Business Planning

When is a business valuation important?

By Arthur Reed Snyder, Jr., JD

A business valuation can act as the capstone when an owner needs to build a greater understanding of his or her business. Business owners often don't know where their business stands on a given day and are only peripherally aware of the facts and figures that form the foundation of their business's financial health. Many business owners have come to discover that a business valuation is a singularly invaluable tool that can help guide them through the many phases of their business's life cycle by helping them to see where they've been, know where they are, and make plans for where they want to be.

Benefits of a business valuation

The process of obtaining a valuation gives the owner an opportunity to look at the whole picture from a better vantage point. A business valuation can help an owner understand where their business stands today, give insight into the historical trends that their business has established for itself and give them an understanding of how healthy and sound their business is in the present. It can help an owner compare their business to others like it and provide an understanding of the business's value so an owner can know what it's worth.

A valuation provides a great starting point when it is time for an owner to sell the entire business as a going concern or even a partial interest in the business. Owners often find that the hardest part of the negotiation process is finding the starting point. They don't want to leave anything on the negotiating table, and that desire can create undue stress. The valuation lets an owner confidently establish a starting point as negotiations begin. It's important to note that the valuation isn't the be-all and end-all when value is considered, it is just a starting point. But being confident in the soundness of your starting point can mean all the difference when a buyer and an owner come to terms. The owner must still fight for important deal terms and concede those that can be sacrificed. If an owner has faith in the starting point, he or she can conclude negotiations with some assurance that little was left on the negotiation table.

To that end, a business valuation is also a great emergency brake. It can let owners know that they are not ready to sell, yet. Owners can find themselves at the negotiating table having no support for their asking price while a buyer drives a hard bargain. Owners often find it difficult to separate the intrinsic value they place on their business from the economic value reflected in a valuation that uses widely accepted valuation principals. Whether the business's calculated value is high or low when compared to the owner's perception, the knowledge of the valuation's conclusion can be the reality check an owner needs during negotiations and can give an owner insight into whether negotiations are likely to bear fruit or whether it is time to walk away from the negotiating table. It is better to gain those insights before time and money have been spent on counsel and due diligence only to discover that hard negotiations are not going to result in a sale.

A business valuation is also very useful when it comes to matters of succession planning. When succession planning begins, owners can find themselves talking about buy-sell agreements, incentivizing employees, and identifying the business's key personnel. It is during these planning discussions that the business valuation helps an owner see and understand the hard and fast facts and figures that must be considered when trying to optimize tax, estate, and business succession consequences. With the multitude of available succession planning techniques, the business valuation becomes an invaluable tool used to support an owner's decisions and guide the planning process. It is also an important tool to use when key persons want to become owners or when it is time for family to step up to become part of the ownership group. Planning is always easier when owners and their advisors have more facts and more data. The planning process goes smoothly and quickly when all the necessary information is readily available.

Approaches to valuing a business

Given the many ways a business valuation can help a business owner, it is helpful to understand the different ways value can be determined. The three principal ways of valuing a business are the asset approach, income approach, and market approach. Several different methods are categorized under each of these three approaches and each category's methods have many common elements among them. The business valuation can be prepared using any one or a number of these three approaches, and the valuation may also be determined by assigning a relative weight to each approach in order to arrive at a blended determination of value.

ASSET APPROACH. The asset approach generally determines a business's value by taking its assets and subtracting from them the business's debts and liabilities. This approach is often insufficient when valuing a service business or a business that is not capital intensive. The asset approach is subject to additional considerations like determining how the word "asset" is defined. For example, are assets valued at the historical book value of the asset or the asset's fair market value? The asset approach is limited in as much as the business's value is seen as a determination of the value of the business's parts rather than the whole.

INCOME APPROACH. The income approach generally determines a business's value by looking at historical earnings and projected future earnings to establish value. The most common expression of this approach is the discounted cash flow

(DCF) method. The DCF method analyzes past earnings and current earnings to determine a base set of expectations for future earnings which are projected forward for several years and then discounted back to determine the present value of the business. The approach is useful when valuing a service business or a business composed of intangible and hard-to-value assets. The income approach is subject to additional considerations like how best to account for the difference in value between a business that pays corporate taxes and one that doesn't. The income approach considers the business as a going concern and does not consider its constituent parts. In other words, income approach does not account for the separate value of the business's fixed assets or its intangible assets in the process of valuing the income stream.

MARKET APPROACH. The market approach generally determines a business's value by comparing the business to public companies that are similar and in the same industry or by looking at recent transactions involving similar businesses in the same industry. The approach is useful when data about similar companies is abundant and time is not. The market approach can be limited when there are not enough public companies that are comparable. It also is difficult to find comprehensive data sources that share data about recent transactions from similar companies since virtually all private transactions are not centrally tracked. Lastly, it is difficult to make broad assumptions about small business when the comparable companies are several orders of magnitude larger. The larger the business being valued, the greater the likelihood that relevant comparable data sets can be found to use the market approach; without that data, the approach won't generate relevant business values.

When to begin

Beginning the process of obtaining even a thumbnail sketch of a business's value can be a very rewarding process. A business valuation can help owners gain a better understanding of their business, plan for the ultimate sale or disposition of their life's work, or help them and their successors plan for the day they cede control of the business and hand the reins over to the next generation. When all is said and done, a business valuation is an excellent tool that is easily obtained which can help business owners regardless of where along their business's life cycle they find themselves. As with all business planning strategies, working with a professional will help ensure the best results.

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