



Valuations

From Divestopedia

419 The Parkway # 224, Greer SC 29650
864 641 8131 – info@chvgroup.com

How Your Company Is Valued Depends on the Buyer

Based on your analysis, you have a good idea of what [buyer type](#) will be interested in acquiring your company. [But how will that buyer type value your business?](#) Before we consider that, let's review the valuation methodologies. The following is a brief overview of the [valuation](#) process. A complete understanding of business valuation would require a college course at the MBA level!

You should note that valuing a business is not an exact science. Even the best appraisers need to make subjective decisions in the valuation process. Consequently, business valuations for the same company can vary from appraiser to appraiser.

Basic Valuation Approaches

There are three fundamental approaches to valuing a business. They are:

Market Approach — This works best in real estate because there are so few parameters to consider, and they are consistent by region and price range. Businesses, on the other hand, have an almost infinite number of moving parts, so comparable sales must be used in conjunction with other valuation methods. The problem with employing this approach to private SMBs (small and medium-sized businesses) is that there's not enough data to compare apples to apples. The [market approach](#) is probably better suited to valuing public companies where a large amount of data can be gleaned.

Income Approach — The [income approach](#) may be the most common for valuing private SMBs. As expected, it is based on company revenues and earnings. One method is called Multiple of Discretionary Earnings (SDE) Method, where the SDE is defined as the net operating income plus adjustments plus the owner's salary. The [multiple](#) is the inverse of the [capitalization rate](#) (cap rate) which is determined from an analysis of the company. Another method, the [discounted cash flows](#), is based on reasonable [projections](#) (usually five years), and uses a discount rate (usually the cap rate plus rate of growth) to calculate the present value of the future cash flows.

Asset Approach — The [asset approach](#) is used when the [fair market value](#) replacement cost of assets represents most, if not all, of the value of the business. Obviously, it is based on the [net tangible assets](#) of the business: the machinery, equipment, furniture and fixtures, etc. It's typically used when the business is [no longer a going concern](#), or if the business has been losing money for the last few years.

Valuation Method Depends on Buyer Type

Let's look at the most likely valuation methods used by each buyer type: ·



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Strategic Buyer — These are typically large private or public companies. By their very nature, [strategic buyers](#) are interested in how the [acquisition](#) of your company can benefit them in the future and they are not so concerned about what your company has done in the past. Consequently, the most likely valuation method will be the discounted cash flow approach.

Sophisticated Financial Buyer — These buyers are typically small investment groups, [private equity groups](#) (PEGs) and small companies interested in growth by acquisition. These buyers are interested in what your company has done in the past as well as opportunities for growth in the future. Consequently, the most likely valuation methods will be the [various multiples of earnings](#) (using [EBIT](#) and [EBITDA](#)) and the discounted cash flow approach.

Lifestyle Buyer — The [lifestyle buyers](#) are looking for an income, the ability to build equity, and the ability to service their debt from future cash flows. There is a saying about this buyer type that they will buy the future, but they will only pay for the past. If they are looking at three companies, and everything else is equal except for the prospects, they will buy the company that presents the best opportunities. Consequently, the valuation method of choice for this buyer type is the multiple of [seller discretionary earnings](#). For larger companies still within this buyer type segment, they may use the multiple of EBITDA method. The only difference between the two is that seller discretionary earnings includes the owner's normalized salary and [multiple of EBITDA](#) does not.

Industry Buyer — Don't confuse the industry buyer with the strategic buyer. The industry buyer is usually somebody in your niche that you know and considers your company inferior to his/her company. He/She's typically a bottom feeder and is trolling for a company to buy on the cheap for certain assets that your company may have. If he/she uses a valuation method, it will be the asset approach — probably a book value method. If there's any possibility that this buyer may be interested in buying your company (total assets plus goodwill), then you must seek professional help to even the playing field.

Conclusion

The valuation methods used by the buyer types presented above are certainly not cast in stone. In any given situation any buyer type may use several different valuation methods. If a buyer uses several different valuation methods, each method is typically weighted and the valuation methods by buyer type suggested above usually receive a higher weighting.

For more information on Valuation, Term Sheet, LOI and Purchase Agreement or other transaction questions, contact [Tony Koechli](#)

The 7 Business Valuation Methods All Entrepreneurs Should Know – Terms

Market Value, Asset-Based Valuation, ROI-Based Valuation, Discounted Cash Flow (DCF), Capitalization of Earnings, Multiples of Earnings, Book Value.
