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Business Valuation Methods



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The true value of a company is the perceived value to a buyer, who is ready, willing and able to buy it.



There are a number of instances when you may need to determine the market value of a business. Certainly, buying and selling a business is the most common reason. Estate planning, reorganization, or verification of your worth for lenders or investors are other reasons.

Valuing a company is hardly a precise science and can vary depending on the type of business and the reason for coming up with a valuation. There are a wide range of factors that go into the process - from the book value to a host of tangible and intangible elements. In general, the value of the business will rely on an analysis of the company's cash flow. In other words, its ability to generate consistent profits will ultimately determine its worth in the marketplace.

Business valuation should be considered a starting point for buyers and sellers. It's rare that buyers and sellers come up with a similar figure, if, for no other reason, than the seller is looking for a higher price. Your goal should be to determine a ballpark figure from which the buyer and the seller can negotiate a price that they can both live with. Look carefully at the numbers, but keep in mind that businesses are as unique and complex as the people who run them and are not capable of being valued by a simplistic rule of thumb.

Here are some of the common methods used to come up with a value.

- Asset valuation;
- Capitalization of income valuation;
- Owner benefit valuation;
- Multiplier or market valuation.



Asset Valuation

Asset valuation is used when a company is asset-intensive. Retail businesses and manufacturing companies fall into this category. This process takes into account the following figures, the sum of which determines the market value:

- Fair market value of fixed assets and equipment (FMV/FA) - This is the price you would pay on the open market to purchase the assets or equipment.
- Leasehold improvements (LI) - These are the changes to the physical property that would be considered part of the property if you were to sell it or not renew a lease.
- Owner benefit (OB) - This is the seller's discretionary cash for one year; you can get this from the adjusted income statement.
- Inventory (I) - Wholesale value of inventory, including raw materials, work-in-progress, and finished goods or products.

Capitalization of income valuation

This method places no value on fixed assets such as equipment, and takes into account a greater number of intangibles. This valuation method is best used for non-asset intensive businesses like service companies.

It is recommended giving each factor a rating of 0-5, with 5 being the most positive score. The average of these factors will be the "capitalization rate" which is multiplied by the buyer's discretionary cash to determine the market value of the business. The factors are:

- Owner's reason for selling;
- Length of time the company has been in business;
- Length of time current owner has owned the business;
- Degree of risk;
- Profitability;
- Location;
- Growth history;
- Competition;
- Entry barriers;
- Future potential for the industry;
- Customer base;
- Technology.

Again, add up the total ratings, and divide by 12 to come up with an average value to use as the capitalization rate. You next have to come up with a figure for "buyer's discretionary cash" which is 75% of owner benefit (seller's discretionary cash for one year as stated on the income statement). You multiply the two figures to determine the market value.



Owner benefit valuation

This formula focuses on the seller's discretionary cash flow and is used most often for valuing businesses whose value comes from their ability to generate cash flow and profit. It uses a fairly simple formula – you multiply the owner benefit times 2.2727 to get the market value. The multiplier takes into account standard figures such as a 10% return on investment, a living wage equal to 30% of owner benefit, and debt service of 25%.

Multiplier or market valuation.

This approach finds the value of a business by using an "industry average" sales figure as a multiplier. This industry average number is based on what comparable businesses have sold for recently. As a result, an industry-specific formula is devised, usually based on a multiple of gross sales. This is where some people have trouble with these formulas, because they often don't focus on bottom line profits or cash flow. Plus, they don't take into account how different two businesses in the same industry can be.

Here are a few industry multiplier examples:

- Travel agencies – .05 to .1 X annual gross sales
- Ad agencies – .75 X annual gross sales
- Retail businesses – .75 to 1.5 X annual net profit + inventory + equipment
- Real estate agencies – .75 to 3.0 X annual net profit + assets

Disclaimer

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