb" that are often used to roughly estimate business value through multiples of EBITDA, earnings, cash flow, etc.

There are thousands of businesses in the U.S., in countless industries and with vastly different financial profiles. Some of these businesses have a recent history of little or no profitability. So… if cash flow or earnings are the source of a company's value, is a business with no profitability in recent years worthless? Often times, the answer is no. In fact, businesses that have generated no profit from operations during the past five years could still have significant value – here are five examples:

1. ***Company is cyclical.*** For valuation, historical performance is useful only when it provides an indicator of future performance potential (since a new investor would only be entitled to *future* cash flows and dividends). Cyclical and other companies dependent on industry and economic conditions often go through alternating periods of weak and strong performance. Assessing the value of a business of this type often involves taking a long-term perspective, and evaluating performance potential through a range of economic and industry conditions. Therefore, looking at recent performance, when the company may have been mired in an economic recession, may not be an accurate portrayal of its capabilities in the long run.

2. ***Company has not reached maturity.*** New businesses are formed every day, and frequently these younger businesses have operating losses for many years until the employee talent is hired, products are developed, customers are gained. Therefore, even a business with losses may be valuable, especially if that business is on the right growth path and has begun to develop tangible and intangible assets that can drive cash flow over the long-term.

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3. ***Company has significant assets.*** Some asset-intensive businesses are better evaluated by their asset base rather than their earnings generation, since at the very least a prospective buyer could potentially liquidate these assets. Distributors are a common example.

4. ***Company is valuable to a synergistic buyer.*** A company that is not profitable on a stand-alone basis may have value to a competitor or another company through synergies created by its acquisition. These buyers may be able to eliminate expenses or generate new revenue opportunities, either for the target company or the acquiring company. Typically, a business must provide strategic value to two or more companies in order to command this strategic price – otherwise, why would a sole buyer pay it?

5. ***Company is a "prestige" investment.*** What if a company has rarely or never generated profit from operations, and it is likely that it never will? It may still be valuable if a market of potential buyers exist. But why would a buyer be interested in a business that has minimal profit potential? Some owners target "prestige" investments, such as professional sports franchises, restaurants/nightclubs, and other publicly-known businesses. Investors in these businesses may realize certain intrinsic benefits of ownership, and may still realize a return through capital appreciation if they are able to sell the company at a higher price than it was purchased.

The above examples highlight how a valuator often must look past historical profitability in assessing business value. Since there are countless factors to consider when estimating the value of a business, it is typically advisable to seek a qualified outside opinion.

GBQ Consulting's valuation team issues hundreds of opinions annually on the value of businesses, business interests, and intangible assets of both privately-held and publicly traded companies, for a variety of purposes.