Calculating the Right Price When Selling Your Business

Valuation – An Objective Look

Considerable time and effort are involved in preparing a formal business valuation. If you are considering selling your business, make sure it reflects the current transaction market.

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Introduction

"What do you think my company is worth?" This is a question asked frequently by prospective clients who are considering the sale of their companies. Although there are many other factors that can affect a business owner's decision to pursue a sale, valuation is an essential matter for Business Owner's to understand.

While there are several ways to approach "value", to be discussed in this article, it is critical to establish the purpose for the valuation. Our purpose is the sale of the business to a willing, knowledgeable buyer. This is basically the definition of Fair Market Value.

The leading business valuation associations, the American Society of Appraiser (ASA), the Institute of Business appraiser (IBA), and the National Association of Certified Valuation Analysts (NACVA), all agree on three major approaches to business valuation; the Cost Approach, the Market Approach, and the Income Approach.

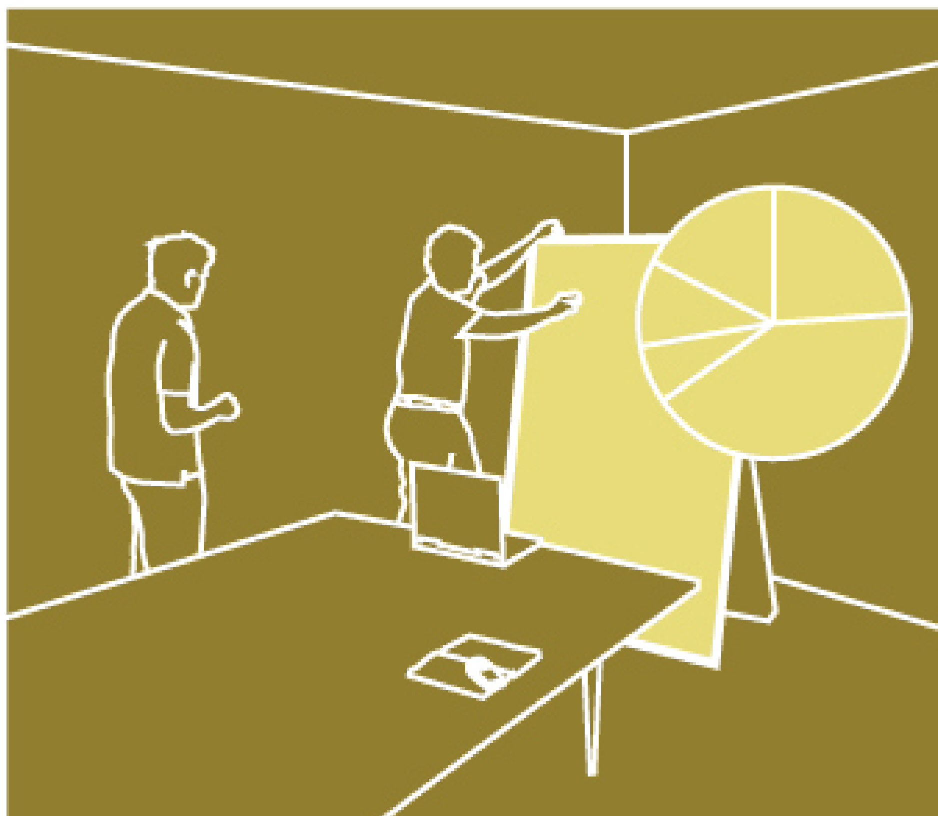
A brief description of the most commonly used methods under each approach follows below.

Valuation Approaches and Methods

Cost Approach

The Cost Approach, also known as the Asset-based Approach, involves determining a company's value by analyzing the market value of a company's assets. This approach often serves as a valuation floor since most companies have greater value as a "going concern" than they would if its assets were liquidated in an orderly manner. This is because the "present value" of future cash flows generated by the assets including certain intangible assets usually exceeds the liquidation value of the tangible assets. The difference between the asset value and going concern value is commonly referred to as "goodwill".

