Business Valuation

Business valuation goes far beyond simple multiples. To get some idea of what your business might be worth, we will discuss three methods of valuation…

It's likely your business is your largest asset so it's normal to want to know what it is worth. However business valuation is what might be called a "subjective science."

The science part is what people learn in school: an MBA or a finance degree is a start, or you can become a business valuation professional by learning the theory behind business valuation and earn professional credentials.

The subjective part is much harder because every buyer's circumstances can be different. Therefore two buyers could look at the same set of company financials and offer vastly different amounts to buy the business.

Click the link below to see the full article which provides the basic science and math behind the three most common business valuation approaches. Keep in mind that there will always be outliers that fall well outside of these frameworks. These are called *strategic sales*, where a business is valued based on what it is worth *in the buyer's hands*. Strategic acquisitions, however, represent the minority of acquisitions, so use the three methods presented here to triangulate around a realistic value for your particular company.

Assets-based
The most basic way to value a business is to look at the value of its hard assets minus its debts. For example imagine an electrical contractor company with trucks and tools and other equipment. These hard assets have value, which can be calculated by estimating the resale value of the equipment.

This valuation method often gives the lowest value for your company because it assumes your company does not have any "Good Will." In accountant jargon, "Good Will" has nothing to do with how well-liked your company might be; Good Will is defined as the difference between your company's market value (what someone is willing to pay for it) and the value of your net assets (assets minus liabilities).

Typically, companies have at least some Good Will, so in most cases you will get a higher valuation by using one of the other two methods described next.

Discounted Cash Flow
In this method, the buyer is estimating what your future stream of cash flow is worth to them today. To begin they must try to figure out how much profit your company expects

to make in the next few years. The more stable and predictable your cash flows, the more years of future cash they will consider in their value determination.

Once the buyer has an estimate of what the company's profit is likely to be in the foreseeable future, and a valuation of what your business is likely to be worth when they want to sell it in the future, the buyer will apply a "discount rate" that takes into consideration the time value of money. The discount rate is determined by the buyer's cost of capital and how risky they perceive your business to be.

Rather than getting too concerned with the actual math behind the discounted cash flow valuation technique, it's best to understand what affects your value when using this method. They are: 1) how much profit the business is expected to make in the future; and 2) how reliable those estimates are.

Keep in mind that with business valuation approaches there will always be one that is better suited for your business given the data that is presented. . For example, if you are using Discounted Cash Flow to value the company, the hard assets owned by the company are assumed to be integral to the generation of the profit the buyer is purchasing and therefore not added yet again to your company's value.

A money-losing landscaping business owning a $2 million piece of land is going to be better off using the Asset-based valuation method; whereas a consulting firm that expects to earn $500,000 in profit next year, but has little in the way of hard assets, will fetch a higher valuation using the Discounted Cash Flow method or the Comparables technique described next.

Comparables

Another common business valuation technique is to look at the value of comparable companies that have sold or for whom their value is public. For example, accounting firms typically trade at one times gross recurring fees. Home and office security companies trade at about two times monitoring revenue, and most security company owners know the Comparables technique because they are often getting approached to sell by private equity firms combining small security firms. You typically can find out what other companies in your industry are selling for by asking around at your annual industry conference.

The problem with using the Comparables methodology is that it often leads owners to make an apples-to-oranges comparison. For example, a small medical device manufacturer might think that, because GE is trading for 20 times last year's earnings on the New York Stock Exchange, they too are worth 20 times last year's profit. However, when looking at the more than 13,000 businesses analyzed through the The Value Builder System, it's clear that a small medical device manufacturer is likely to trade closer to five times pre-tax profit.

Smaller companies are deeply discounted when compared to their Fortune 500 counterparts, so comparing your company with a Fortune 500 giant will typically be disappointing.

Finally, the downside of selling your business is that you don't get to decide *which* methodology the buyer will choose or what combination of weight they will apply to each approach. A buyer will do the math on what your business is worth *to them* behind closed doors. If they decide your business is strategic, plan to back up the Brinks truck because you're about to get handsomely rewarded for your company. But in most cases, a buyer will use one or a combination of the three approaches described here to come up with an offer to buy your business.

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