Small Business Valuation Methods

Adjusted Book Value Valuation Methods

Your MBA performs two types of adjusted book value small business valuation: Tangible Book Value and Economic Book Value (also known as book value at market).

Tangible Book Value small business valuation is different than book value in that it deducts from asset value intangible assets, which are assets that are not hard (e.g., goodwill, patents, capitalized start-up expenses and deferred financing costs).

Economic Book Value small business valuation allows for a value analysis that adjusts the assets to their market value. This small business valuation allows valuation of goodwill, real estate, inventories and other assets at their market value.

Book Value

Is simply the small business valuation based upon the accounting books of the business. Assets less liabilities equal the owner's equity, which is the "Book Value" of the business. The problem with book value small business valuation methods is that the accounting records may not accurately reflect the true value of the assets in the small business valuation.

Cost of Equity

In financial theory, the Cost of Equity means the return that *stockholders* require from a company. The traditional formula for cost of equity (COE) is the dividend t of capital is a term used in the field of financial investment to refer to the cost of a company's funds (both debt and equity), or, from an investor's point of view "the shareholder's required return on a portfolio of all the company's existing securities " It is used to evaluate new projects of a company as it is the minimum return that investors expect for providing capital to the company, thus setting a benchmark that a new project has to meet.

$$\text{Cost of Equity} = \frac{\text{Dividends per Share (for next year)}}{\text{Current Market Value of Stock}} + \text{Growth Rate of Dividends}$$

**This business valuation method is traditionally utilized for publicly traded companies.*

Discounted Cash Flow Valuation Methods

Are the small business valuation methods best used to conduct a business valuation on an entity established for the purpose of fulfilling a specific project, in certain startup and other companies where cash flow is more important than net income, and when a certain time frame is set where an investor wishes to see his investment returned over a specific period of time. In discounted cash flow, the present value of liabilities is subtracted from the combined present value of cash flow and tangible assets, which determines the value of the business.

Discounted Earnings

This determines the value of a small business based upon the present value of projected future earnings, discounted by the required rate of return (capitalization rate). Usually, the question is how well earnings are projected.

Dividend Capitalization

Since most closely held companies do not pay dividends, when using dividend capitalization valuators must first determine dividend paying capacity of a business. Dividend paying capacity based on average net income and on average cash flow is used. To determine dividend paying capacity, near term capital needs, expansion plans, debt repayment, operation cushion, contractual requirements, past dividend paying history of a business and dividends of a comparable company should be investigated. After analyzing these factors, percent of average net income and of average cash flow that can be used for the payment of dividends can be estimated. What also must be determined is the dividend yield, which can best be determined by analyzing comparable companies. As with the price earnings ratio method, this usually produces a subjective result.

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Income Capitalization Valuation Methods

First you must determine the capitalization rate - a rate of return required to take on the risk of operating the business (the riskier the business, the higher the required return). Earnings are then divided by that capitalization rate. The earnings figure to be capitalized should be one that reflects the true nature of the business, such as the last three years average, current year or projected year. When determining a capitalization rate you should compare with rates available to similarly risky investments.

Liquidation Value

This type of small business valuation is similar to an adjusted book value analysis. Liquidation value is different than a book valuation in that it uses the value of the assets at liquidation, which is often less than market and sometimes book. Liabilities are deducted from the liquidation value of the assets to determine the liquidation value of the small business. Liquidation value can be used to determine the bare bottom benchmark value of a business, since this should be the funds the business may bring upon small business valuation.

Price Earnings Multiple

The price-earnings ratio (P/E) is simply the price of a company's share of common stock in the public market divided by its earnings per share. Multiply this multiple by the net income and you will have a value for the business. If the business has no income, there is no business valuation. If the common stock in not publicly traded, business valuation of the stock is purely subjective. This may not be the best choice of business valuation methods, but can provide a benchmark business valuation.

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Profit Multiple Small Business Valuation

Profit and sales multiples are the most widely used small business valuation benchmarks used in valuing a business. The information needed is pretax profits and a market multiplier, which may be 1, 2, 3, or 4 and usually a ceiling of 5. The market multiplier can be found in various financial publications, as well as analyzing the sale of comparable businesses. These small business valuation methods are easy to understand and use. The profit multiple is often used as the small business valuation ceiling benchmark.

Replacement Value

This type of small business valuation is similar to an adjusted book value analysis. Replacement value is different than liquidation value in that is uses the value of the replacement value of assets, which is usually higher than a book valuation. Liabilities are deducted from the replacement value of the assets to determine the replacement value of the small business.

Sales Multiple Small Business Valuation Methods

Sales and profit multiples are the most widely used business valuation methods benchmark used in valuing a business. The information needed is annual sales and an industry multiplier, which is usually a range of .25 to 1 or higher. The industry multiplier can be found in various financial publications, as well as analyzing sales of comparable businesses. This method is easy to understand and use. The sales multiple is often used as the business valuation benchmark.

True Value Small Business Valuation

Is the amount that a buyer is finally willing to pay. This is the "real world" in small business valuation methods.