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Small Business Valuation Methods

How to Evaluate Small, Privately-Owned Businesses

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PREFACE

Valuation is the natural starting point toward buying or selling a business or securities through the stock market. Essential in wealth management, the valuation process allows the measurement of the strengths and weaknesses of a company and provides a historical reference for its development. Determining the value of a business is a complex task that is more like abstract art than an exact science.

Moreover, the concept of company value is better defined by a range of possible values than by an absolute and definitive dollar amount, since each method is associated with many assumptions and sensitive variables.

Subjectivity and biases may also be obstacles to a fair valuation analysis, a touch of behavioral finance is therefore necessary.

This book is not an academic and exhaustive list of all the existing valuation models; on the contrary, it focuses on essential methods grouped into three global approaches: the asset-based approach, the fundamental or discounted cash flow (DCF) approach, and the comparable company or market approach. The models explained are applicable to both small unlisted companies and large public companies.

Ultimately, this guide provides the financial theory and valuation basics needed to estimate the value of a small business.

A PRACTICAL BOOK

As the name suggests, this is a practical book.

Many pedagogical cases (15) and illustrations (33) underpin its pragmatic and didactic content.

However, it also contains enough theories to satisfy an expert audience.

For example, the author guides the junior business appraiser by indicating benchmarks that can be applied directly. A company appraisal cannot reach perfection, but requires a great deal of humility and pragmatism, especially in the small- and medium-sized enterprise segment.

THE TARGET OF THE BOOK

This book is ideal for business owners and additional players in the business world, legal professionals, accountants, wealth management advisers, and bankers, while also of interest to business school students and investors.

THE PURPOSE OF THE BOOK

The objective is to offer the reader the necessary tools to value a small company or—more modestly, to provide the ability to understand, give constructive feedback, and improve an appraisal report performed by a valuation professional.

THE LIMITS OF THE BOOK

The book focuses on the theme of valuation.

It does not address the buyout of a business with all of its human, legal, fiscal, or negotiating strategy components.

It establishes the fair value of an independent entity, not the price of a controlling interest in a company benefiting from synergies.

The goal is not to deprive the business owner of the valuable advice of a recognized expert in the field of business acquisitions.

Further, this book does not aim to cover taxation, accounting, or consolidation principles, as there is already a multitude of high-quality books on these subjects.

Only chartered accountants or business lawyers are fully familiar with the accounting, legal, or tax environment of the companies for which they are responsible.

PRACTICAL READING OF THE BOOK

The reader can read this book following two approaches:

In the sequential theoretical approach, the reader discovers each method, which is accompanied by practical, small case studies.

In the pragmatic approach, readers begin directly with a synthetic case study on Company SEGA, a golf management company. Subsequently, they can gradually reference the theoretical points of the previous chapters.

A special thank you goes to Tula Weis, Executive Editor, to Uma Vinesh, Project Coordinator at Palgrave Macmillan, and to Zobariya Jidda, Project Manager.

Thank you to Cambridge Proofreading LLC and to Scribbr for improving my English writing style.

Je salut aussi mes deux enfants, Samantha et Fabian.

Brest, France

Yannick Coulon

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- *Le guide pratique de la valorisation d'une PME*, Gualino, April 2021
- *Rational investing with ratios*, Palgrave MacMillan, Jan 2020
- *L'essentiel des ratios financiers*, Maxima, 2018
- *Guide pratique de la finance d'entreprise*, Gualino, 2017
- *Guide pratique de la finance comportementale*, Gualino, 2016

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CHAPTER 1

Enterprise Value, Company Value, and Other Essential Financial Data

Abstract This chapter outlines the essential metrics utilized in valuation. The core of the chapter focuses on **enterprise value** and **equity value**. The final portion of this chapter addresses the importance of understanding a company's positioning and strategy as a prerequisite for analyzing its financial statements. Several short case studies and illustrations are included. Key takeaways on these metrics and their limitations conclude the chapter.

Keywords Behavioral finance · Capital employed · Confirmation bias · Core and non-core assets · Efficient market · Enterprise value (EV) · Excess or surplus cash · Fair market value (FMV) · Financial bubbles · Michael E. Porter's strategy matrix · Net assets · Net operating assets · Operating and non-operating assets · Strategy and positioning

1.1 DEFINITION OF TWO ESSENTIAL AGGREGATES

It is of paramount importance to understand the differences between enterprise value (EV) and equity value.

Let us start with enterprise value.

1.1.1 *Enterprise Value*

Enterprise value or firm value is the fair market value (FMV) of core operating assets. EV is also the market value of capital employed.

It seems therefore logical to focus first on the definitions of operating assets and consequently capital employed.

Capital Employed

Capital employed is the total amount of capital that has been invested in a company for generating its core operating profit.

By construction, this amount is equivalent to the sum of all core operating assets of the company.

Non-core assets

Non-core assets are non-essential and non-strategic assets that are not required for running the company's core operations. These non-operating assets or excess assets do not generate recurring EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) or EBIT (Earnings Before Interest and Taxes).

Assets such as excess or surplus cash, investments in marketable securities or non-strategic minority holdings (non-consolidated) belong to this asset category. Land and real-estate investments can also be non-core assets if they are not necessary for the company's business operations (i.e., they were probably necessary in the past but no longer in use today or discontinued). If sold, the net proceeds would boost the cash holdings of the company and could be used to reduce debt. The proceeds could also be used to pay dividends. These non-core assets may generate non-operating income (interest or rent) and expenses (property tax) but the net impact on the company's bottom line is usually limited.

Net Operating Assets

The net operating assets are assets used in the operations of the business including the operating fixed assets (tangible and intangible) and the networking capital from operations.

Current operating liabilities are deducted from current operating assets to form the networking capital from operations.

$$\text{Net Operating Assets} = \text{Operating Assets} - \text{Operating Liabilities}$$

Definition of Enterprise Value

Enterprise value is commonly used as an important valuation tool by M&A companies (Mergers and Acquisitions). The EV aggregate has also become increasingly important for stock market analysis when using ratios such as EV to EBITDA multiple and all its possible variations. EV multiples are valuation metrics that are highly complementary to the classic price to earnings ratio (P/E ratio).

Enterprise value is the **fair market value** of the core operating or business assets of a company. It is a strong and proven concept that clearly links operating assets, debt, and cash. It can be explained either by the asset side or the equity side of the balance sheet, and thus it has a dual definition.

Enterprise value can also be defined as the theoretical takeover price of a company and is inclusive of the payoff of all capital claims (i.e., equity + financial debt obligations). This takeover price would allow for the purchase of the company's entire capital base and the repayment of all incurred financial debt (including lease obligations), while enabling the buyer to benefit from non-core assets (including excess cash) that could contribute to its debt repayment. In this way, we can understand enterprise value as the price tag of a "debt-free" company.

Enterprise value also represents the total amount of capital invested by common or preferred shareholders, long-term or short-term debt holders, or any additional direct or indirect long-term provider of funds to the company. Even a short-term loan provider is considered a long-term capital investor because short-credit facilities are typically renewed on an annual basis.

A trade debt (under accounts payable) is not an interest-bearing debt and should not be included in the category of capital employed. The goal of a supplier is to deliver the goods or services that are needed throughout the course of the business cycle, not to provide funding. Moreover, accounts payable are already included in the calculation of the non-cash working capital from operations (i.e., networking capital).

One area of difficulty is minority interest (non-controlling interest) which is added to provide consistency within EV ratios. If the parent