



The Art and Science of Business Appraisal – Market Data Edition

by Shawn Hyde, Executive Director ISBA

If one spends any significant length of time studying business valuation, eventually one will come across the phrase, "art and science". Someone will say, "Business valuation is as much an art as it is a science," or something along those lines. When I find myself saying that phrase during the classes I teach, generally, at least one of the attendees will ask a question about the 'art' aspect, and ask for an example. I thought that question sounded like a good article topic for this month, so here goes...



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I want to consider how one is able to incorporate some art into an analysis utilizing market data consisting of transactions of similar privately held businesses across the country.

The first step is to have compared the subject business' operations to the industry average through comparative financial ratio analysis. The assumption of such a comparative analysis is that the industry average is a benchmark against which one can compare the subject business operations in order to identify overall strength or lack of the same.

For example, if the turnover ratios indicate the subject business is taking longer than the average to pay their bills, or to receive their accounts receivable, then the appraiser can make the correlating assumption that the business' operating risk may be elevated as compared to the industry average.

If we assume that the average business would match up fairly close to the industry average with benchmarking, then we can also assume that the average business would sell for an average multiple from the transactional market data we obtain from those various databases. A corollary to these assumptions is that a business whose comparative ratios indicated that it has been operating with more or less risk than the industry average, then that same business would be worthless or more than an average business, respectively.

In other words, value equals income divided by risk, and the larger the risk, the lower the value. And the opposite is also true, the lower the risk, the higher the value.

Notice where the 'art' is in all of that? The science portion is in utilizing the data to arrive at conclusions, but quantifying those conclusions, and deciding the amount of impact each should have on the selection of a multiple/risk rate is all about an appraiser's judgment.

If business appraisal involves art, then the words used by an appraiser in the narrative are the brush describing the amount of risk involved.

When the report has been written, and the story of the analysis has been told, if the appraiser drew appropriate conclusions and explained them to the reader as if drawing that reader a picture, then, in my opinion, the appraiser has done a good job.

I never was any good in art class, but I believe I am doing well illustrating my opinions of value for my clients. Continuously selecting an average or median multiple for every valuation project, seems to prevent the 'art' aspect from being applied. A coherent and useful analysis requires data, but it also requires expert judgment, and that judgment is what we appraisers bring to the table.