Examining Three Common Approaches in Business Valuations

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When engaged to estimate the value of a private business interest, an appraiser considers the nature of the company and its industry, the availability of market data, the valuation's purpose, the basis of value and other relevant criteria. With this general information in mind, the appraiser then typically turns to either one or a combination of three common appraisal approaches.

The Asset-Based Approach

The asset-based (or cost) approach derives an investment's value by quantifying its replacement cost. In other words, a business is worth the combined value of its assets net of liabilities.

Courts praise the asset-based approach for its perceived simplicity and objectivity - especially for those companies that depend primarily on hard assets or asset-holding companies. The approach can take a couple of different forms, including:

The adjusted book value method. Under this variation, appraisers adjust balance sheet items (reported at book value) to their individual fair market values. Although off-balance sheet assets and liabilities are typically considered, this method tends to downplay internally generated intangible assets (such as client lists, brands and goodwill) and contingent items (such as pending litigation or insurance claims).

Additionally, appraisers may need to hire outside appraisers to estimate the value of assets outside their area of expertise, such as real estate or intellectual property. These experts add cost, and courts may question the objectivity of their conclusions.

The excess earnings method. This technique derives intangible value from the capitalization of excess earnings and is popular in some jurisdictions for valuing small professional practices.

The IRS created this method to compensate distilleries and breweries for value impaired during Prohibition. Thus, its inputs (such as tangible assets, income and capitalization rates) aren't well defined in valuation literature. Accordingly, IRS Revenue Ruling 69-609 recommends that appraisers reserve this method for situations in which "no better method is available."

The Income Approach

With this approach, an appraiser derives a company's value from its anticipated economic benefits. Common methods include the discounted future earnings method and the capitalization of earnings method.

Both methods employ discounted cash flow projections that rely on subjective assumptions such as projected future earnings, growth rates and cost of capital. Small changes in these variables can affect the appraiser's final estimation significantly. Additionally, these methods are relatively complex, making them difficult to explain to non-experts.

Despite its relative complexity, the income approach is gaining acceptance - especially in tax and divorce cases. When pricing an investment, investors compare risk to anticipated benefits in terms of dividends and appreciation. Accordingly, discounting is a popular form of analysis for strategic decision making as well as mergers and acquisitions.

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The Market Approach

The market approach bases a company's value on transactions involving similar business interests by typically relying on public stock prices and private/public transaction databases for comparable data. Because of its perceived objectivity, it's preferred in certain jurisdictions, including the Tax Court.

Valuation methods falling under the market approach umbrella include:

The guideline public company method. Differences between public and private business ownership prompt numerous criticisms of this method. Yet the availability of real-time market quotes and proliferation of high-quality, inexpensive financial data on public companies offer advantages - especially when valuing a minority interest and for private businesses that are large enough to consider going public.

The Merger and Acquisition (M&A) Method. Various proprietary databases track the details of private and public M&A activity. Unfortunately, reports of private deals are rarely independently verified, possibly leading to duplicate transactions, limited details and errors. Additionally, transactions may include elements of synergistic value that can misrepresent fair market value.

The M&A method is not without its merits, however. If an appraiser identifies an adequate number of meaningful, timely comparables, this technique makes sense - particularly for companies operating in active M&A markets or when valuing a controlling interest.

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