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Informal Business Valuation Opens the Door to the Business Market

Business owners invest time, energy, and money to develop and grow their business. Over time the business often becomes the source of the family's livelihood and a major portion of their estate. It's not unusual to hear that the business is also the source of the owner's retirement. Unfortunately, many owners don't have a clear understanding of what their business is worth. Consequently, it's a great place to start a conversation with a business owner and open the door to many business insurance opportunities.

Determining the Value of the Business

Business valuation is a critical component to an owner's business succession and retirement plans but there is no single method of determining a business's value. In fact, a business could have many "values" based on the purpose of the valuation. For example, a valuation done for gifting or transfer internally may focus on the low side of a valuation while an outside sale might want a high valuation. It is important for the business owner to understand that determining the value of a closely held business is not an exact science. Various methods may be used for different purposes. The three basic approaches to valuing a business are the asset approach, market approach, and income approach.

Market Approach to Business Valuation

The market or comparative method involves valuing a business based on the prices of actual sales of similar or comparative companies with the assumption that similar companies will have similar relative values. This approach requires finding a sufficient number of companies with similarities to the business being valued. This method is difficult to use with small, closely held companies because of the difficulty of identifying comparable companies.

Asset Approach to Business Valuation

The asset approach assumes that the value of a business is based on the underlying value of the business assets. Generally, the assets and liabilities are adjusted from the book value of the balance sheet to their respective fair market value. The resulting excess of the value of the assets over the liabilities of the business is the fair market value of the business. The fundamental problem with the asset approach is that it looks at the business assets as valuable in and of themselves, without regard to their impact on the business as a going concern.

Income Approach to Business Valuation

The income approach may be the most commonly accepted approach to estimating the fair market value of a business. It examines the flow of income from the business and converts that income stream into a value for the business. There are a few variations on the income approach, with the capitalization of income/earnings one of the most commonly used methods.

The capitalization of income method rests on the concept that the value of a business is a function of the income stream. Typically, a weighted average of the last three to five years after-tax adjusted earnings is used as the starting point. Next, an appropriate capitalization rate must be determined. The capitalization rate is a percentage to convert income to value. Ideally, this rate is determined by examining rates of publicly traded companies. Where capitalization rates are not available, a guideline is used (the higher the percentage the riskier or less stable the business). The inversion of this rate, the capitalization factor, is multiplied by the average earnings to reach an estimated value for the business.

How DBS Can Help?

Several of the DBS carriers provide no-cost informal valuations. Some will also review existing buy-sell agreements. So, the next time you are with a business owner and conversation leads to preparation for the owner's retirement you might want to offer to do an informal business valuation. To learn more about how to get an informal valuation, contact Terri Getman, J.D., CLU, ChFC, RICP, AEP (Distinguished) at extension 230.

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