How Do You Value a Business?

Why Business Valuation Is Important

The process of arriving at an accurate assessment when valuing a business is perhaps the most challenging aspect of any prospective small business purchase. A seller has arrived at a specific price he or she wants for the company, and one must determine if that business value is accurate. Pay too much, and you will struggle to make a profit. Pay too little - well, there’s hardly a down side there, but the scenario is unlikely at best. There are several ways to value a business; choosing the most appropriate one for your situation - and ensuring that it’s accurate - can make the difference between success and failure.

Three Basic Approaches

Small business valuation generally falls into one of three categories:

Asset approach

Every business purchase involves the acquisition of assets. Tangible assets include such items as property, equipment, inventory, supplies, and so on. Intangible assets may involve patents, trademarks, copyrights, and an active client base. It is fairly easy to determine the value of tangible assets, which is based on how much it would cost you to replace everything at today’s prices. There should be some discounting for depreciation. Arriving at the proper value of intangible assets is more complicated and can often be a point of contention between seller and buyer.

Market approach

Here is where a business value formula comes into play - actually, numerous formulas depending upon such factors as sales volume and type of industry. This is a favorite method employed by business brokers, who over the years have derived complex formulas to apply to three basic business elements - gross sales, net earnings, and asset value. Most of these formulas operate on the basis of analyzing an "average" business, so the business valuation for companies at either end of the spectrum may well be skewed.

Income approach

This business valuation formula converts some earnings factor into a fixed value by looking at capitalization rates, the existing bank lending discount rate, or some combination of the two. There are generally four factors under consideration - pretax earnings, after-tax revenues, discretionary earnings, and cash flow.

Drawbacks to Basic Approaches to Valuing a Small Business

Some of the methods outlined above may not work very well when attempting a small business valuation. Take the asset approach, for example. A business can be asset-rich yet not bring in enough revenue to make it profitable. And looking at it from the other angle, plenty of companies with minimal assets - out-of-date computers or low-priced inventory - can be very successful. A variation on the market approach is sometimes called "rule of thumb", which involves comparing the business being sold to a similar venture. The problem here is that no two businesses are ever exactly the same. Variables include location, management style, or employee competence. This method provides a good starting point but should not be relied upon as the sole arbiter of value.

Top Business Valuation Formula

Many business brokers - people who buy and sell businesses for a living - prefer something known as the "multiple" method. You may be familiar with a business being sold for "x times its earnings." The primary challenge here is to determine the proper value for x. First we begin by measuring "owner benefits," which forms the base price. An owner benefits (OB) amount is the total dollars you can expect to generate or make available based upon past earnings. First, count up the net profits and include the owner’s salary and benefits. Next, add back any non-cash expenses, which would include interest and depreciation. After you arrive at that figure - the base value of the business - it’s time to decide which multiple to use.

Choosing a Business Valuation Formula Multiple

Small businesses generally should sell at one to three times the above figure. Here are the criteria to use when deciding which number to select. Use "1x" if the owner is the business, meaning that the company relies almost solely on the proprietor for its success. This would obviously include one-man operations, but also consulting businesses and professional practices. Use "3x" if the company has been around for more than three years, owns valuable intellectual property or an exclusive sales territory, is part of a booming industry, or has a significant number of repeat customers. Anything outside these parameters will likely belong to the "2x" category. One final thought - the OB amount can be a determining factor as well. For example, a business whose OB number is $250,000 may warrant a 3x multiplier, but one that hits $650,000 (all other factors being equal) might justify 4x or 5x factors. At the end of the day, using more than one business valuation formula will help you decide what the business is worth, compared to its asking price.