ENTREPRENEURSHIP LAW FIRM, P.L.
Advising Business Owners

Technical Methods of Business Valuation: An Overview

At some point in time, every business owner wonders: "How much is my business worth?" After all the effort you've expended to build your business, its nice to know that you've built a significant asset.

This article provides you with basic information about business valuation so you can: (i) understand the process and basic concepts; and (ii) be an educated consumer of business valuation services.

The most important things to know about business valuation are:

- it's a combination of **art and science**;
- it's not fixed **(knowing how the valuation is done can help you increase the value of your business)**; and
- it's an **educated guess**.

True business valuation (i.e., getting the "fair market value" of your business) truly occurs only when you sell a business at arms-length. Only then are all of the factors the effect valuation (including payment terms) known.

However, by using the following methods, you should arrive at a value range for your business.

The first step in any valuation is to analyze the business, its assets, history and market. Of course, a valuation is only as good as the information about the business. So, its critical to ensure all of your information is accurate and complete.

Central to this analysis is financial information. Accurate financial recording keeping is essential to establishing business value.

Yet, often financial information must be legitimately "recast" to reduce the effects of tax decisions and owner benefits, and to be able to compare the results against other similar businesses.

Basic Business Valuation Methods.

There are four basic business valuation methods:

- Asset Based Valuation;
- Market Based Valuation;
- Earnings Based Valuation;
- Cash-Flow Based Valuation.

Each method involves detailed analysis and calculations.

This article provides only general information. It is not legal advice and may not be relied upon as legal advice. All stories and anecdotes have been modified to ensure that no confidential or identifying information is provided.

The Entrepreneurship Law Firm advises business owners about starting, purchasing, improving, protecting and cashing out of their businesses. For more information about the firm and its services go to **EntrepreneurshipLawFirm.com**. We can be reached at 407-649-7777 or by e-mail at Ed@EntrepreneurshipLawFirm.com, 930 Woodcock Road, Ste. 223, Orlando, FL 32803.

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Asset Based Valuation

Generally, asset based valuation is used to determine the bottom end price (i.e., liquidation value) for an operating or "going concern" business. However, it is the preferred method for holding companies, such as a real estate holding company, where the company's assets reflect its true value.

Liquidation Value. To determine the liquidation value, you first establish the current liquidation market prices for all business assets, except those that can't be sold (e.g., special equipment, or other assets with no market). From that the outstanding liabilities (mortgages, etc.) are deducted, resulting in a business value if operations were ceased immediately.

Replacement Value. To determine the business assets replacement value, you establish the current market prices for the business assets.

Unfortunately, it is difficult to value the intangible assets (e.g., trademarks, goodwill, etc.) when using asset based valuation. As a result, asset based valuation is not usually an accurate estimate of business value.

Market Based Valuation

A Market Based Valuation analyzes the prices of other similar businesses to determine an approximate valuation for your business. Generally, the steps are:

1. Analyze the public markets to determine price-to-earnings ("P/E") ratios for similar companies;
2. Determine the average or median P/E ratio of those companies; and
3. Multiply that P/E ratio by the net ordinary pre-tax earnings of your business.

Sounds straight forward. Unfortunately, there are several drawbacks.

First, public companies tend to be quite different than closely held businesses, including access to capital, layers of management, liquidity for owners, and many other things. Therefore, even if a P/E ratio for a similar public company is determined, that ratio will have to be modified to account for the differences between the companies. The extent of the modification is the "devil in the details."

Second, the sale of a public company stock (from which the P/E ratio is determined) usually involves the sale of a minority interest in the company. The sale of a closely held company, on the other hand, usually involves the sale of a majority (controlling) interest. Controlling interest transfers are made at a premium to minority interest transfers. Therefore, an (upward) adjustment to the P/E ratio for transfer of a controlling interest is also necessary.

Third, the public market P/E ratio includes a discounted expectation of the future prospects of the company. For many reasons, public companies can grow at a higher rate than closely held companies and they're not dependent on the buyer's expertise. Thus, the portion of the P/E ratio applicable to future prospects should be reduced.

