GENERATING AN ACCURATE BUSINESS VALUATION: IMPORTANT CONSIDERATIONS FOR THE INCOME, MARKET AND ASSET APPROACHES

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EXECUTIVE SUMMARY

The three major approaches to business valuation - the income approach, market approach and asset approach - must be navigated successfully to generate an accurate business value. This whitepaper includes an overview of the approaches, along with associated methods, and a discussion of the challenges with each approach.

Whether you are new to business valuation and looking for a useful overview or you are preparing to scale a mature valuation practice, this whitepaper can help. Additionally, this resource can be used as training material for new hires in business valuation practices.

INTRODUCTION

Performing quality business valuations is a major factor in successful deals among brokers. According to researchers from Pepperdine University, a valuation gap in pricing is the leading cause for sale engagements ending without a transaction. The process of business valuation can be arduous, but using the major approaches along with professional judgment allows the valuation professional to reach the appropriate value of a company. However, it is necessary to recognize that each approach includes specific considerations that ought to be taken into account.

INCOME APPROACH

Income Approach

The most frequently used method is the income approach, which focuses on converting the anticipated future income of a company into a present value. Within this approach, a business valuation professional can choose to use the discounted future benefits method, capitalization of benefits, capitalization or capitalization for excess earnings. One commonly used method is discounted future benefits, sometimes referred to as discounted cash flow.

The idea behind this method is that a potential investor values $1,000 today more than they value $1,000 in 3 months, 12 months or 10 years. To invest $1,000, accounting for opportunity cost and future uncertainity, they must be compensated in the form of a price discount. Critical to this calculation, one must determine an appropriate discount rate.

The formula below can be repeated for each year included in the calcuation and then summed to determine the net present value.

$$DCF = CF_t / (1+r)^t$$

DCF = Discounted cash flows

CF_t = Cash flow in period t

r = Discount rate

INCOME APPROACH (CONT.)

Valuation experts using different valuation techniques will need to make adjustments accordingly. Essentially, future cash flows from an asset are discounted to account for uncertainty as well as the required return to potential owners. Below are some of the common pitfalls associated with the income approach that valuation professionals face:

- **Relying on the business:** There is a lack of public information when using the income approach, and the valuation professional must access the company's books to gain all of the necessary data to complete the valuation. These company books have withstood less public scrutiny and can be flawed. Any errors with the company's books will cause problems in the valuation.
- **Non-predictability:** Future cash flows are uncertain, especially for smaller companies. The dependence on hypothetical projections results in lower values.
- **Using a required return:** Potential investors in smaller businesses should be compensated for increased risks associated with a smaller business. If the investor uses the required rate of return that is needed for a larger company, then the investor could overpay. The valuation expert therefore needs to be clear about the required return for customers.
- **Under-forecasting growth:** Some businesses grow so fast that a valuation professional could under-predict the growth and inappropriately reduce the current value. This leaves a potential investor turning down beneficial opportunities or an existing owner not receiving proper compensation.

Market Approach

When using the market approach, business valuation experts determine value by comparing a company to other companies in the same industry, of the same size and/or within the same region. The main methods within the approach are guideline public company, merged and acquired company, and prior transaction in subject company. For a "back of the napkin" value, use the rule of thumb method. The market approach is best used in addition to other valuation approaches, as there are several drawbacks:

- **Finding matches:** The greatest pitfall of the market approach is a lack of true comparable transactions. Sales events do not take place endlessly and every company is unique, so it often becomes a task of forcing a square peg in a round hole. Additionally, finding a true comparison can lead to manipulation of data to fit the biases of the valuation professional of the client.
- **Using public companies to value private companies:** The scale and complexity of many public companies oftentimes makes them unfit for private company comparison. This is not simply a matter of the much larger size (comparing a local pizza place to Dominos); it is a matter of complexity. Half of Dominos' revenue is generated in 75 international markets, and 97% of Dominos' stores are owned by independent franchisees.

> Beware quick comparisons between public and private companies

This is often true and requires a valuation expert to do considerable analytical work on the public entity to make it a truly comparable business. It also requires the public business to disclose more than is typically required by the SEC and to do so on a consistent basis.

- **The only constant is change:** Using comparable transactions is inherently retrospective when valuation is forward-looking. Using a past-based valuation to reach a current valuation requires a poorly informed assumption that all factors within a market are constant over time. One example of constant change is the expectations around interest rates, which change by the week and impact the valuation of all assets. To avoid this pitfall, the professional should make his or her own predictions about the future and the generate valuation from there.

