Business Valuation

How much is your business worth?

There are many reasons why you might need to know how much your business is worth. For example, it may be required for a business loan. Or, it can be used as a baseline to help you plan your steps towards improving your company's profitability and growth. Maybe you are thinking about passing your business onto a family member or selling it to a third party. Whatever the reason may be, knowing how much your business is worth and how it can be valued is important in helping you make informed decisions about the future of your business.

It is important to know that there is no one set of formula in determining how much a business is worth. Different purposes for conducting a business valuation drive the use of different valuation standards. A variety of approaches and methods are also available depending on the industry, stage of business lifecycle and future prospects.

A business valuation often involves:

- Understanding the industry in which your business operates, including key revenue drivers and metrics;
- Analyzing historical financial information, and forecasting future cash flows;
- Understanding the key assets contributing to the value of the business, including tangible assets or intangible assets like key persons;
- Assessing the market and applying an appropriate valuation approach relative to the industry the business operates in; and
- Noting any underlying assumptions and considerations in the valuation approach.

The following will discuss common business valuation methods which are utilized for companies that are expected to continue operations for the foreseeable future.

Common Business Valuation Approach and Methodology

Asset-Based Approach

The asset-based approach determines the value of a business based on its assets net of its liabilities, both tangible and intangible, recorded and unrecorded. It is widely used when the majority of the value of the company is driven by the fair market value of its assets such as in a real estate holding company or a capital-intensive company. The assets are typically appraised as if they will continue to be used in the business as opposed to at their liquidation cost. This method basically determines the cost required to recreate a business and the value calculated is generally viewed as a "floor-value" of the business. It can also be an appropriate method when the cashflow of a business is not representative of its overall value.

Market-Based Approach

The underlying notion of the market-based approach is that the value of a business can be determined by looking at available data with respect to comparable companies. The availability of comparable data is an important consideration of whether the market-based approach is suitable. Comparable companies could be those operating in a similar industry or region(s), have similar risk profiles, and are similar in size measured by annual revenue, cash flow or other relevant factors. Typically, a valuator will look at available public and private company data, and transaction prices of recently sold or listed companies. Once a valuation is calculated, a multiple from a set of comparable data is then identified and applied to a business's financial metric, such as EBITDA (earnings before interest, tax, depreciation and amortization) to estimate its value.

Multiples in market-based valuations are ratios using various financial metrics. Common multiples used in business valuation under the market-based approach include:

- Share Price / Earnings Per Share
- Enterprise Value / Revenue
- Purchase Price / EBITDA

Ex. Company A with an EBITDA of $2 million is recently sold for $5 million. It has a Purchase Price/EBITDA multiple of 2.5.

Using Company A as a comparable, Company B with EBITDA of $3 million may be valued at $7.5 million ($3 million x 2.5).

Income-Based Approach

Earnings and cash flow based valuations are both considered income-based approaches. Under these valuations, businesses are valued using the present value of either the future estimated earnings or cash flows they generate.

As a starting point, income or cash flow, based on historical data and forward projection, is 'normalized' to reflect the normal operations of the business. In other words, adjustments are made to remove anomalies such as one-time gains or losses that are non-recurring, non-business incomes and expenses from non-business assets, or discretionary expenses that are non-essential for the business operations. In addition, non-cash expenses such as depreciation and amortization may also be removed from the accounting income or cash flow figure.

Common income-based methods include:

- Discounted Earnings/Cash Flow Method
- The Capitalization of Earnings /Cash Flow Method

Discounted Earnings /Cash Flows Method

The discounted earnings or discounted cash flow method is often used when the companies being evaluated are start-ups and are projected to have varying rates of growth and income streams. Under this method, appropriate discount rates are determined and applied to projected annual earnings or cash flows for a limited number of years to derive their present values. At a very high level, a discount rate is the rate of return that a theoretical purchaser would require in an investment. A terminal value is also determined by capturing the expected annual earnings/cash flow of the business beyond the projected period into perpetuity. The sum of the present values for the projected years plus the present value of the terminal value of the business form the value of the business.

