bdc*

How to evaluate a potential business acquisition

Choosing the right valuation method depends on the company and transaction

Read time: 5 minutes

Haggling over the price is usually one of the main hurdles in negotiating a business purchase. This is made more difficult by the complexity of business valuation; determining a fair value isn't possible without carefully studying the company's financial information, sales trends, customer and supplier base, and much more.

This is why it's generally a good idea to hire a professional business valuator to produce an independent valuation. Their report can uncover hidden financial issues and provide a good basis for negotiations.

"Valuation is a qualitative exercise. It's not formulaic. Many aspects go into the value," says Dennis Leung, a chartered business valuator with accounting and advisory firm Grant Thornton and chair of the communications committee of the Canadian Institute of Chartered Business Valuators.

Here are the three steps Leung follows to determine the value of a company.

1. Decide the level of valuation

The first step is to determine the level of complexity and assurance needed in the valuation report. A valuator can prepare three different levels of report ranging from basic to highly detailed.

The more thorough the report, the greater the cost and assurance that the valuation accurately reflects the company's true worth.

Calculation report

This is the simplest level of valuation report. It is typically a top-level report that provides limited details—for example, only a minimal breakdown of sales data. Such a report may be suitable to establish a preliminary valuation assessment.

Estimate report

An estimate report provides a mid-range level of detail and gives a higher level of assurance than a calculation report. It typically involves some review and corroboration of company information and may contain sales breakdowns by service line or division. It is often used for acquisitions.

Comprehensive report

A comprehensive report offers the highest level of detail and assurance. It involves thorough review and corroboration of information and may include market and economic research and detailed breakdowns of figures. It is common in more complex acquisitions and situations involving litigation or regulatory scrutiny.

2. Get business information

Once an engagement letter has been signed with the subject company, the valuator will be able to access the financial documents and other information they need to prepare the valuation report. The amount of information depends on the type of report they must prepare. It typically includes:

financial statements for the past three to five years
the prior year's tax return
a list of discretionary and non-recurring or one-time expenses
management compensation
business location, square footage and ownership or rental status of facilities
number of employees
patents, bylaws, and shareholder agreements

In some cases, especially if a more detailed report is being prepared, a valuator may also ask for:

a sales breakdown by customer for the past three to five years (in order to determine customer concentration, which can affect value)
information on supplier concentration
product margins by service line

The valuator may also follow up with:

clarifying questions to the company and an on-site visit
independent research on market conditions, business trends and risk factors

"It's a collaborative approach," Leung says. "We always tell the client we need to understand the business. They have the knowledge that makes the valuation possible."

3. Apply appropriate valuation method

Three main methods are available to determine the value of a company. A valuator chooses the method or combination of methods best suited to the type of business and the information available to them.

Keep in mind that the valuator determines a company's stand-alone fair market value to an arm's-length party. This means the company's value without any potential synergies or strategic considerations from the buyer.

The purchase price of the business may differ from the fair market value determined by a valuator because of various factors, such as the buyer's strategic interests or expected synergies, the owner's eagerness to sell, due diligence, available financing and the company's capacity to smoothly transition to new ownership.

Earnings-based methods

These approaches are commonly used for businesses that generate reasonable profits and whose value is greater than that of their net assets alone.

A valuator determines the company's value by reviewing past results and forecasted cash flow or earnings. They may also assess how reasonable the the company's projections are.

"Valuation is usually forward-looking," Leung says. "A buyer isn't buying what the business earned in the past, but what it will earn in the future. Historic results provide guidance, but they aren't necessarily indicative of future results."

A variety of income-based approaches is available.

Capitalized cash flow: Used when cash flow is expected to remain stable in future years.
Discounted cash flow: Used when cash flow is expected to fluctuate substantially in future years, such as when a company is growing rapidly.

Market-based methods

These approaches calculate a valuation by applying a valuation multiple, which may be based on EBITDA (earnings before interest, taxes, depreciation and amortization), revenue or other metrics. The specific figure used and type of ratio vary greatly depending on many factors, including:

industry and location
market conditions
sales trends
multiples used by comparable businesses
size and maturity of the company
past and forecasted earnings and cash flow stability
customer and supplier diversification
goodwill and intellectual property
dependence on owners and key employees
workforce engagement

Asset-based methods

Asset-based approaches are typically used for businesses whose value is asset-related rather than operations-related—for example in the real estate sector. They are also applied when a business doesn't generate a sufficient return on the assets employed or is expected to be liquidated. The valuator may in some cases need to call in a real estate or equipment appraiser for additional input.

Here are two common asset-based approaches.

Adjusted book value: Liabilities are subtracted from the fair market value of the company's assets.
Liquidation value: Liabilities are subtracted from the amount that the company's assets could sell for in a liquidation sale minus liquidation expenses.

> Related to this article:
> **Entrepreneur story - Software firm is in shape to dominate spa and fitness industry**

Explore more

BDC also recommends

- **Buying a business? How to protect yourself from potential liabilities**
- **How a minority investor can help you buy a business**
- **Five mistakes to avoid when buying a business**

Entrepreneur's toolkit

- **Business plan template**
- **Financial tools**

Discover our solutions

Financing

- **Boost your new business with start-up financing**

Advisory services

- **Obtain business coaching to grow your company**
- **Improve your financial management to stay profitable**