

It's Not Magic, It's a Triangle

How Do I Know the Real Value of My Business?

Whether you are thinking about buying or selling, be aware the term 'value' is more a product of art than science. Sure there are many opinions of how to determine value. But without a real buyer and seller agreeing on a price, establishing a value of a company is a professional judgement based on several fact and opinions.

A Buyer will judge the value of the Selling firm on a stand-alone basis while also estimating what incremental value or synergies will occur between the firms, once the Selling firm is acquired. A Seller will also establish a value for their company on a stand-alone basis, then, with the help of a Merger and Acquisitions professional determine the type of firm that will pay the most for the synergies your company will help to create for them.

In the end, true value can only be determined by the amount a buyer is willing to pay. So where do we begin to determine this stand-alone value of a company? We suggest you build a model first, then choose the valuation that best fit into the model. A useful approach to building this model is to design a “**Value Triangle.**”

Essentially the triangle should answer 3 questions:

- What is my company worth if I continue to do the same thing that I have done in the past?
- What have others paid for companies similar to my own?
- What is my company worth if I perform better (or worse) in the future than I have in the past?

These questions are simple by design. However, it usually takes an experienced business valuation professional to sort through the plethora of assumptions both internal and external to the company, which will be used as inputs to the calculations. Valuation techniques come in a variety of shapes and sizes, but few can apply to all situations and rarely can one stand alone as an exclusive determinant of value. An experienced evaluator should choose at least one method to help answer three fundamental questions described above.

To answer the first question, an appraiser should primarily base their assumptions on what the business has done in the past. This approach includes all calculations that are heavily dependent on the past performance of the business. These methods could include:

- A multiple of the average historical earnings or sales.
- A discounted cash flow forecast based on a company's average operating performance or recent trends repeating themselves into the future.
- Several other hybrids of the above two methods.

To answer the second question, an appraiser should primarily base their assumptions and data on prices or values other similar companies received for selling their company within the last 12 to 18 months. A significant amount of market research will validate what the appraiser is using as comparable companies. These methods could include:

- A multiple of earnings
- A multiple of sales
- A multiple of assets
- A multiple of Book Value
- A multiple of nearly anything that draws an effective comparison within a specific industry

To answer the third question, an appraiser should primarily base their assumptions and data on the reasonable future projected performance of the business. This differs from the first category in that history is only used to provide a realistic boundary for the forecast. However, many of us have never seen a forecast that shows anything but increasing sales and profits! These methods include:

- A multiple of future sales and earnings
- A discounted cash flow forecast based on the sales and profits the company expects to experience in the future
- Several hybrids of the above two methods

There are certainly many more specific tools and calculations that various people may employ to estimate value. However, the best way to estimate a company's value (short of receiving an offer from a third party) is to insist your valuation professional choose at least one tool or calculation within each of the three categories of the “**Value Triangle**,” which will most appropriately indicate the fair value of your company.

Future articles within this series will address several of the elements discussed within this article in more detail. Next in the series is how to select a qualified business appraisal firm.