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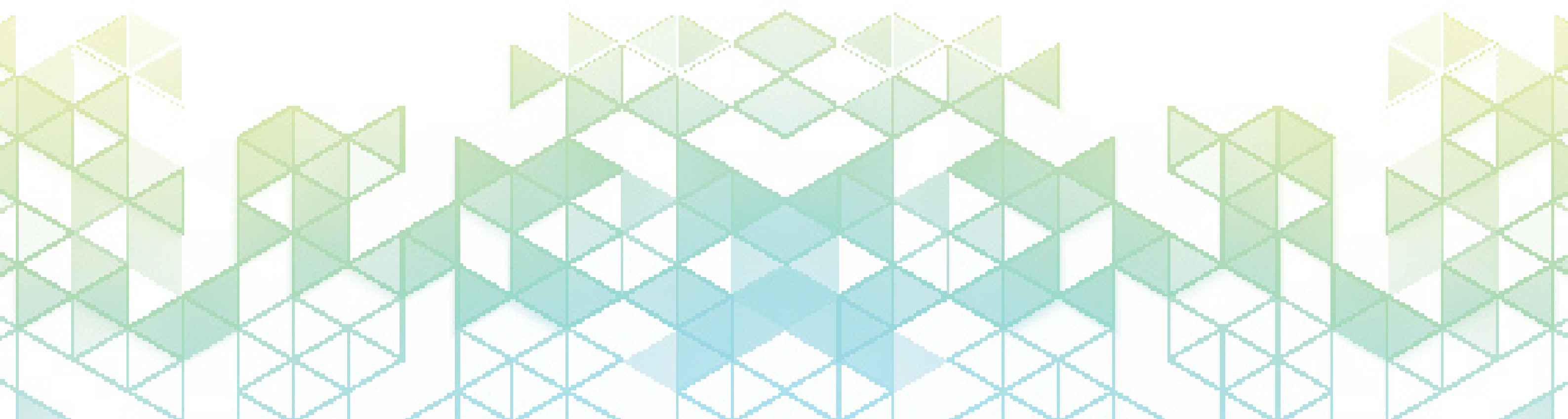
Valuing Your Business



There are many different circumstances when a business owner may need to estimate the value of their company and stock, and it's important that the estimate be as accurate as possible. This document covers the reasons for needing a valuation and the methodologies used in a valuation.

Why You Need a Valuation

When most people think of a business valuation, they think of the process of buying or selling a business. However, there are many other reasons a business owner might need to get an accurate valuation for their business – long before a final sale.

As a business owner or partner, you may need to purchase life insurance or casualty insurance. The underwriter may require a valuation of your business to show insurable interest, which is generally the value of the asset or person being insured.

Businesses with partners frequently purchase life insurance, which in conjunction with a buy-sell agreement, enables the business to purchase the equity interests of a deceased partner. A third-party valuation helps determine a fair value for the equity and an appropriate amount of insurance needed.

On a related note, a living partner or shareholder may want to exit their business and sell their interests back to the company, in which case a third-party valuation can be used to determine a fair market value of their equity interests.

Nobody likes to think about it, but in the event of divorce, a valuation of a business that's included in marital assets may be necessary to reach a settlement.

Lenders will frequently perform valuations to determine the value of assets that may serve as collateral for a loan or other financing.

As a business owner, you may need to plan for the transfer of assets to your heirs and for potential estate taxes upon death. You may also need to figure out how to equalize an estate that includes a business, among multiple heirs, even if only one beneficiary wants to take over the business. A valuation will help you create an estate plan that not only minimizes estate taxes but properly divides assets across beneficiaries.

Finally, with any merger or acquisition, a valuation may be used to support a sale price, determine equity interests in the surviving entity, or support financing required to complete a transaction.

There are three primary approaches to valuing a business - the asset approach, the income approach, and the market approach.

The Asset Approach

The Asset Approach determines a value by adding the market value of the assets, both tangible and intangible, and subtracting the market value of the liabilities. This approach is most useful for asset-heavy companies where most of the business value resides in the assets rather than in expected future cash flow.

It is important to note that the fair market value of an asset may be very different from its "book value" on the company's balance sheet. This is because the book value of an asset may not accurately reflect its fair market value, especially when accelerated depreciation was taken against an asset.