On average a dollar of earnings from a public company represented between twelve and twenty dollars of market price. For closely held companies, however the range is three to seven. Thus, the maximum P/E ratio that should be used to value a closely held business is generally seven.

Earnings Based Valuation

Closely related to the Market approach is the Earnings Based Valuation. Under the earnings based valuation, the business value is set by the following formula:

Valuation = Weighted Average of Normalized Earnings Before Taxes / Capitalization Rate

Weighted Average of Normalized Earnings Before Taxes.

To determine normalized earnings, you calculate a weighted average of earnings over a specific time period, usually five years.

Annual earnings reported on financial statements or tax returns are usually modified. First, deductions are taken from earnings for special events such as one-time extra-ordinary gains and credits given for extraordinary losses.

Second, if owners receive salary or benefits greater than they would receive outside the company, the excess payments are added back to company earnings. Conversely, if owners are not paid a salary or benefits at a market rate, the underpayment is deducted from earnings.

Once earnings are modified, they're weighted based on the time received. The most recent earnings are heavily weighted, while earlier years' earnings are discounted.

For example, the present year's earnings may be weighted at 1.5 or 2 times, while the first year's earnings may be weighted at .200. Sometimes a 5, 4, 3, 2, 1 approach is used, multiplying each year's earnings by its factor, adding the totals and dividing by 15.

The weighting value depends on the stage of life of the company and the company's growth over the time period. For a mature company, weighting will probably be consistent. For a start-up venture, earlier years will probably be discounted more heavily.

But there is no justification for heavily weighting nearer years merely because current financial performance is superb.

Capitalization Rate.

Weighting the earnings may be somewhat difficult, but the real trick with earnings based valuation is the capitalization rate.

Capitalization rate (or just "cap rate") is the return on investment expected by the investor/buyer. In a way, it is a statement of the risk involved in your business compared with available investments.

For example, if "no-risk" investments (e.g., CD's and government short term bonds) are generating annual returns of 4.5%, stock market blue chips 10-12%, and "small caps" 15-18%, then your small business capitalization rate will more than all of them.

Why? Because running a small business is much more risky than investing in a public company.

If your venture is heavily dependent on you, the industry is changing or your earnings fluctuating rapidly, the capitalization rate for your business could be as high as 50%.

However, for most closely held businesses, the correct "cap rate" is between 15% and 33%. Thus, as a rule of thumb, most closely held businesses are worth between 3 and 5 times the weighted average of the normalized earnings before taxes.

The obvious problems with the earnings based valuation are selecting the appropriate earnings weighting method and capitalization rate. These problems are, however, less severe than the problems with the other valuation methods.

Cash-Flow Based Valuation

The cash flow based valuation is similar in some aspects to the earnings based approach. Cash flow based valuation bases business value on the future cash coming from the business. That cash flow is discounted to a net present value at a specific discount rate to determine the value of the business.

The cash flow method is the least used method for valuation. First, it is difficult to estimate future cash flows from the business (although a good approximation can be made based on

historical cash flows). Second, selecting the discount rate is more problematic than selecting a capitalization rate.

It is, however, useful for analyzing cash available for debt service after a purchase. If projects free cash flow for debt service and uses that as a method to approximate a portion of the business value. Therefore, cash flow is a good check for other methods.

Other Factors:

There are additional "soft" factors to be used in adjusting business value. After an approximate value is determined with other methods, that value can be increased or reduced based on soft factors, including:

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1. *Overall "health" of the Business;*
2. *The reason for selling;*
3. *Cost of entry for new participants;*
4. *Market –growing, steady or contracting;*
5. *Competition – severe, moderate or limited;*
6. *Legal Environment – not regulated to highly regulated; and*
7. *Business Assets:*

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- *Facilities*
- *Equipment*
- *Employees*
- *Intellectual Property*
- *Goodwill and Market Image.*

Conclusion.

Remember, a business valuation provides a range estimated based on an educated guess. To fully understand the valuation, you must review the methods used to arrive at the value and the information upon which it is based. And prior to acting on a valuation (as a buyer), you should thoroughly review the business for yourself.