

Chapter 3: Summary of Business Valuation Approaches

There are three basic approaches to valuing a business. These approaches are the: (1) cost (asset based), (2) market, and (3) income approach. Sometimes these approaches provide similar values, but often times there may be wide discrepancies between the cost approach versus the income and market approaches due to goodwill not being incorporated in a cost approach.

Overview

A summary of the main business valuation approaches can be seen in Table 3-1.

Table 3-1: General Valuation Methods

Approaches	Valuation Methods	Techniques
Cost	<i>Underlying Assets</i>	Adjusted net asset value, liquidation value, book value.
Market	<i>Multiples of public stock data or private transactions</i>	Price/earnings, price/dividends, price/gross cash flow, price/book value, price/revenue, price/net asset value, invested capital/sales, invested capital/cash flow, invested capital/pretax cash flow, invested capital/EBITDA, multiple of owner’s discretionary earnings, rules of thumb, etc.
Income	<i>Capitalization</i> <i>Discounted Future Earnings</i>	Capitalization of earnings, net cash flow, pretax cash flow, etc. Discounted net cash flow, future earnings, owner’s discretionary cash flow, etc.
Other		Excess earnings, company or industry specific methods, etc.

Cost Approach

First, the cost or asset approach equates the book value to the market value of a business. Asset values may be determined based on the book value, adjusted book value, or estimated liquidation value of the company. If the book value of the equity equates to the market value of the equity, then this is coincidental. Generally, book value which is nothing more than an accumulation of historical earnings that were not otherwise disposed of, does not usually reflect the fair market value of the stockholders' equity. As a result, an adjusted book value approach is often utilized.

Adjusted book value substitutes adjusted fair market values for book values on a balance sheet. Usually, the tangible non current assets are individually appraised, and the current assets and debt are reviewed to determine adjusted values. The most recent balance sheet statement at or close to the appraisal date is utilized. Book value considers only historical accounting costs and, in most instances, cannot be considered as a reliable indicator of the market value of invested capital. In some cases, the intangible assets are also appraised.

Another method, the estimated liquidation value, estimates the net value which can be obtained through individual sales of the business assets (e.g. equipment, accounts receivable, real estate). It requires no consideration of earnings, goodwill, or going concern value, because the presumption is made that the business enterprise will no longer be ongoing. Estimated liquidation value is considered only when the underlying assets are worth more if the business is terminated and the assets are sold individually rather than being sold as part of a going concern.

Market Approach

Second, the market approach compares the business ownership interest in a company to similar business ownership interests that have been sold in the market, based upon some multiple. Examples of the market approach include the Guideline Company Method (using publicly traded companies), market transactions in the ownership of the subject company, and prices paid for similar companies in the merger and acquisition marketplace. Due to the lack of available public information on the mergers and acquisitions of similar companies, most people rely upon the guideline company method (publicly traded company information).

The guideline company method is an investigation of publicly traded companies which are similar to the subject company with regard to service, performance, or markets exploited. Market multiples for the comparable, publicly traded companies are then determined based on the ratio of the market price of their invested capital to various parameters, such as earnings, cash flows, book value, etc. In selecting multiples for the subject company, consideration is given to the relative financial condition and operating performance of the publicly traded comparables.

For very small companies, some multiple of owner's discretionary cash flow, or percentage of sales is often used based upon actual sales of smaller businesses.

A summary of the value premises, mechanics, and advantages/disadvantages can be seen in Table 3-2. Summary

Table 3-2: Advantages and Limitations of Valuation Techniques

	Cost	Market	Income
Typical Techniques	Accounting book value, adjusted book value, liquidation value	Guideline public company multiples, merger and acquisition comparables, industry rules of thumb, prior transactions in the subject company's stock	Capitalization of earning power; discounted cash flow
Premise	Value depends on cost to reproduce/replace "as is." The perspective is backward looking where asset values are critical	Value depends upon comparative value where the perspective is sideways-looking and where value is based upon recent transactions or trades	Value depends on future cash returns to the owner
Mechanics	Identify and appraise "stated" assets and off-balance sheet or "unstated" assets; consider combined value	Analyze the assets' fundamentals and select "comparable" companies or transactions	Project the cash flows (often on a borrowings free basis); calculate a discount and capitalization rate; calculate the residual (terminal) value; sum the present value of the residual value and the present value of the cash flows
Advantages	Good for companies with losses or poor earnings, for certain financial institutions, and for real estate or other asset intensive businesses	Good data since it is based upon arm's length transactions; IPO pricing is often done based on comparables; there is a large pool of data	Reflects purchaser's real perspective, incorporates synergies, and is theoretically valid
Disadvantages	Cash flows may not equate to asset value; intangibles are not typically recognized	The concluded value may be imprecise since "comparables" are not actually or truly comparable	There is substantial subjectivity regarding projections, discount rate and the horizon or duration of the business

Source: Stewart, Stephen A. "Using Valuation Skills for Profit;" Unpublished Presentation; Fulcrum Information Services Conference: The Valuation Institute, San Francisco California, March 27-28, 2000.

Income Approach

A third method of value determination is the income approach. This technique requires that the earning capacity of the appraised company be investigated and that the expected earning capacity be capitalized at a rate sufficient to satisfy the investment and business risk requirements of ownership. The application of this approach usually requires a sufficient earnings history to provide a clear indication of expected future performance.

This approach to value may take many forms: a discounted cash flow model, the capitalization of stabilized earnings, an excess earnings approach, etc. For intangible assets, this may include a relief from royalty concept, the capitalization of earnings, or a loss of income/cash flow savings methodology. No matter what technique is chosen, consideration must be given to the selection of the appropriate discount rate.

Reconciliation

After the analysis has been completed it is important to understand the reconciliation process, and the limitations of each analysis for the respective company being valued. These limitations can be summarized in Table 3-3.

Table 3-3: Usability of the Three Business Valuation Methods

		Company Growth			
		←			→
		Declining	Low	Moderate	High
Cost		Medium/High	Medium/High	Medium/ Low	Low
Market		Low/Medium	Medium	Medium	Medium/Heavy
Income		Low	Low/Medium	Medium/ Heavy	Medium/Heavy
		←			
		Strength (Weighting) of Each Technique			

Exceptions to the above rules are observable, but Table 3-3 gives a good overall indication of the strength of each valuation method.