



Abstract: Because there are many ways to appraise a business and because valuations are so complicated, it's essential that buyers and sellers engage valuation professionals. Valuers can determine which appraisal method or methods are most appropriate given the type of company, the purpose of the appraisal and the interest being valued. Valuation methods discussed in this article include the asset-based, market, discounted cash flow and capitalization of cash flows approaches.

Business valuation basics

What you should know about the value of your company

In the context of a potential business sale, value can mean different things depending on whether you're a buyer or seller. Because there are many ways to appraise a business and because valuations are so complicated, it's essential that — whichever side of the negotiation table you sit on — you engage a valuation professional. Valuers determine which appraisal method (or methods) are most appropriate given the type of company, the purpose of the appraisal and the interest being valued.

Working with an appraiser

Seek an appraisal early in the merger and acquisition process. If you're a seller, a valuation report not only gives you an idea of how much your company is worth, but also offers insights into how you can improve your business model before putting your company on the market.

There are ways owners can help their valuator make a fair and accurate appraisal. First, gather data on financial performance, marketing and sales, operations, and products and services. Then be prepared to provide your valuator with information related to the worth of intangible assets — for example, how your intellectual property might create barriers to entry — or about companies producing similar products but working outside your market. The closer you work with your appraiser, the greater opportunity you have to put your company in context.

If you're on the buy side, scrutinize any assumptions the valuator uses — both about the company and the industry. If you have information that contradicts anything in the initial valuation report, discuss it with the appraiser before the final report is issued.

Asset-based approach

Valuers may use one or more methods to arrive at a business value. One common approach is the asset-based method, in which an appraiser determines the fair market value of the business's underlying assets minus the fair market value of its liabilities.

This type of valuation focuses on the tangible value of the business's underlying assets and is likely to be appropriate where a company's profits are so small they don't contribute to its value. This method also would be appropriate for businesses whose value lies in the worth of their individual assets rather than their earnings streams — for example, real estate and investment companies.

Market approach

With the market approach, a valuator may use multiples that are the mean or median ratio of the transaction price at which similar companies have recently sold, as a multiple of their annual gross sales (price/gross sales). Or the appraiser may use multiples that are the mean or median ratio of earnings as a multiple of the transaction price for which similar companies have sold (price/earnings).

Market multiples are good for getting a “feel” for a company’s value. Unfortunately, when using this approach a valuator doesn’t usually have pertinent details of each company’s sales transactions. What’s more, information might not be available regarding, for example, the comparable companies’ expected future growth rates or risks associated with them. For these reasons, the market approach typically is used as a “reasonableness check” to supplement the value determined by another method.

Discounted cash flow method

The discounted cash-flow (DCF) method measures the value of a company’s expected future cash flows, as discounted to present value.

A valuator normally adjusts five years of a company’s historical financial statements to market value. The appraiser then converts expected after-tax net income to free cash flow for several future years by adding depreciation, amortization and interest expense (net of taxes), subtracting amounts for expected capital expenditures and working capital requirements. Next, the valuator discounts each of projected years’ free cash flow to present value by discounting the respective amounts using a risk factor (the discount rate).

Capitalization of cash flows method

The capitalization of cash flows approach is a method whereby economic benefits (cash flows) for a single representative period are converted to value through division of a capitalization rate. Under this method, expected annual future economic benefits — cash flows — are used as a proxy for all future benefits.

This method isn’t appropriate for financially volatile companies. It’s generally applied when a company’s future earnings are expected to be fairly steady.

Just a starting point

Valuing a company for sale is an imprecise art, and the results generally should be considered only a starting point for deal participants. Once you get to the bargaining table, other factors, including financing and deal structure, also will play large roles in determining the company’s ultimate sale price.

Sidebar: Assumptions involved in creating a valuation

When projecting a company’s future profitability, a valuator using most appraisal methods will likely rely on the following information about the business:

- History of growth and expected growth trends,

- Target market size,
- Competition,
- Supplier relationships,
- Contractual relationships,
- Product or service pricing and marketing,
- Length of sales cycle,
- Costs related to creating products or services,
- Risk factors, from legal exposure to regulation, and
- Information on the industry and economic factors.