

Understanding Your Business Valuation – Approaches and Discounts

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When determining what your business is worth, understanding the business valuation process is crucial. This process involves a comprehensive analysis of a company’s financial position, market conditions, and future growth potential, all of which combine to establish its overall value. Whether you’re planning to sell, attract investors, or prepare for a merger, selecting the right valuation method and applying the appropriate discounts can have a significant impact on your company’s valuation.

This article explores the fundamentals of [business valuation](#), including the key valuation approaches and methods used to assess the value of a company. We’ll also examine how different discounts are applied to adjust for factors like marketability, control, and risk. Using a fictional technology company as an example, we’ll demonstrate how these principles are applied in practice.

The Basics of Business Valuation

[Business valuation](#) refers to the process of determining the economic value of a business, typically for the purpose of selling, raising capital, or assessing growth potential. The valuation process involves several different methods and approaches that aim to capture a company’s financial health, its assets, and the income it generates. Every valuation relies on [business valuation standards and regulatory guidance](#).

Why Business Valuation is Important

For business owners, understanding the value of their company is essential for making informed decisions. A clear valuation helps during strategic planning, investment negotiations, and succession planning. Additionally, buyers and investors rely on accurate [company valuation](#) data to determine how much they are willing to pay for or invest in the business.

Businesses are valued based on many factors, including their assets, revenues, earnings, and market position. To arrive at a fair business valuation, professionals often rely on a combination of approaches, each of which is tailored to the type of business and the purpose of the valuation.

Common Business Valuation Approaches

There are three primary approaches for business valuation that experts use to assess the value of a company: the income approach, the market approach, and the asset-based approach. Each approach relies on different data and provides a unique perspective on the business valuation.

1. The Income Approach

The income approach is one of the most widely used methods to value a business, especially for companies with predictable earnings and cash flows. This valuation method estimates the present worth of a company based on its future income-generating potential. The central idea behind the income approach is that a business's current value is equal to the present value of its future cash flows.

Discounted Cash Flow (DCF) Method

[Company Valuation Using the Income Approach](#) involves forecasting the company's future cash flows and then discounting them back to their present value using a discount rate. The discount rate reflects the risk associated with the company and its future earnings potential. The DCF method is particularly useful for growth-oriented companies, such as those in the technology sector, where future profitability is a major driver of value.

2. The Market Approach

[Company Valuation Using the Market Approach](#) focuses on comparing the subject company to other similar businesses that have been sold or are publicly traded in the same industry. This method is useful when there is a substantial amount of data on comparable businesses that can serve as a benchmark for determining a company's market value.

Comparable Company Analysis (CCA)

One common variant of the market approach is the comparable company analysis (CCA). This method evaluates companies with similar financial characteristics and operational models to determine the value of the business. By comparing revenue multiples, earnings multiples, or other financial metrics, the value of a company can be inferred from the market value of its peers.

Example: Valuing InnovateTech Solutions Using CCA

Suppose we find three comparable software companies that have been recently sold in the market:

- DataCloud Inc.: Sold for \$30 million, with annual revenue of \$6 million (5x revenue multiple)
- CloudNet Solutions: Sold for \$40 million, with annual revenue of \$8 million (5x revenue multiple)
- SecureData Systems: Sold for \$50 million, with annual revenue of \$10 million (5x revenue multiple)

If InnovateTech Solutions has an annual revenue of \$6 million, and the average revenue multiple for comparable companies is 5x, the market value of InnovateTech Solutions would be approximately \$30 million (\$6 million x 5).

3. The Asset-Based Approach

The asset-based approach evaluates a company by assessing the total value of its assets and subtracting its liabilities. This method is often used for companies with significant tangible assets, such as real estate firms, manufacturing companies, or businesses with large amounts of inventory. The asset-based approach is also commonly used when the business is being liquidated.

Asset-Based Valuation Method

[Company Valuation Using the Asset-Based Approach](#) calculates the value of a company by adding up the fair market value of all its tangible and intangible assets and then subtracting its liabilities. The asset-based valuation method focuses on the value of the company's physical and intellectual property rather than its income or cash flow potential.

Example: Valuing InnovateTech Solutions Using the Asset-Based Approach

If InnovateTech Solutions has the following assets:

- Software patents: \$10 million
- Office equipment: \$1.5 million
- Cash: \$3 million
- Total liabilities: \$2 million

Using the asset-based approach, we would calculate the value of the company as follows:

- Total assets: \$14.5 million
- Minus liabilities: \$2 million
- Net asset value: \$12.5 million

The asset-based value of InnovateTech Solutions would therefore be \$12.5 million, reflecting the value of its tangible and intangible assets minus liabilities.

Valuation Discounts: Adjusting for Risk and Marketability

Once the [corporate valuation](#) is complete, discounts may need to be applied to account for factors such as lack of control, lack of marketability, and the risk associated with the company. These discounts adjust the valuation to better reflect the realities of selling a business or a partial interest in a business.

1. Discount for Lack of Marketability (DLOM)

The discount for lack of marketability (DLOM) reflects the reduced value of shares in a private company compared to publicly traded shares. Private company shares are not easily sold or liquidated, and this illiquidity reduces their marketability. A DLOM typically ranges from 10% to 30%, depending on the company's size, industry, and ease of sale.

For example, if InnovateTech Solutions is a private company valued at \$30 million, but its shares are illiquid, a DLOM of 15% could be applied. This would reduce the market value of the business to \$25.5 million ($\$30 \text{ million} \times 0.85$).

2. Control Premium

A control premium is added when a buyer is acquiring a controlling interest in a company. A control premium reflects the increased value of being able to influence business strategy, operations, and decision-making. Control premiums vary, but they typically range from 10% to 30%.

If a buyer is acquiring a controlling stake in InnovateTech Solutions, a 20% control premium might be applied, increasing the market value of the business from \$30 million to \$36 million.

Choosing the Right Valuation Approach

When deciding which [corporate valuation](#) method to use, it's important to consider the type of business, its financial characteristics, and the purpose of the valuation. For example:

- The income approach is ideal for businesses with predictable earnings and cash flows, such as tech companies like InnovateTech Solutions.
- The market approach works well for businesses in industries where comparable companies are frequently bought and sold, allowing for accurate market comparisons.
- The asset-based approach is best suited for asset-heavy businesses, such as real estate firms or manufacturing companies.

[This applies in the sale of the company, about which you can read more here: Valuation Methods of Business Valuation in the Sale of a Company](#)

Conclusion: Understanding Approaches and Discounts in Business Valuation

A thorough business valuation involves more than just calculating numbers—it requires a deep understanding of the business, its industry, and the purpose of the valuation. By using the right valuation approach, whether it's the income approach, market approach, or asset-based approach, business owners can gain insight into the true value of their business.

Additionally, applying appropriate discounts helps adjust the valuation for real-world factors like control, marketability, and risk. For InnovateTech Solutions, the combination of DCF analysis and market comparisons, along with adjustments for lack of control and marketability, provides a comprehensive picture of what the business is worth.

For business owners, understanding these [company valuation](#) approaches and discounts is critical for making strategic decisions about selling, raising capital, or planning for growth. Working with valuation professionals ensures that the valuation process is accurate, reliable, and tailored to the specific needs of the company.