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 be reflected on the balance sheet, but which might have considerable value to your company and a buyer, such as trade names, patents, customer lists, etc. Ultimately the primary value assigned to the intangible assets is derived from their ability to create cash flow. This leads back to the Income Approach which is discussed below.



The Market Approach

The Market Approach involves methods that use transactional data from completed "deals" to help determine a company's value through comparison analysis. These Deal Databases include private and public company transactions. The theory behind this approach is that valuation measured by similar companies that have been sold in arms-length transactions should represent a good way for helping estimate the value of your Company. Adjustments are commonly made to these valuation measures before comparison to the subject company to ensure an "apples-to-apples" analysis. 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. The biggest problem with the private company transactions is ensuring that the reported data adheres to the rigors of professional valuation.

- Guideline Public Company Method – This method involves using public company market multiples derived from their stock prices for companies in the same or similar industries as your company. The public company multiples usually need to be discounted significantly to reflect the higher risks (e.g., size, customer concentration, management depth, access to financing, etc.) inherent in most smaller private companies as well as the "lack of marketability" and liquidity of a private company.

Income Approach

The limitation with the Market Approach is the lack of "quality" or consistency in the transactional data. Most private company "databases" are suspect for several reasons. First, they do not adhere to the all-cash at closing requirement because of earn-outs or seller financing. This typically overstates "multiples". Because the information on private transactions is confidential and unverifiable, this typically leads to overstatement also. I do think transaction databases are useful if used by skilled valuators.

The Income Approach

The Income Approach involves converting future anticipated economic benefits (e.g., cash flow) into a single dollar amount expressed in "Present Value". "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 the Income Approach are the Single Period Capitalization Method and the Multiple Period Capitalization Method.

- Single Period Capitalization Method – This method involves converting representative (based on some type of averaging) 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 number of years.

- 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 (based on similar assumptions used in the Single Period Method) 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 non-constant growth rates. The discount rate used must be consistent for the "income" being used for discounting. The assessment of discount rates is an advanced topic for another venue.

The Income Approach is the dominant method used by professional "buyers". Ultimately they are looking to invest their money (and their clients) at an attractive rate of return (i.e. Capitalization Rate).of assets owned by the company, other types of appraisers (e.g., real estate,

Conclusion

The methods discussed above are the most commonly used by business valuation professionals. Although considerable time and effort is involved in preparing formal, certified business valuations, the results will only reflect a realistic value of a if it has factored in the current market conditions. This is where Professional Investment Bankers (like CFA) play such an important role. They have the ability to combine the academic side of valuation professionals with the market realities to advise their clients on price expectations. A skilled intermediary should be able to use your historical financials (past 5 years) and an interview with you about your company and its industry to give you a very reasonable estimate. They will assess your company's strengths and weaknesses and factor in current market conditions relative to qualified buyers. It should take less than 20 hours to develop a good estimate of value.

For example, most companies that CFA represents are in the lower middle market ($5 to $50 mm valuations). They will typically have a "cost of capital" between 20 to 25% depending on their size, consistency of profitability and the nature of their business. This discount rate will be lowered by the company's expected growth rate (if positive). Let's assume the growth rate is 5% and that it's cost of capital was 25%, then its discount rate would be 20%. Let's assume that a company's profit (cash flow) was expected to grow from $3 million in 2010. A 20% discount rate would produce a value of $15 million (i.e. a 5 multiple). Typically for an estimate of market value I use a plus or minus 10% yielding a valuation range of $13.5 to $16.5 million.

I want to use our recent economic environment to explain how the Income Approach makes "common sense". Most companies "profitability" are down relative to 2008 and the cost of capital for most companies is up because of perceived higher risk in profit and growth expectations. This yields a lower valuation than would have existed in 2008.

Professional Bankers can assist owners improve sellers price expectation to the high side of the range by identifying qualified buyers and creating competition (the key to maximizing value). By screening several very interested, qualified buyers and making sure they understand the "process", buyers compete for the opportunity to acquire your company. Often owners do not hire professional help and end up negotiating with only one buyer. This naturally leads to a lower price.

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