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Valuing a private business: Three approaches

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According to recent data, more than half of business owners are over 55. As these owners think about the next phase of life, many wonder what the lifetime of effort they put into building their business may be worth.

Planning around transitioning ownership, whether by sale or by transferring (or gifting) to the next generation, requires an understanding of the value of the business.

Any business owner likely understands that their business makes up a large portion, if not the majority, of their personal net worth. But figuring out the value of a private business may seem mysterious and even overwhelming.

The toolkit to valuing a business consists of three approaches: asset, income and market. These approaches can be used in isolation or combination.

Circumstances specific to the business, location, employees, industry and economy will dictate which approaches are best in each circumstance.

Asset approach

The asset approach, sometimes called a cost approach, is based on the principle of substitution, where an investor would not pay more for an asset than it would cost them to build or purchase a similar asset.

This approach derives the business's value by estimating the value of each of its underlying assets (both tangible and intangible) and liabilities.

This approach is most appropriate for valuing real estate; investment holding companies; capital-intensive companies, such as construction companies with large quantities of equipment; or even very early-stage companies that have yet to produce earnings.

Income approach

The income approach is primarily employed for valuing operating companies that already are, or are expected to become, profitable. This approach generally considers future earnings and the risk of achieving those earnings.

The income approach can be performed in two ways: the discounted cash flow (DCF) method and the capitalized cash flow (cap cash flow) method.

The DCF considers projected cash flows, often a few years' worth, and then discounts the cash flows to present value. Experts use a discount rate (often called a rate of return) that reflects the risks of achieving the projections.

The cap cash flow method is a simplified version of the DCF that considers only one period of cash flow. This period is divided by a rate of return that is adjusted for growth. This method is typically used when long-term stable cash flows are expected.

Market approach

The market approach determines value based on similar investments in the marketplace. There are three common methods used under the market approach: (1) prior transactions in the subject company's stock, (2) the guideline public company method, and (3) the transaction (merger and acquisition) method.

All three methods involve analyzing comparable companies whose equity has sold and the multiples they sold for. The sales price is divided by a measure of the company's earnings to understand the multiple they traded for as a guideline to determining what multiple might be appropriate for the company being valued.

For example, if a company is sold for $100 million and it has $200 million in revenue, its revenue multiple is 0.5x ($100M/ $200M). A valuation expert would look at the traits of that company to determine whether the same 0.5x revenue multiple should be used in valuing the subject business, based on its attributes.

Arriving at a conclusion of value

To arrive at a conclusion, a valuation expert considers the applicability of each of the approaches to value and the availability of data.

In any analysis, the value of a business will consider multiple factors, including its financial performance; the risk of achieving projected results; factors specific to the company such as employees, operations and equipment; and the state of the economy and/ or industry.

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