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How to Determine the Value of a Closely Held Business

The small business owner often needs to determine the value of their investment in a closely held business. Unlike an investment in public stock a small business owner cannot merely consult the Wall Street Journal to obtain the most recent fair market quote on their shares. Rather, the small business owner must estimate value. This estimation process typically requires a detailed analysis of the company's future growth, risk, industry outlook, and national and regional economic conditions, not an easy task. In fact, the inherent complexities in small business appraisal make the task seem virtually impossible to most small business owners.

Despite the complexities business appraisers use several approaches to determine the fair market value of investments in private equity. These approaches, which are based upon different economic theories regarding the value of corporations, include the following:

Income Approach

Market Approach

Asset Approach

Income Approach

The income approach is perhaps the most theoretically appealing methodology for valuing a closely held company, as the approach focuses on the economic variable that matters most to private business owners: the cash flow distributing power of their company. More specifically, methods within the income approach equate the value of a business to the present value of its future expected cash flows; that is, the value of a company is determined by estimating or projecting the company's future cash flows and discounting them to the present using a rate of return commensurate

with the risk of achieving the cash flows. The underlying economic rationale of the approach is that buyers price businesses on the basis of earning a fair rate of return on their investment given competing alternatives in the marketplace.

The two most common methods within the income approach include the discounted cash flow method and the capitalization of cash flow method. The discounted cash flow method is a multi-period model that involves projecting the company's net cash flow over a period of abnormal or unstable growth and then estimating value once the business has stabilized through application of a terminal value. The estimated cash flows and terminal value are then discounted to the present using an annual rate of return, commonly referred to as the discount rate. The present values are then summed together to determine the value of the business. This approach is most commonly applied to rapidly growing business or businesses whose cash flows have not stabilized.

The capitalization of net cash flow method is a short-form version of the discounted cash flow method that involves capitalizing (i.e. dividing) a single representative estimate of the company's sustainable net cash flow (i.e. typically current years or some weighted average of prior year's net cash flow) by a capitalization rate. The capitalization rate is literally the discount rate, or required annual return on the investment, less an estimate of the long-term sustainable growth rate in the company's net cash flow. This method assumes that the business will grow at the sustainable long-term rate (which can be positive, negative, or zero) into perpetuity. Therefore, the method is only appropriate for companies that have stabilized.

The net cash flow used in both approaches refers to the amount of cash that can be distributed to the owners without affecting the company's day-to-day operations or future growth opportunities. Warren Buffet often refers to this cash flow as the company's owner earnings. More specifically, owners' earnings, or net cash flow, refers to the normalized net income (on an after-tax basis) plus (a) depreciation, amortization, and non-cash charges minus (b) incremental investments in net working capital, minus (c) incremental investments in capital expenditures, plus/minus (d) net repayments of debt principal. The normalized net income should exclude non-recurring, non-operating, and unusual items, such as overcompensation to the owner.

The primary advantage of the income approach is its theoretical appeal; that is, the method specifically relates the price of a business to its future

expected cash flows and risk. In addition, the approach is very flexible, allowing the user to specifically communicate the economic variables driving value. The primary disadvantage of the approach is that it is sensitive to the inputs. For example, a very small change in the growth rate assumption or discount rate can have a significant influence on value. The model output is only as good as its input.

Market Approach

The market approach is an alternative valuation approach that utilizes the valuation multiples of comparable companies to determine the value of another company. A valuation multiple is merely a ratio of price to some underlying fundamental metric, such as revenue or pre-tax earnings. For example, if a comparable company with \$1,000,000 in pre-tax earnings, recently sold for \$5,000,000 the price-to-pre-tax earnings multiple would be 5x (i.e. $\$5,000,000 / \$1,000,000 = 5x$). The pricing multiple would then be utilized to value the company. The market approach is grounded in the theory of substitution, or the economic concept that similar assets should command similar prices.

The two common methods within the market approach include the publicly traded guideline company method and the private transactions method. The publicly traded guideline company method uses the pricing information of publicly traded companies as an indication of value. This method is generally appropriate for larger business where sufficient comparable companies can be found in the public marketplace. The private transactions method utilizes the sales terms of private market transactions. This method is generally more appropriate for smaller private companies. The transaction information can usually be obtained from a broker or a private market transactions database, such as Pratt's Stats.

The primary advantage of the market approach is that the approach is market based; that is, the pricing and valuation information comes from actual prices and sales transactions in the marketplace. Therefore, the market approach can often provide very timely and compelling evidence of fair market value. The primary disadvantage of this approach is usually lack of truly comparative data. Since most small private businesses are unique in some respect, this can become a significant obstacle. In addition, the underlying assumptions driving a pricing multiple (i.e. growth and risk) are usually hidden in market data. Therefore, a subjective adjustment is often necessary to make the multiple relevant for your company.

Asset Approach

The asset approach takes a different perspective of the company by examining the economic value of the company's assets and liabilities. The approach essentially involves the identification and revaluation the company's assets and liabilities, including the company's intangible assets and contingent liabilities. The method begins with the company's historical cost basis balance sheet. The balance sheet is then adjusted to fair market value. Some of the common adjustments include the write-off of bad debts and obsolete inventories and the revaluation of equipment and real estate to their current appraised values. The economic value of the liabilities is then deducted from the economic value of the assets to determine the economic value of the business equity.

The asset based approach can be used to value any business, but is usually more appropriate for an asset intensive business, such as an asset holding company. The method is usually less suitable for a business with substantial intangible value, such as a very profitable service business. Nonetheless, the asset based approach can often provide a minimum or "floor" value on a business with substantial intangible value.

The primary advantage of the asset based approach is its intuitive appeal. In addition, the method can help explain which specific assets and liabilities are contributing to the economic value of the corporation. The primary disadvantage of the method is that it can be expensive and time consuming to implement, especially if done properly. The method usually requires outside expertise from real estate and equipment appraisers, for example.

Conclusion

The valuation of a small business is as difficult task. Despite the complexities, however, the value of a small business can be estimated using one of several commonly accepted business valuation approaches: the income approach, the market approach, and the asset approach. The discussion above presented a very simplistic view of these three approaches. Each approach has strengths and weaknesses and each may be more or less suitable for different situations. The actual process of performing a detailed business valuation is much more complicated than the simplified explanations above. Typically, a detailed valuation will require an extensive analysis of the company's industry, customers, suppliers, facilities, outlook for growth, financial statements, and risks. In addition, the national economic outlook and other market conditions can have a dramatic impact on the fair market value of a private company's

shares.

If you would like to obtain more information about the appraisal of your company, please do not hesitate to contact our valuation services department.

- Joshua B. Angell, Valuation Analyst at Moore, Ellrich & Neal, P.A.