VALUTATION CAN LOOK FORWARD,

helping business owners define

strategies for growth

Asset Approach

The asset approach is most commonly used for a company preparing for liquidation or one that is based on its assets. It uses the value of the company's tangible and intangible assets as well as the liability to determine value. Unlike the income and market approaches, the asset approach focuses primarily on the company's balance sheet. The valuation professional will begin with a recent balance, then mark certain items to market and add off-balance sheet items that would be relevant to an acquirer. Marking to market, also known as re-valuing, is the area where the valuation professional uses their own judgment and strategic thinking.

Certain items, like cash accounts, receivables and accounts payable are relatively easy to value, but other items are considerably more challenging. There are several issues that come with the asset approach.

- **Valuing property, plant and equipment:** PP&E is often one of the largest items on the balance sheet and represents the most stored value. This is especially true for manufacturing or asset-heavy service businesses. Assessing these items on the balance sheet has a few drawbacks. The valuation professional has expertise in the area of finding the value of a business, but not necessarily land or used equipment. This creates a potential pitfall because valuing these items requires a different set of skills.

  Marking these items to market requires a significant amount of estimation because as there are no public markets for these items.

ASSET APPROACH (CONT.)

The forecasted value for PP&E based on its useful life is not necessarily what the market would pay for it. Land similarly requires some combination of comparable transactions and intrinsic value to have a quality estimate for the asset approach.

- **Off-balance sheet items:** The asset approach begins with the balance sheet, but does not end there. Valuing off-balance sheet items like lease obligations, pension and healthcare related obligations and intangible assets is inherently challenging. Retail businesses have large lease obligations that function more like assets and liabilities. These items would be included in the asset-based valuation, which is where the expert can run into issues.

  Additionally, intangible items such as goodwill, trademarks and patents are difficult to value and pose more challenges to the asset-based approach. This is one of the reasons why the asset approach is not particularly effective for asset-light companies like software businesses where most of the company's value is intangible. The valuation professional is left to estimate the market value of this intellectual property using comparable companies, which may require consulting an outside expert.

- **Liquidation:** The valuation professional is expected to value items at their market value but if there is a liquidation occurring, particularly as it relates to bankruptcy, then the market will undervalue the assets of the distressed company. This raises the issue of the valuation expert not using true intrinsic value but rather the dramatically undervalued market price.

CONCLUSION

Determining an accurate valuation requires a blend of the three approaches and the methods associated with each. Using only one approach will lead to an insufficient (and inaccurate) result for most business owners. Even though private company valuation is designed to follow a common set of rules to create a consistent framework for valuation, there can be significant swings in value depending on how the valuation professional choses to execute the engagement. Having a consistent process for valuations can help create not only a great service for clients but also repeat business for the valuation practice.

Business valuation demand is on the rise and will continue as business owners in the baby boomer population reach retirement age. Additionally, M&A activity reached an all time high in 2015.

Valuation professionals can perform quality business valuations to support this growth by familiarizing themselves with the nuance of each approach and method.

ABOUT **SAGEWORKS & THE AUTHOR**

Sageworks provides a web-based, professional-grade valuation solution that helps valuation professionals simplify their processes and create opportunity for growth in their practices. Valuation experts leverage the software to reduce errors and save time in performing valuations compliant with SSVS No. 1.

For more information about Sageworks Valuation Solution, please visit: https://valuation.sageworks.com/.

About the Author:

Bakley Smith, CFA, is the founder of Lead Agency, a service that connects top businesses with strategic, marketing and financial resources. He resides in New York City with his wife. Read his Blog.

ADDITIONAL **RESOURCES**

Investopedia: Introduction to Discounted Cash Flow Valuation
http://www.investopedia.com/walkthrough/corporate-finance/3/discounted-cash-flow/introduction.aspx

Whitepaper: Changes in the Business Valuation Industry, June 2015.
http://web.sageworks.com/valuation/whitepaper/changes-in-the-business-valuation-industry-opportunities-and-pitfalls/

Whitepaper: Business Valuations Challenges and Opportunities, updated June 2015.
http://web.sageworks.com/business-valuations-whitepaper/

Checklist: How to Win New Valuation Clients.
http://web.sageworks.com/valuation/how-to-win-new-valuation-clients-checklist/

Dealogic, M&A Statshot, June 22nd, 2015.
http://www.dealogic.com/media/market-insights/ma-statshot/

Sageworks Valuation Resources
https://www.sageworks.com/valuation/resources.aspx