Different Approaches to Business Valuations

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Selden Fox

Accounting for your future

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Performing a business valuation can help the business owner and management determine what their business is worth. In other words, it is a way to measure their business's economic value. Determining the value of a business is an essential exercise for many reasons. In many cases, a valuation is conducted because the business is involved in a sale or acquisition. In other cases, determining a company's value is needed for shareholder buy-ins, estate planning or for litigation, such as divorce cases.

For most business owners, a business valuation will only be conducted one or two times during the tenure of their ownership. Thus, many are unfamiliar with how valuations are conducted and the various approaches that can be taken.

There are three acceptable methods that practitioners can use to perform a business valuation: the income approach, the market approach, and the asset approach. Each method may at times appear more theoretically justified in its use than others. The soundness of a particular method is entirely based on the relative circumstances involved in each individual case.

The following provides a summary to help business owners understand the basics of these three approaches and when they are commonly used.

The Income Approach

When the earnings capacity of the company is a factor to be considered in a business valuation, the income approach is used. In simple terms, performing an income-based valuation involves looking at an organization's financial history to make projections about their future profits and thus determine its value. A general way of determining the value of a business or business ownership interest is using one or more methods that convert anticipated economic benefits into a present single amount.

INCOME APPROACH METHODS

When using this approach, the two primary methods for determining a company's value are the discounted cash flow method and the capitalization of cash flow.

DISCOUNTED CASH FLOW

The discounted cash flow method arrives at a valuation based on projected cash flows by discounting them at the date of the valuation. The key to this method is to choose a suitable discount rate. When using this method, it is important to identify the cash flow streams from the company, a discount rate that reflects the risk tolerance of the investor as well as the long-term value of the business. This approach is quite versatile and can account for significant variation in a company's growth expectations over a period of several years.

CAPITALIZATION OF CASH FLOW

This method arrives at a valuation by dividing the total cash flow stream of a business by its capitalization rate. The capitalization of cash flow method is considered easier to perform than the discounted cash flow method, but it assumes that the rate of growth for the company in question will be stable from one year to the next.

Unfortunately, many companies are unable to make this assumption because economic and market fluctuations impact demand and expected growth. For this reason, the Discounted Cash Flow Method is often recommended when growth rates cannot be predicted or have historically been erratic. This method is more theoretically sound in valuing a profitable business where the investor's intent is to provide for a return on investment over and above a reasonable amount of compensation and future benefit streams or earnings are likely to be level or growing at a steady rate.

The Market Approach

The idea behind the market approach is that the value of a business can be determined by reference to reasonably comparable guideline companies for which transaction values are known. The market approach mirrors how the value of residential real property is valued. Through an analysis of prior sales for comparable homes, or in this case businesses, a value for the entity is determined.

WHAT IS THE MARKET APPROACH?

The market approach values a business by looking to the marketplace for recent sales of similar businesses. This approach is attempting to ascertain the business's "fair market value," or the "going rate." Although it can be difficult to find comparable data, the market approach can be the ideal method to use when the business being valued closely resembles other businesses on the open market in various characteristics such as industry, market influence, revenue, and growth potential. If there are only a handful of similar businesses for comparison, an alternate valuation method may be the better option. It would also be difficult to use the market approach to assign value to a sole proprietorship; finding information on sales of privately held businesses may be challenging.

ADVANTAGES AND DISADVANTAGES

As with any valuation approach the market approach has significant advantages and disadvantages. The first advantage is that is uses actual data based on actual transaction prices, not estimated based on several complex assumptions or judgments. The market approach can also be relatively simple to apply as this approach derives estimates of value from relatively simple financial ratios, drawn from a group of similar companies.

Some drawbacks for the market approach are that it is often difficult to obtain recent comparable company data and the standard of value being used may be unclear. Many companies are so unusual, small, diversified, etc. that there have not been any sales of similar companies. Also, most transaction databases provide financial and pricing data but do not explicitly indicate whether the reported transaction was arms-length, strategic, synergistic, asset versus stock, etc. The standard of value is the most important determining factor of a valuation and if this is unclear in a previous sale then it is difficult to compare sales.

