How to Value a Company

A Guide to Putting a Price Tag on Your Business

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Overview

Your business is probably your biggest asset, so it's important to have an accurate estimate of its value. The only problem is that company valuation is a complex discipline that involves several different factors. **How much is my company worth**? What is the best strategy for business valuation? What are the variables that drive the value of a company?

This whitepaper is intended to give you some basic insights on the most popular business valuation methods. You will also learn how to **value a company** starting with a standard framework. At the end of the paper, you should have a basic understanding and all the tools you need to conduct an elementary business valuation.

Introduction

Placing a valuation on your business is a complex procedure. It takes the perfect combination of science and expertise. Company valuations are an art, not a science. Quote too low a figure, and you will undersell your company; aim too high, and you will never sell.

Determining a fair value for a company is never an easy process. To the owner, the process of valuation is personal and emotional, and many times, they have an unrealistic idea of how much their company is worth. To the buyer, the valuation process is far more objective. In addition, is this a financial or strategic buyer? Both will look at "fair value" differently. Finding balance can prove to be extremely difficult.

A business valuation takes strategic and in-depth analysis to determine an accurate estimation of a company's worth. There are numerous factors included in the process of establishing a selling price and determining whether an investor's offer is fair. It takes more than just a range of numbers to value a company. However, the biggest factor that will affect the value of a company is, of course, how much a buyer is willing to pay.

With that in mind, this whitepaper will try to answer a small business owners' more stringent question: **how much is my company worth**?

Methods of Valuation

As stated previously, Company Valuations is not an exact science, and there are different ways one can estimate the **value of any business.** Each of these methods is based on different financial information and presumptions, which might result in a different value. For instance, one method is based on the expectation of future cash flows, while other is based on the value of the assets of business.

Whichever method is to be used to value a company, you should prepare a statement of income and profit/loss since most buyers request this document to estimate the cost of goods sold and operating expenses.

- **Discounted Cash Flow**

From the buyer's perspective, this is the most accurate way to **value a company** because it forces the business owner to give more attention to details like trends in sales and profits and the capitalized value of the company. This method of valuation reflects the amount of money the investor estimates to come into the business in the next few years. Based on these cash flow figures, a buyer can determine their return on investment.

There are three critical questions one needs to answer to capitalize future earning:

- ***Value:*** How much is the business worth today, based on what it will earn in the future?
- ***The Rate of Return*:** What is the investor's expected rate of return?
- ***Equity Share*:** How much equity will the investor get for their investment?

Once the investor has an estimate of future cash flow, they determine the *discount rate*, which takes the time value of money into consideration. This variable is established by the buyer's capital cost and how sensitive they believe the business or the industry to be.

To make things easier, keep in mind that there are two important factors that impact the value of your business when using this method: expected earnings to make and how solid those predictions are.

- **Assets-Based**

The most common way to **value a company** is to determine the value of its hard assets. The assets usually purchased in a buy-sell process include merchandise, inventory, equipment, sales, office supply (hard assets) and intellectual properties, brands (the soft assets) and the goodwill.

One of the most important assets that need to be considered and evaluated in the buy-sell process is goodwill. From an accounting point of view, goodwill is defined as the difference between you business's market value and the worth of your hard assets. However, goodwill can also refer to the value of the loyalty of your business's customers, and it's connected to a good name, reputation for stellar products and customer service, experienced personnel, and favorable location. Most companies have a collection of intangible assets in the form of patents, people, special procedures, intellectual properties, licenses and brand recognition that add to their value.

There are instances in which evaluating a business by asset appraisal is more efficient than the discounted cash flow method. For instance, a money-losing restaurant with a real estate value of $1 million is going to benefit more from the asset-based method, while a software company that estimates a $3000,000 in profit this year, but has few assets, will gain a more profitable valuation with the discounted cash flow technique. A discounted cash flow (DCF) is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them to arrive at a present value estimate, which is used to evaluate the potential for investment.

- **The Comparables Approach**

Another way to value a company is to analyze the financial worth of comparable businesses that have sold in the recent past. However, the issue with this method is that it often leads owners to make wrong assumptions. For instance, a small accounting firm might believe that since Deloitte is trading for 12 times last year's earning, their company is worth at least 12 times last year's profit. However, in most situations, the reality is completely different. Size, depth of management, not being driven by one or a few owners are just a few reasons why smaller company's multiples of earnings can be a third to one-half of those in the same industry but Fortune 1000 in size.

A Framework for Business Valuation

Any business owner looking to sell their company can benefit from understanding the basic science behind valuation and the factors that drive the value of a company. An accurate estimate of the value of your company will make a buyer or investor consider your business while poor evaluation can impact their decision.

So, how do you **value a small business**?

Here is an outline that might help you get an accurate answer to your question: "**How much is my company worth**?"

- **Step One:** Calculate the Seller's Discretionary Cash Flow (SDCF)

The starting point of any business valuation, whether big or small, should be to determine the *Seller's Discretionary Cash Flow* (SDCF) or Total Owner's Benefit.

SDCF refers to the pre-tax earnings of business before the owner's salary, non-cash costs, charitable donations, leisure activities, business-related expenses, any personal costs, as well as one-time expenses like the settlement of a lawsuit.

The great thing about SDCF is that it gives business owners an idea of their company's true cash flow potential.

SDCF can be determined as follows:

- Begin with the pre-tax earnings of your business;
- Add non-operating costs and subtract non-operating earnings;
- Add interest expenses and deduct interest income;
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- Add one-time costs, if necessary, and subtract non-recurring revenue;

- **Step Two:** Determine the SDCF Multiplier

Most businesses are traded for between one and three times the SDCF. This value is known as the SDCF multiplier, and it depends on several factors, such as market trends, industry, company size, owner risk, the company's assets, and so on.

However, the biggest variable influencing SDCF is owner risk – the dependence/independence of the business from the owner. If a company is highly attached to the owner, it can be difficult to transfer it to the new ownership, thus affecting its value. Market trends are also crucial. For instance, if you are selling you company in a niche that is expected to decline in the future, you can expect the SDCF multiplier to be lower than normal.

- **Step Three:** Add Business Assets and Deduct Business Liabilities

At the end of the business valuation process, you need to consider the assets and liabilities that are not contained in the SDCF multiplier.

Most business owners include intangible assets, such as reputation, goodwill, or personnel, in their SDCF multiplier. Likewise, equipment, furniture, and fixtures are also accounted for. However, as some experts point out, some popular databases don't contain inventory in their SDCF multiplier, so it needs to be annexed separately by the business owners.

Other tangible assets such as real estate or cash are also not included in the SDCF multiplier by most business owners.

In the end, the company valuation formula should look something like this:

Company Estimated Value = SDCF * Multiplier + Assets not contained in the SDCF multiplier – Business liabilities.

Conclusion

Business valuation is a complex process, and different industries have their methods for determining their companies' worth. If you are not sure which method of valuation is best for you, a professional evaluator can help you establish a selling price and determine whether an investor's offer is fair.

Business Appraisal Florida can help. Whether you are pondering a prospective business transaction, launching into succession planning or encountering financial distress, our team effectively assimilates the information, makes the tough calls, and renders a solid valuation to help clients reach their objective.

If you wish to learn more about how to **value a company**, don't hesitate to contact us.