THREE TYPES OF BUSINESS VALUE, KNOW WHICH APPLIES TO YOUR SITUATION

Why do business valuations arrive at such seemingly different answers to a single question? One reason is that valuation analysts hold two opposing perspectives on the nature of business value. Some see valuation from a 'perfect market' perspective, while others from an M&A perspective. The two different valuation models generally track with two concepts known as Value-to-the-Holder and Value-in-Exchange.

The perfect market likes to approach valuation as a single present value analysis, while M&A divides the problem into two risks. In the first, a business and its ownership are viewed together, as one organism. In the latter, the business is viewed as-if stripped of its owner. It is the 'owner-less' business that is sold in an acquisition, and the 'extras' of leverage, entity type, owner strengths, while conceptually present, are ignored. The M&A professional has no interest in these owner factors.

Clearly, selling a business is the model for Value-in-Exchange. So, if the need is for an open-market price of a business, we do better following the M&A model, not the theoretical approach. The M&A model not only uses an 'owner-less' business for its basis, it also measures cash flows with EBITDA. EBITDA is the benefit being acquired in the M&A transaction. An acquirer gets to configure how its cash is spent, and how it is structured, different from the previous owner. The buyer may re-invest the EBITDA back into the business, or it may distribute it to equity holders. It may fold the acquisition into an existing company, or it could set it up as a separate entity. It may borrow and leverage the return to equity holders, or could be debt-free. All these options are available to the buyer, and this basic view of market value defines Value-in-Exchange.

On the other hand, Value-to-the-Holder is reflected in shares of equity. This Owner Value has the added elements that M&A professionals ignore. If a company is over-leveraged, we care. If the company is diverting cash to perquisites, we care. If the company is cash-poor, we care. So, to value equity shares, we want a different approach. We look at non-operating assets and liabilities for their impact. For cash flows, EBITDA is replaced by Free Cash Flow (FCF). FCF is the benefit flowing to equity holders because it reflects the actual owner choices on all those options that a buyer has available. By making their choices, owners eliminate options and narrow the possibilities, so value is different from when the company as a whole is sold.

This entity-level Owner Value, is a distinct stage, and is not an open-market price as seen in public markets. Owner Value is the stage where investors negotiate a buy-in price, or where shareholders exit in a dispute. It is the value used when splitting a company in a divorce. In contrast to Owner equity in a company, the open-market price of a share is different. The open-market price of a share is used for tax assessment and converted by a Discount for Lack of Marketability. You can think of this as the conversion from owner value to asset value. The 'asset perspective' is the perspective of U.S. regulations under the Fair Market Value and GAAP standards.

These distinctions are critically important as there are billions of dollars at stake every year in transactions and disputes and tax assessments. It is the Exchange view of a whole company that controls the price where you sell your business. It is the Owner view of Value-to-the-Holder that is used for investment and dispute resolution. And, it is FMV of shares that is used for tax assessment. With many valuation experts firmly anchored in a rigid school of thought, knowing which type of value applies to you is critical for selecting the right expert for your situation.

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