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Methods of Valuing a Business

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Business valuation is a mixture of art and science wrapped up in a professional's opinion. But in the real world, the value of a business is what a buyer will pay for the enterprise. How a buyer can determine a fair value can be based on methods described below. Each of these methods may have variations depending on application and specific situations. It's common to value a business by a number of different methods and use a weighted average for the final valuation.

There are a number of reasons to value a business but for purposes of this article we will limit our scope to valuing businesses for the purpose of buying and selling. Below are the approaches with specific methods used within each.

1. The Income Approach

This is the most widely recognized approach to estimating economic value. The income approach is an income-oriented method of estimating economic value. It involves estimating the amount of future income/earnings that will be produced by a business along with and the expected rate of return required by the investor to determine an estimated value. There are two different methods within the Income Approach.

The first method is the **Capitalization of Earnings Method**. The term capitalization refers to the process of dividing a known or assumed amount of return on an investment by a known or assumed rate of return to determine the principle to invest. You take the estimated net income (adjusted earnings) by an estimated rate of return resulting in an investment value.

$$\text{Investment Value} = \text{Adjusted Earnings divided by Capitalization Rate}$$

While the mathematics of the capitalization is quite simple, the process of estimating net earnings and selecting the appropriate capitalization is complex. The following outline is simplified and shows the basic steps of the capitalization of earning method:

1. Determine the type of earnings to be capitalized.
 - Owner's discretionary income (includes owner salary)
 - Earnings before interest, taxes, depreciation and amortization
 - Earnings before interest and taxes
 - Net Profit After Tax
 - Free Cash Flow
2. Prepare a recast statement of earnings based on historical earnings.
3. Choose a capitalization rate.
4. Calculate the investment value.



The capitalization method is used when growth of the company is forecasted to be flat or less than 5% annually. When growth is expected to be greater than 5% it would be appropriate to use the **Discounted Future Earnings Method**.

In applying the discounted future earnings method to estimating economic value, the amount of future earnings from the business is estimated for each forecasted period. The estimated earnings for each year are then discounted at the appropriate discount rate to determine their present value. The present value of each period of estimated earnings for all future years are then added to determine the total present value. The last step determines what we call the terminal value. It's the residual value of the property at the end of the period of years being estimated. This value is discounted to its equivalent present value and added to the present value of the future earnings to determine total economic value. This method is most often used in merger and acquisition valuations.

2. Market Data Approach

In estimating the value of businesses using the market data approach the valuator attempts to identify publicly and privately held businesses that have been sold, which are similar to the one being appraised. The appraiser then uses information about the selling prices of these businesses as a basis for estimating the value of the business being appraised. As one uses this type of approach it is important to appropriately compare the size of the business being valued.

Over recent years more and more information on privately-held business sales are being documented among business brokers and intermediaries, it is still sometimes difficult to obtain information on past business transactions due to the uniqueness and scarcity of data. One should be very careful to make sure you are comparing apples to apples in transaction data.

3. Tangible Assets (Replacement Cost Approach)

In some instances, a business is worth no more than the value of its tangible assets. This would be the case for some (not all) businesses that are losing money or paying the owner(s) less in total than fair market compensation. You would adjust the assets values up or down on the balance sheet to their present fair market value less the company's liabilities.

4. Cost to Create Approach

Sometimes companies or individuals will purchase a company just to avoid the difficulties of starting from scratch. The buyer will calculate the company's his or her start up costs using costs incurred and time expended.

This method can be used for the business as whole or certain assets such as copyrights and patents. Various proprietary items such as trade formulas or processes, customer lists, are other examples of assets that can also be valued by means of the cost to create approach.



5. Rules of Thumb

What are rules of thumb? Rules of thumb or industry formulas are supposedly market derived units of comparison (from Market Data Approach). The multiple or percentage contained in the formula is an expression of the relationship between gross purchase price and/or some indicator of the operating results of the business (Sales, Net Profit, Gross Profit...etc.).

Since these formulas are statistically derived from the sale of many businesses of each type. You have to be very careful because the formulas are based on averages. Not all businesses operate at the industry average, which would overvalue or undervalue a business if the rule of thumb was applied. They do serve their purpose if the appraiser can determine the business operates in the averages of the industry.

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