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3 Common Business Valuation Methods

If you watch a television show like Dancing With The Stars or America's Got Talent, it may seem that the judges' scores are arbitrary and subject to interpretation that our untrained eyes don't understand. We may think a dazzling effort was made, but then the performance receives low scores. How do these judges reach their results? What methods or factors do judges consider?

In the world of business valuation, understanding the results of a valuation report can also be a challenge. Questions may arise such as:

- How was the concluded value reached?
- What valuation methodologies could have been applied?
- What valuation methods were utilized?

Whether you are valuing an entire business enterprise, real or personal property, intangible assets (such as during a purchase price allocation), options or other derivative securities, etc., there are three general approaches to determining value: (i) income approach; (ii) market approach; and (iii) asset (or cost) approach. Each approach contains different methodologies based on varying factors. It is the role of the valuation analyst to determine which of these valuation methodologies to consider, apply and ultimately rely upon to reach a concluded value. The following summarizes each of the general approaches as well as the most common valuation methodologies associated with each approach used specifically in business valuation.

Income Approach

In general, income-based valuation methodologies convert an anticipated future benefit stream (e.g., cash flows or earnings) into a single amount by discounting that benefit stream to present value using an appropriate discount rate. In other words, any income approach is predicated on determining the present value of a future benefit stream. The income approach generally consists of two methods: single-period capitalization and multi-period discounting. The following summarizes these two most common forms of the income approach used in the valuation of businesses.

- *Capitalization of Cash Flow Method*: This method (sometimes referred to as the "CCF Method") values a business based on a single expected cash flow stream, capitalized by a risk-adjusted rate of return. It is most appropriate to utilize the Capitalization of Cash Flow Method when a subject company (i) has current or historical results that are believed to be representative of future results; and (ii) is only projected to grow at a sustainable and modest growth rate. In general, this approach is often used for companies that are mature in nature and are experiencing a relatively consistent stream of revenues and earnings.

- *Discounted Cash Flow Method*: The Discounted Cash Flow Method (commonly referred to as the "DCF Method") is a multi-period discounting model that determines the value of a business based on the present value of its expected future benefit stream. Specifically, the DCF Method is based on the theory that the value of a company is equal to the sum of both (i) the present value of projected future benefits over a specific, discrete period and (ii) the present value of a residual value. The discrete period encompasses the period of time extending through the point that future cash flows are expected to stabilize before growing at a constant rate into the future, while the residual value represents the present value of all cash flows beyond the discrete period. The DCF Method projects the distributable cash flows a business is expected to generate and discounts those cash flows to a present value basis as of the date of analysis using an after-tax, risk-adjusted cash flow rate of return. Distributable cash flow is used as the benefit stream in this analysis as it represents the earnings available to distribute to investors after considering the reinvestment required to fund a company's future growth. In general, the DCF Method is often used for companies that expect varying levels of revenue and earnings growth in the future.

Market Approach

Valuation methodologies under the market approach calculate value based on the prices paid for ownership interests in companies similar to the subject company. In business valuation, there are two principal methods used in the market approach, as follows:

- *Guideline Transaction Method*: The Guideline Transaction Method values a business based on pricing multiples derived from the sale of companies that are similar to the subject company. The steps taken in the guideline transaction method include finding transactions involving the purchase of comparable companies, selecting the transactions that closely mirror the company's operations and which occurred in similar industry and economic conditions, and finally, applying the indicated pricing multiples from the representative transactions.

- *Guideline Public Company Method*: The Guideline Public Company method values a business based on trading multiples derived from publicly traded companies that are similar to the subject company. The steps taken in the guideline public company method include identifying comparable public companies, adjusting the indicated multiples for differences in size and risk relative to the subject company, and then applying pricing multiples from the representative companies. Ideally, the selected guideline companies compete in the same industry as the subject company; however, when such publicly traded companies do not exist (or exist to a small extent), other companies with similar characteristics such as markets served, growth outlook, risk profile or other relevant factors can be considered. In both the Guideline Public Company Method and the Guideline Transaction Method exact comparability is not required, though closer comparables are preferred.

Asset Approach

In business valuation, the asset approach is a valuation technique that determines the value of a subject company based on the market value of its assets and liabilities. The primary valuation methodology used in the asset approach is the Adjusted Net Asset Method, which is summarized below.

- *Adjusted Net Asset Method*: In the application of the Adjusted Net Asset Method, a company's equity value is calculated as the difference between the fair market value of the company's assets and liabilities. Under this method, the assets are adjusted from book value to fair market value and the total adjusted assets are then reduced by recorded and unrecorded liabilities. Application of the Adjusted Net Asset Method typically establishes a “floor value” of a company that would be realized upon a sale of a company’s assets and satisfaction of its liabilities. This methodology is appropriate in the case of holding companies or capital-intensive companies, when losses are continually generated, or when valuation methodologies based on a company’s net income or cash flow levels indicate a value lower than its net asset value. Lastly, the Adjusted Net Asset Value Method does not explicitly incorporate any intangible asset value or goodwill of a subject company, which are more appropriately reflected in the values derived through the application of an income approach and/or a market approach.

Reconciling Valuation Methodologies and Conclusions of Value

Ultimately, the valuation methodologies considered and utilized in a business valuation engagement are at the discretion of the appraiser based on the factors associated with the specific engagement. If multiple valuation methodologies are utilized, the valuation analyst must also consider the extent to which the indicated conclusions of value should be relied upon. In some cases, one valuation methodology is given primary or even sole consideration. In other instances, each methodology may provide a reliable indication of value and a weighting of values (either explicit or implicit) must be considered.

A working knowledge of the common valuation methodologies applied during the course of a business valuation can prove vital in understanding the context and reasonableness of the conclusions within a valuation report, almost as if you were able to see the dancing show judges’ scorecards before they hold them up to the audience and contestants.

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