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How to Value Your Company - The Income Approach

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As an entrepreneur, it is helpful, if not necessary, to know the estimated value of your company, even if you're not ready to sell. You've worked hard to establish your industry foothold and may intend to take on a business partner or sell somewhere down the road. Even if you don't have such plans, for the typical business owner, the business represents not only the present, but also the future. For that reason alone, it's important to not only have an idea of how much your company is worth but also a realistic basis for it.

Still, an estimated business value is not so cut and dried. A business is ultimately worth as much as a potential buyer is willing to pay. Even so, getting to an agreed-upon number may depend upon the buyer's and seller's ability to agree to a common valuation method and the assumptions used. That's why we created this three-part series that details the different generally recognized valuation methods a business owner can use to determine their company's business value, as well as which approach is best suited for what type of business.

Part one in the series discussed the asset-based approach. In part two below, we'll discuss the income method. Part three will discuss the market approach.

The discussion below is intended to be an overview and has been simplified for illustrative purposes.

INCOME APPROACH

Operating companies with profitable operations, like a retail business, a restaurant or a manufacturing company, are best suited for this valuation approach. While the asset-based approach starts with your balance sheet, the income approach starts with your income statement (also known as the profit and loss statement). Your business value is determined by estimating the net income you expect to make through some future point and then recalculating that cash flow in terms of today's dollar values (also known as the present value).

There are two common ways to apply this valuation approach and we'll detail each below: the discounted earnings/cash flow (DCF) and capitalization of earnings methods.

DISCOUNTED EARNINGS/CASH FLOW (DCF)

This method calculates a company's expected earnings stream or cash flow over some time horizon, five years for example. Your forecasting skills will have a significant impact on the overall end value. For this reason, it's important to carefully select your assumptions. Take growth rate from year to year, for instance. Do you expect five percent growth? Or zero? Then, what discount rate will you use? What about the capitalization rate? The numbers you select will have a considerable impact on your estimated business value. The more realistic your chosen variables, the more reasonable your estimation will be.

The basic steps for the DCF method are:

1. Obtain or prepare a forecast of net cash flows for the next five years;

2. Calculate your "terminal" or "residual" value. This is usually equivalent to the fifth year's forecast, which is then projected into perpetuity, then divided by a capitalization rate;

3. Using an appropriate discount rate, calculate the present value of the five-year forecast;

4. Using the capitalization rate, calculate the present value of the terminal value;

5. Sum up the two present values and deduct the amount of any existing interest-bearing debt. The result is the estimated value of your business.

A look at an illustration can help clarify how this valuation method works. In the example below, we selected differing discount and capitalization rates; the difference between the two numbers relates to the 5% estimated annual growth that's shown.

<u>Illustration – In our example, the estimated business value is $1,669,470:</u>

- ❖ Assumptions:

- Year one of the forecast cash flows below is the year following the valuation date
- After-tax discount rate is 12.71%

- After-tax capitalization rate is 7.45%
- There is interest-bearing debt of $371,000

1. Obtain or prepare forecast of future cash flow for the next five years:

After-tax cash flow to be received at the end of:

Year 1	$ 314,051
Year 2	82,743
Year 3	132,297
Year 4	132,336
Year 5	187,154

2. Calculate the terminal value:

- $2,512,129 (Year 5, $187,154 divided by 7.45%)

3. Calculate the present value of the forecast net cash flows:

End of	Net Cash Flow	Present Value Factor (12.71%)	Present Value
Year 1	$ 314,051	0.94193	$ 295,814
Year 2	82,743	0.83571	69,149
Year 3	132,297	0.74147	98,094
Year 4	132,336	0.65786	87,059
Year 5	187,154	0.58367	109,236
			$ 659,352

4. Calculate the present value of the terminal value:

End of	Terminal Flow	Present Value Factor (12.71%)	Present Value
Year 5	$ 2,512,129	0.54978	$ 1,381,118

5. Add both present values and deduct interest-bearing debt to arrive at the estimated business value:

PV of forecast cash flows	$ 659,352
PV of terminal value	1,381,118
	$ 2,040,470
Deduct: Interest-bearing debt	(371,000)
Value of business	**$ 1,669,470**

The DCF method is suitable for business owners who expect their company to experience rapid or unpredictable growth in future years.

CAPITALIZATION OF EARNINGS

The capitalization of earnings method is appropriate for business owners who expect a steady growth trajectory or to anticipate minimal fluctuation in earnings. This method doesn't distinguish between earnings variations in future years; instead, it assumes that profits will be steady from year to year. Once that steady earnings number is determined, it is discounted to present value by using an appropriate capitalization rate.

In theory, your estimated value under the DCF method should approximate your estimated value under the capitalization of earnings method, so long as your company's earnings are expected to grow at a constant rate. Even if you expect a steady growth rate, the DCF is more suitable if you'd rather use specific revenue or expense amounts in your forecast.

Ultimately, a potential suitor and you may not see eye-to-eye about how to best value your company.

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You may view your company as one with a strong potential for future earnings, while the prospective buyer may see one with a lot of assets that she can sell, or perhaps she's focused on a key product to integrate into her existing business. In part three of this series we will discuss the market approach to valuation. Part one discussed the asset-based approach.

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