Four Approaches to Business Valuation

Arthur F. Rothberg, Managing Director, CFO Edge, LLC

It's ironic that many Los Angeles and Southern California business owners spend much of their lives working to build their companies, but they have very little (if any) idea of how much money their business is actually worth. Often, the idea of business valuation doesn't even occur to owners until they start thinking about selling their company or passing it on to their heirs

The value of a closely held business will change over time, based on a variety of different factors: sales volume, profitability, cash flow, strength of the management team, stability of the customer base, growth potential, and the overall condition of the industry, to name a few. But there are many reasons other than selling why you may need to conduct a business valuation, such as drafting a buy/sell agreement, going through a divorce, creating an ESOP, and dealing with taxation matters or stockholder disputes.

Perhaps most importantly, the process of valuing your business will give you a better understanding of the main factors that help increase your company's value. With this knowledge, you can then focus your time, energy and resources in these areas, rather than in areas that add little or no value to your company.

An Emotional Subject

The subject of value can get emotional when applied to a business. Not surprisingly, owners tend to assign a higher value to their companies than outsiders (especially buyers) do since they have spent countless hours as well as their own blood, sweat and tears building the company.

Therefore, the best way to get a true handle on your company's value is to have a professional business valuation performed by a trained business valuator. Before beginning the process of obtaining a business valuation, though, it's a good idea to narrow down the specific purpose of the valuation. In other words, what are the specific circumstances surrounding the valuation, and for whom are you trying to determine the business' value?

This is important because there are several different methods (or standards of value) that can be used to value a business, depending on the situation and the goal of the valuation. A different standard of value will likely be used if a business is being valued for sale, for example, than if it's being valued as part of a divorce settlement.

There are four main standards of value that are used in most business valuations. A professional business valuator will know which is the best one to use in your particular situation:

1. Fair Market Value (FMV) — The most common standard of value, FMV is used in most federal and state tax matters, including estate and gift taxes. The American Institute of Certified Public Accounts' (AICPA) International Glossary of Business Valuation Terms defines FMV as the "price, expressed in cash equivalents, at which property or business would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, where neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

2. Investment Value — Often used in the case of a business sale, merger or acquisition, this standard determines the value of a business to a strategic buyer. It usually assumes that synergies exist between the buyer and the seller that would increase the business' value to the specific buyer. If a business meets a buyer's specific criteria for companies it might want to purchase — it manufactures complimentary products or occupies a unique niche in the marketplace, for example — it will have a higher value to that buyer.

3. Intrinsic Value — This is the standard that a financial analyst would use to determine the value of a company. It considers the value of the business' assets and earning power, among other factors. If FMV is lower than intrinsic value, an analyst would rate the company favorably as a "buy."

4. Fair Value — Most commonly used in cases of dissenting stockholders' disputes, this is often defined as "the value of shares immediately before the effectuation of the corporate action to which the dissenter objects." Valuation discounts usually are not applied with this standard.

In addition to deciding which one of these four standards of value to use, a professional business valuator will also choose one of these three valuation approaches:

1. The *market approach* looks at the value of comparable companies. It's similar to how real estate agents look at the value of comparable homes (or comps) when pricing a house for sale.

2. The *asset approach* looks at the book value of the company's tangible assets.

3. The *income approach* considers cash flow, adjusted earnings capitalization, P/E multiples and similar measurements to try to project future earnings.

Concluding Thoughts

There are many valid reasons why Los Angeles and Southern California business leaders and executives may want to have a business valuation performed on their companies. Care should be taken in choosing a professional business valuator to work with, though. Many valuators specialize in valuing certain kinds of businesses, so it makes sense to look for one that specializes in your industry. An outsourced CFO services provider can help you find the right business valuator for your company and situation.

About CFO Edge

CFO Edge, LLC is a leading Southern California provider of outsourced CFO services. Based in Los Angeles, we are a group of experienced chief financial officers who engage with CEOs and CFOs on demand to address strategic planning, business management, and day-to-day financial operations challenges. Our seasoned professionals deliver services as interim CFOs, part-time CFOs, project-based CFOs, recruitment-to-permanent CFOs and interim-to-permanent CFOs. At CFO Edge, we're passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 626.683.8840.