PRICING MULTIPLES

Pricing multiples are used to help determine a reasonable selling price for a business based on market data. Pricing multiples are ratios calculated by comparing the sales price to a specific performance characteristic. A few of the more common pricing multiples include:

- Selling price divided by gross revenue
- Selling price divided by sales
- Selling price divided by cash flow
- Selling price divided by the book value of business assets
- Selling price divided by net income

A valuation professional would calculate the pricing multiples for comparable businesses and determine the best way to aggregate that information. Sometimes, a simple average is best. Other times, a range is ideal.

MARKET APPROACH METHODS

There are two main ways for valuation professionals to utilize the market-based approach to value a business.

They can use the Comparative Transaction Method which requires the business valuation consultant to gather data on the sales of private companies. This method is possible only if the private sales data is available, so it may not be practical for certain industries.

The Guideline Publicly Traded Company Method is when the valuation professional gathers data on publicly traded companies. Publicly traded information is readily available, and the data is reliable. However, this method often only considers the sale of a non-controlling ownership interest which may not translate to the sale of the entire business.

The Asset Approach

The Asset Approach measures the current market value of a company's assets subtracted from its liabilities to determine the value of a business. As part of the analysis, the valuation professional will determine which of the company's assets and liabilities should be evaluated and how to measure each. Depending on the size of the company, this can be challenging. Identifying the assets to be evaluated requires vision beyond the balance sheet. Often companies may not think of certain business factors as assets, such as internally developed products or innovative business methods, which can certainly impact the value of the company.

ASSET APPROACH METHODS

When using this approach, there are two primary methods for determining a company's value, which include:

ASSET ACCUMULATION

The asset accumulation method is primarily used to value companies with a significant number of assets and earnings that don't support a value greater than the value of tangible assets. Examples of such companies may include real estate holding or oil and gas companies. This method uses the sum of the listed tangible assets and liabilities listed on the balance sheet with the goal of arriving at a total value based on the value of individual assets. A step up or discount must be applied to account for the cost to obtain similar assets in current market conditions. Finally, the intangible assets (e.g., strategic partnerships and intellectual property) and liabilities (e.g., pending litigation or tax obligations) of a company are considered and a final value assigned.

CAPITALIZED EXCESS EARNINGS

The capitalized excess earnings method is also known as the Treasury Method because it was introduced by the Department of the Treasury in the 1920s to determine the value of a company's goodwill. The basic concept behind this method is that it seeks to determine the value of a company beyond its tangible assets by separating and assigning a value to its intangible assets. It arrives at a value by determining income produced by tangible assets and adds it to the value of intangible assets. This method is often used for small business valuations in the context of a divorce.

Contact Us

Experienced practitioners can identify the appropriate business valuation method for each unique situation – if the data is available, it may be the market approach, or a valuation analyst may decide that the asset or income approach are better suited for a valuation. A business valuation analyst will have the expertise necessary to select the valuation method that is best for your situation.

If you have questions about valuation methods, or need assistance with a business valuation, John Wojcik, CPA, MST, CVA can help.

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John works with a variety of the firm's clients, including individuals, family businesses, business owners, and closely held businesses. He provides tax planning, research, consulting, and compliance services. He is a licensed public accountant in Illinois and is a member of the AICPA and the Illinois CPA Society. John is a Certified Valuation Analyst and a member of the National Association of Certified Valuators and Analysts. John is also active with the Oak Brook Chamber of Commerce. John earned two bachelor's degrees in accounting and finance from Illinois State University and his MST in taxation from Northern Illinois University – College of Business. He joined Selden Fox in 2008 immediately after completing his undergraduate studies. In his spare time, he enjoys golfing and spending time with his wife and two young children.