

FINANCIAL PERSPECTIVE



Using the market approach to value your business

By David J. Mayotte

In a recent trading session, the Dow Jones Industrials closed up nearly 62 points. Today, in early-morning trading, the Dow is up 20 points ... or is it down 20 points? Or was it down 20 and then up 20? Every day we are inundated with business and financial updates. It is hard to keep up with all the information that comes out. What does all this information mean? If you are a small-business owner or someone looking to acquire a business, it means that the fair market value of a business is always changing.

There are three basic approaches to value a business entity; these include the asset-based approach, the income approach and the market approach. This article will focus on the market approach to valuing a business entity.

The market approach is a general way of determining an indication of value of a business entity's assets and/or equity using one or more methods that compares a business entity to similar investments that have been sold. This article will present three common methods to apply the market approach. These three methods are simple and easy to calculate. It is, however, much harder to obtain an indication of value for a business entity because the business entity's results will most likely need numerous adjustments to make the entity comparable to its guideline publicly traded companies.

The most common adjustments include shareholder perks and benefits that tend to distort the privately held

business's results. This step will need to be done before finding comparable guideline public companies.

The next step is to find public companies with which to make a comparison. This can be a difficult and an oftentimes hopeless task. Publicly traded companies tend to be much larger than the average privately held business. In addition, the risks are not the same for public and private companies. For instance, publicly traded companies have access to the public markets for debt financing and stock issuances while privately held businesses might not have this ability.

It is also hard to find a comparable public company that is in the exact same business as the business entity that is being valued, as many publicly traded companies tend to have many different segments/divisions of their company.

Let's say that you are fortunate enough to find a comparable guideline company. Now what? Well, this is where the everyday volatility of the stock market can affect the business entity's fair market value. Some common market methods would include the price/earnings (P/E) ratio, the price/book value ratio and the price/dividends ratio.

The P/E ratio is a very common ratio that compares a company's market price per share to its earnings per share. For instance, if Company A's common stock price is \$20 per share and its earnings are \$1.25 per share, then their P/E ratio is 16 (\$20 divided by \$1.25). This is a very simple calculation and it can be meaningful. But, it could also be useless.

If the company's earnings are grow-

ing very quickly, the P/E ratio, which tends to use the past 12-month's historical earnings, might not represent an accurate reflection of the company as compared to other companies in its same industry. Do not compare the P/E ratio to other nonguideline companies because it will not be meaningful. A manufacturer of widgets should not be comparing their P/E ratio to that of a high-tech computer consulting company.

The price/book value ratio is simply the company's market price per share to its book value. For instance, if Company B's common stock price is \$30 per share and its book value is \$10 per share, then their price/book ratio is 3 (\$30 divided by \$10). This also is a very quick and easy calculation to compute. But, is it meaningful? It may be, but chances are, it is not.

One item that may distort this calculation is the fact that fixed assets are presented on a company's balance sheet at their historical cost less any accumulated depreciation expensed since the company's acquisition of that asset. The company's building and machinery may be very valuable at today's market prices but it may have a zero value on the company's balance sheet.

The price/dividends ratio compares a company's market price per share to its dividends per share. For instance, if Company C's common stock price is \$10 per share and its annual dividend per share is 50 cents per share, then their price/dividends ratio is 20 (\$10 divided

by 50 cents). A more common market multiple quoted is often the reciprocal of the price/dividends ratio, which is the yield. The yield is computed as follows: the annual dividend per share divided by the market price per common share. For Company C, its yield is 5 percent (50 cents divided by \$10).

Depending on the industry in which the company operates, the ratio and yield may or may not be meaningful. Small, privately held businesses tend not to pay dividends and instead substitute salaries and bonuses for the shareholders.

Dividends are still double taxed (they have to be paid out with after tax profits of the corporation and they are taxed as income to the recipient). In addition, companies generally retain a reasonable portion of the profits to meet capital expenditures and other competition.

Even after we have calculated the value of the business entity based on these three market methods, there are still numerous other market methods to consider as well as the asset-based and income approaches, which were not yet considered. These will be touched upon in a future article.

As for the Dow, it closed down 31 points.

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