Ex. The following are the present value (PV) of adjusted cash flows of ABC Company

PV of annual cash flows for the projected periods:

Year 1	$35, 600
Year 2	$47, 800
Year 3	$63, 200
	$146,600
Add: PV of Terminal Value	$200, 400
Business Value	$347,000

The Capitalization of Earnings/Cash Flow Method

Using the capitalization of earnings or cash flow method, once a normalized earning or cash flow figure for a single period is calculated, a divisor, referred to as the capitalization rate is then applied to determine the business value. The capitalization rate is generally viewed as a business' discount rate minus its expected long-term sustainable growth rate. Often, you will see the use of a "capitalization multiple" instead which is the inverse of the capitalization rate (see example below). This valuation method is typically used for mature companies that are expected to have relatively stable earnings/cash flow in the future. Capitalization of earnings is frequently used in the valuation of real estate businesses.

Ex. Company XYZ has a normalized EBITDA of $100,000 with a 20% capitalization rate

Business Value = $100,000 / 20%

= $500,000

Capitalization Rate of 20% is the same as a 5x **Capitalization Multiple:** $100,000 x 5 = $500,000

After determining the business value using either the Discounted or Capitalized methods, further adjustments may still be necessary to determine the overall business value. For example, adding the net realizable value of redundant assets. Redundant assets are generally assets that are not necessary to the ongoing operations of a business and therefore do not affect the cash flow or income the business generates. For this purpose, net realizable value typically refers to the market value less disposition costs and taxes.

Capitalization and Discount Rates

Determining the appropriate capitalization and discount rates is one of the most difficult and contentious areas in business valuation. Although the two are not technically the same, they are closely related and are both based on the concept of risk and return. There are various models and formulas available to "build-up" a rate, which often involves a thorough assessment of the various external and internal factors associated with the business. Examples of some external and internal factors affecting a company's business valuation are as follows:

External Factors	Internal Factors
• General economy • General condition of the merger and acquisition market and of the particular industry that the company is in • Government policies and regulations affecting the particular industry that the company is in • Existing conditions of the particular industry that the company is in • Competitive environment of the particular industry that the company is in	• Financial position of the business • Competitive position of the business • Brand reputation • Size of the business • Quality of customer and supplier base • Strength of management and intellectual capital • Growth trajectory

Other Considerations

Price vs. Value

It is important to recognize that the value of your business may not be the same as how much potential buyers are willing to pay for it. There are many factors that may result in a difference between value and price. For example, the seller may be looking for a quick sale and is willing to price the business lower than its value to get a buyers' attention. Alternatively, a buyer may be incentivized to buy your business at a premium due to expected synergies that may be achieved through the acquisition. At the end of the day, your business is worth what someone is willing to pay for it. It is important to get an idea of what that price may be by understanding your business's value so that you have the necessary information to help you negotiate and hopefully identify an offer that most closely matches your asking price and exit strategy.

Business Structure and Tax

Whether your business is incorporated, a sole proprietorship or a partnership, there are distinct tax consequences on the sale of your business, and they can vary greatly depending on how your business is structured and the tax attributes associated with your business. Apart from any valuation (and the ultimate Purchase Price of the business), the amount of money that ends up in your pocket at the end of a transaction may depend greatly on how those proceeds were received (for example, in a corporation or in your personal hands), whether any exemptions for tax apply (for example, the lifetime capital gains tax exemption) and in which tax years those sale proceeds are received. For Canadian resident taxpayers seeking to qualify for certain available tax exemptions or deferrals, some corporate structures must be "qualified" for tax purposes for a period not less than 2 years in advance of the sale. Please discuss the structure of any transaction with your lawyer and tax advisor well in advance of a sale.

Mergers and Acquisitions Advice

Many business owners seek advice in advance of a sale from a Business Broker or Mergers & Acquisitions specialist. These individuals or firms can provide important guidance to business owners regarding valuation, strengths and weaknesses inherent in your business and other factors that may enhance your earnings or the "multiples" achievable on your potential sale transaction. Generally, these intermediaries represent your business in the marketplace and can be helpful in finding buyers you may not be aware of and creating competitive tension which may potentially "bid up" the price of your business. For this advice, you generally pay a "work fee" on a monthly basis during the sale process, and a "success fee" on closing the sale (usually expressed as a percentage of the ultimate Purchase Price).

In Canada, discussing your situation with a Chartered Business Valuator or a Chartered Professional Accountant experienced in business valuations can help you establish a relevant and realistic value for your business.

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