Valuation: Getting the **Right Price** When Selling Your Business

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Introduction

“What do you think my company is worth?” is the question we are most commonly asked by our clients and prospects who are considering the sale of their companies. Answering this question is an important step in determining whether the timing might be right to sell a particular company. Although there are many other factors that will affect whether a business owner should pursue a transaction, this article provides an overview of the most common approaches and methods used in business valuation.

The leading business valuation associations, the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA), all agree on three major approaches to business valuation: the **Income Approach**, the **Market Approach**, and the **Cost Approach**. Under each of these approaches there are several methods that might be employed depending on the specific nature of the company being valued. A brief description of the standard approaches and most commonly used methods under each approach follows below. We conclude with the **True Value Approach**.

Valuation Approaches and Methods

Income Approach

The Income Approach involves valuation methods that convert future anticipated economic benefits (e.g., cash flow) into a single present dollar amount. Depending on the valuation method used, “Income” might be represented by after-tax profit, pre-tax profit, EBIT (earnings before interest and taxes), EBITDA (EBIT plus depreciation and amortization), or other cash flow measures. The two most commonly used methods under this approach are the Single Period Capitalization Method and the Multiple Period Capitalization Method.

- *Single Period Capitalization Method* – This method involves converting representative income for a single period into present dollar value through the use of a capitalization rate (expressed as a percentage). The capitalization rate factors in the risk of achieving the future income as well as a projected growth rate for the specific company being valued. The key assumptions required in order to use this method include stable earnings, a constant growth rate, and the prospect for continued growth for a long time period.

- *Multiple Period Discounting Method (aka Discounted Cash Flow Method)* – This method uses financial projections to determine future income for several periods into the future including a terminal value and a discount rate to convert those future values back to a present value. The advantage of this method is that it can be used for companies with unstable earnings and nonconstant growth rates. It is important that the discount rate

being used is appropriate for the "income" being discounted as small changes in the discount rate can have considerable impact on the present value.

Market Approach

The Market Approach involves valuation methods that use transactional data to help determine a company's value. These methods might involve private company transactions, public company transactions, as well as public company valuation measures using current stock market data. The theory behind this approach is that valuation measures of similar companies that have been sold in arms-length transactions should represent a good proxy for the specific company being valued. Depending on the source of data available and the underlying company being valued, a variety of valuation measures might be used including Enterprise Value (EV) to Sales, EV to EBITDA, EV to EBIT, Price to Earnings, etc.

- *Merger and Acquisition Method (aka Comparable Sales)* – This method involves reviewing transactions for companies that are in the same or similar line of business as the company being valued and then applying the relevant pricing multiples to the subject company to determine its value. Proprietary data bases of private company sales are often utilized in this method. In addition, some public company transaction data is available. Adjustments are commonly made to these valuation measures before applying to the subject company to ensure an "apples-to-apples" comparison. One or many comparable sales might be considered under this method depending on the data available and the degree of similarity to the company being valued.
- *Guideline Public Company Method* – This method involves using market multiples derived from market prices of stocks for companies that are engaged in the same or similar industries as the subject company. This can be a helpful tool in valuing private companies, but these public company multiples usually need to be discounted significantly to reflect the higher risks (e.g., customer concentration, management depth, access to financing, etc.) inherent in most smaller private companies as well as the "lack of marketability" of private company stock.

Cost Approach

The Cost Approach, also known as the Asset-based Approach, involves methods of determining a company's value by analyzing the market value of a company's assets. This valuation approach often serves as a valuation floor since most companies have greater value as a going concern than they would if liquidated, i.e., the present value of future cash flows generated by the assets usually far exceed the liquidation value of those assets. This difference between the asset value and going concern value is commonly referred to as "goodwill". An exception to this might be a low-margin business in a competitive industry that owns its real estate, which has appreciated over time due to its development value. In this case, the asset value may exceed the going concern value of the business.

- *Adjusted Book Value Method* – This method involves reviewing each asset on the company's balance sheet and adjusting it to reflect its estimated market value. Depending on the mix of assets owned by the company, other types of appraisers (e.g., real estate,

machinery and equipment) might need to be consulted as part of the valuation process. In addition, it is important to consider intangible items that might not necessarily be reflected on the balance sheet, but which might have considerable value to a buyer, such as trade names, patents, customer lists, etc.

Conclusion

The valuation methods discussed above represent some of the most commonly used by business valuation professionals to generate an opinion of value. Although considerable time and effort is involved in preparing formal business valuations, unfortunately the results may or may not reflect the "real world" value of a specific company if it were formally offered for sale.

"Real World" or True Value

True value of a company is that which a real, live buyer would be willing to pay if it were formally offered for sale. Depending on the unique aspects of each individual company, the true value may vary significantly from a valuation determined by any of the methods discussed above.

Consulting a professional investment banker can best help you assess the true value of your company. These professionals will assess your company's strengths and weaknesses and employ some of the commonly used valuations methods used by business valuators. They will also leverage their insight into the current marketplace to help determine financing availability and assess many other factors to determine your company's potential value in the market place.

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