How to Value Your Company - The Market Approach

A. Christine Davis, CPA, CFF, CVA, CGMA., Partner

A key factor leading to a smooth business purchase negotiation is having a clear understanding of how a buyer views the value of your business. You may think its value should be based on potential future earnings while a suitor may want to sell off existing assets. A novice understanding of each of the three generally accepted business valuation methods can help you figure out if a potential buyer's offer is in the ballpark.

That's why we created this three-part series -- to detail the different methods a business owner can use to estimate the value of his or her business, as well as which approach is best suited for what type of business.

Part one in the series discussed the asset-based approach. Part two discussed the income method. Part three, presented below, discusses the market approach.

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

Market Approach

If you've ever bought or sold a home, you may already be familiar with the concept of the market approach. As a business owner, you can estimate your company's value in part by looking for similar companies within your industry that have recently sold, known as "comparables" or "comps." The idea behind this approach is that the value of a business can be estimated by looking at reasonably comparable "guideline" companies that have certain financial and sales price information that is publicly available.

The information for a comp may be available because that company sold recently, and the terms of the transaction may have been disclosed. The purpose of analyzing these guideline companies is to figure out if their risk profiles are similar to that of your business. If so, then you have a reason to begin a comparison.

For example, if you own a cosmetics company and found that a similar cosmetics business sold for two times its revenues, you might infer that your business could possibly sell for a similar multiple. However, generally and especially for smaller businesses, it can be difficult to find a comp. This makes the market approach the least advisable method to use on its own. You can, however, estimate your business value by using a blend of the market approach (assuming there are acceptable comps) in combination with the discounted cash flow method (income approach).

It's worth mentioning that, in a formal valuation of a minority interest in a closely held business, certain discounts are applied to determine the value of the minority ownership in a business. The discount for lack of control and discount for lack of marketability would represent a decrease to the estimated value of a minority interest in a business calculated using one or a combination of approaches described throughout this three-part series.

With that in mind, if you are drafting a buy-sell agreement, be mindful of how the purchase price will be determined. Will it be based on the fair market value of your total assets less liabilities, a multiple of revenue, or a qualified professional's valuation estimate? Your familiarity with the basic valuation approaches can empower you to carefully assess potential sale offers, develop a long-term business strategy, or simply clarify or improve upon your concept of what your enterprise is worth based on methods accepted in the business world.

This post originally appeared on First Republic and has been repurposed with permission.