Part 1 – Business Valuation Basics

1 – Introduction to Business Valuation

Defining Value

Before we begin discussing business valuation it is important to define what value is. When asked, most people will struggle to define it then end up using an example like gold is worth more than copper. Value is difficult to define without comparing at least two items. The comparisons must be well defined to have any meaning. For example, a rare one ounce copper coin might be worth more than an ounce of gold. The first step in any valuation is to accurately and completely define the property that is being valued.

Value is also subjective. An ounce of gold scattered throughout a ton of ore may be worthless to someone that doesn't have the capabilities to extract it. Similarly, one business may have a number of values. A strategic buyer that can plug the business's customers into its existing system may perceive more value than a person who is going to run the business day-to-day. The second step in valuation is defining for whom the property is being valued.

What is a Business Valuation?

A business valuation is simply an estimate of what a business is worth. It may also be called a business appraisal and has some similarities with real estate appraisals. A big difference is that much of business value is in the form of intangible assets, or goodwill. Valuing intangible assets is a theoretical process requiring the use of various mathematical and statistical models. Many people try to simplify the process by using industry specific formulas and rules of thumb. These formulas are easy to obtain and are widely used, but they have a number of serious shortcomings. The formulas are typically wide ranging with little guidance on how to make a selection within the range. The source and quality of the data used to create the formulas are usually unknown.

How Much is a Business Worth?

In theory a business is worth the present value of all the future benefits of owning the business. Present value is the process of discounting the value of cash or other property to be received in the future to its current value. There are many benefits (cash and non-cash) to owning a business. Valuation focuses on the financial benefits defined as earnings or cash flow. The rate at which the future benefits are discounted must account for all the risks associated with owning and operating the business. Basically the value of a business comes down to the classic investment paradox – risk vs. return.

Basic Valuation Methods

There are 3 primary approaches to valuing a business – market, income and asset. The market approach uses data from actual sales of similar businesses or from publicly traded companies to value a business. The market approach is the preferred method. The biggest problem is that good quality, comparable data is seldom available. The income approach looks at a business's earnings or cash flow as the primary driver of its value. It is the most commonly used method and works well unless a business has no or marginal earnings. The asset approach tries to value each part (asset) of the business separately. The sum of the parts is the value of the business. This method works well with tangible assets, but not for the intangible ones. The methods of identifying and valuing individual intangible assets are highly theoretical and often produce unrealistic results. The asset approach is often used when a business has few intangible assets or marginal earnings.