The asset approach can be very useful in arriving at a reasonable, fair value for an asset-heavy business. However, it effectively ignores the growth potential and future income potential of the business as an ongoing concern. Because this approach represents the bare minimum value if the company was selling off assets and satisfying liabilities, you can think of it as the floor – the minimum amount you should receive for the business.

The Income Approach

The Income Approach focuses on the value of the company's future income and cash flow. The business value is roughly the net present value of all the company's future income and cash flow, discounted by a required rate of return, also known as a capitalization rate.

If the investment is risky or the expected future earnings are uneven or highly uncertain, a buyer will have a higher required rate of return which decreases the overall value. This compensates a buyer for the additional risk or uncertainty. If the investment has a strong track record of steady and predictable earnings, buyers will accept a lower rate of return, which increases the overall value.

Capitalization of Earnings

If your company has stable and predictable earnings, you may use the capitalization of earnings method. With this method, the income from a specific prior period is divided by the market capitalization rate. For example, hotels and real estate properties are often valued by dividing prior 12-month net operating income by the market capitalization rate to determine value. A business valuation expert can help determine an appropriate capitalization rate, required adjustments, and fair market value.

Capitalization of Earnings

Net Operating Income	$2,000,000
Capitalization Rate	8%
Valuation (before adjustments)	$25,000,000

Discounted Cash Flow

If your company is still growing and has not reached stability, the discounted cash flow method may be appropriate. With this method, the business projects the future annual earnings during the growth phase and at maturity. The annual earnings during the growth phase are discounted to net present value and added to the net present value of earnings at maturity to arrive at an overall valuation.

This type of valuation can be challenging because it's difficult to predict the year-by-year revenue and expenses of a rapidly growing business. However, using this method for growing companies is likely to be closer to the mark than the other methods.

Discounted Cash Flow

	Year 1	Year 2	Year 3	Maturity (exit value)
Earnings	$100K	$150K	$175K	$2.5M
Discount Rate	(1.08)	(1.08)^2	(1.08)^3	(1.08)^4
Present Value	**$92K**	**$129K**	**$139K**	**$1.838M**

Valuation: $2.198 M

The Market Approach

The Market Approach uses data from recent transactions of similar businesses to determine fair market value. Most valuation experts and business brokers have access to large databases of recent transactions. Additionally, many of these databases provide core metrics such as business size, current revenue, trailing revenue, and EBITDA for each transaction.

If the business is very large, it may be easy to find valuation data on comparable publicly traded companies. For smaller companies, it may be more difficult to find these numbers, especially for the individual small business owner who doesn't have access to reams of sales data from networks of brokers.

Every industry is different, and therefore, the core metrics used for valuation purposes may be unique to your industry. A valuation expert will know what core metrics are important for your specific industry.

Which Approach is Best?

No single valuation method is foolproof. Buyers, business brokers, and business valuation experts routinely use multiple methods to arrive at an estimated fair market value.

There are always myriad factors, considerations, and contexts unique to the individual business and local economy where the business operates. Few business owners will have the detailed access to information or specific transaction data that business valuation professionals possess. Business valuation professionals are typically veterans of hundreds or even thousands of valuations and sales.

Final Thoughts

It is important to talk to a valuation expert, and not just right before you plan to sell or enter into a transaction. You should be speaking with a valuation professional throughout your business lifecycle and making continuous adjustments to your risk management, insurance, estate planning, and other forms of planning.

About PBMares, LLP

PBMares, LLP is an accounting and business consulting firm serving U.S. and international clients, with offices in the Mid-Atlantic. The firm unlocks opportunity for clients using the right balance of industry, specialty and general business services in the areas of audit and accounting, tax planning and preparation, pension plan design/administration, and owner-managed/corporate financial consulting. In addition, the firm provides additional services through its affiliates: Artifice Forensic Financial Services, LLC, a financial consulting division specializing in fraud investigations and forensic accounting; PBMares Wealth Management, LLC, a registered investment advisor; and TMDG, LLC, a national healthcare consulting firm specializing in medical claims audits. More information is available online at www.pbmares.com.community-based initiatives.

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