

## The Market Approach

### An Alternative to Income Based Business Valuations

Valuators use a variety of methods to value a business, including income, asset-based and market approaches, or some combination of these approaches. The income approach is used most often for closely held businesses, but the market approach might not get the credit it deserves.

#### Income vs. Market

Under the income approach, a valuator projects a business's future income (based on earnings, cash flow or some other measure of economic benefits) and discounts it to present value. The result, in theory, is the amount a hypothetical buyer would pay a hypothetical seller for the business.

The market approach looks at actual transactions, preferably at arm's length. The valuator considers comparable businesses or transactions and develops multipliers based on the similarities and differences between the comparable and subject companies. In some cases, a value reached under the market approach may be more accurate because it depends on actual prices agreed to by real buyers and sellers.

A market-approach valuation is only as good as its underlying data, so valuers sometimes hesitate to rely on it if insufficient data is available or if available data isn't sufficiently comparable. In the age of the Internet, though, the number of data sources continues to grow. Valuators easily can glean information from online databases of private and public transaction data, listings in trade publications or by brokers, public trades and merger and acquisition activity.

While comparables from the same industry as the subject business are preferred, they're not always required. In some case, it may be possible to rely on comparables from other industries – as long as the companies have similar debt, net fixed assets, revenues, profits and markets – with

appropriate adjustments for industry differences and risk profiles.

#### *The mechanics of the market approach:*

Valuators can employ several different market methods when valuing a closely held business:

*Guideline company method.* This method depends on public company data. The SEC provides a wealth of such information. The breadth of information means a valuator has many possible comparison points, and the transactions are usually at arm's length, making them particularly suitable for valuation purposes. On the other hand, it takes a lot of time and money to comb through, analyze and adjust the mounds of SEC data, and the share prices for public companies are more volatile than for private companies.

Public companies' revenues, markets and capitalizations differ dramatically from those of a smaller business, but valuers can account for those and other disparities with discounts and premiums. For instance, a premium may be justified if the subject business is owned by a single person who exerts significant control over the company, unlike the typical shareholder in a public company. Most experts will argue that because shares in a public company are far more liquid, a discount should be applied.

*Mergers and acquisitions (M&A) method.* The M&A method may suffer in comparison to the guideline company method because less data is available and it can be difficult to verify or even obtain critical information. But M&A transactions are useful because they usually involve 100% interests in companies that are more similar to closely held businesses. The valuator will probably need to apply a discount for lack of control and marketability for closely held businesses. Additional  
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## Did You Know?

- According to "Forbes" magazine, the highest paid chief executive officer in 2005 was Terry S. Semel, CEO of Yahoo, who received \$230.6 million in total compensation.
- From 2001 to 2005, about 47 percent of the companies that went public had negative earnings, according to Jay Ritter, a professor of finance at the University of Fla..
- Based on population, Chinese Mandarin is the most commonly spoken language in the world. Spanish follows in second place, English is third and Bengali is fourth.
- Lawrence J. Ellison, founder and CEO of Oracle Corporation for 25 years earned \$706,077,000 in 2001 after exercising 23 million stock options granted to him ten years earlier. Broken down to a 40-hour work week, this salary is the equivalent of making almost \$340,000 an hour.
- Denmark is the country with the highest income tax. The top rate of tax is 68 percent, with the basic rate starting at 42 percent. Countries with the least income tax are Bahrain and Qatar in the middle east. Citizens there do not pay any income taxes at all. Profits from oil provide over half of the government revenues for both countries.
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## The Market Approach (concluded)

adjustments may be necessary, depending on whether a transaction is a stock or asset purchase.

*Direct market method.* The valuator scrutinizes transactions involving closely held businesses. These businesses generally boast greater price/value stability than public companies, but valuers may have trouble verifying transaction details (especially if data is not reported consistently) and some industries see few transactions. A valuator is likely to pay close attention to differences in liquidity, profits, risk, sales time and terms.

Prior transactions. Valuers also can look at a subject company's own transactions, such as buy-sell agreements, buy-ins, buyouts, mergers, and acquisitions, and offers for sale or purchase.

### It's worth considering

The market approach can prove tricky with smaller businesses, but it shouldn't be ruled out. Even if a valuator relies on the income approach, the market approach can help support his or her conclusions.

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