Michael B. Lehner, CPA/ABV, CFE, ASA
732.412.3825 | mlehner@zbtcpa.com
www.zbtcpa.com

Viewpoint on Value

zbt Certified Public Accounting & Consulting, LLC

.

Market approach

How to pick a relevant pricing multiple

Courts tend to prefer the market approach in business valuation over the income or cost approach, because it's based on real-world transactions. Under the market approach, the value of a private business interest is determined using comparisons to "similar businesses, business ownership interests, securities, or intangible assets that have been sold."

Comparable transactions — which may involve publicly traded stocks or privately held businesses — are analyzed to determine pricing multiples that find a mathematical relationship between a financial variable and selling price (market value). But which pricing multiple provides the most reliable indication of value?

Multiple choices

Business valuation experts select from a varied menu of pricing multiples. Common choices compare deal price to such financial variables as:

- Net sales,
- Earnings before interest, taxes, depreciation and amortization (EBITDA),
- Earnings before interest and taxes (EBIT),
- Discretionary income (with varying definitions),
- Net income, and
- Book value.

There's no universally optimal pricing multiple. Business valuation experts often perform statistical analyses on the sample of comparable transactions to determine which financial variables have the strongest correlation.

Experts also may decide to eliminate "outlier" transactions that might not meet the definition of fair market value. For example, a seller might have been under duress to sell quickly due to bankruptcy or the death of a key person. Or a buyer might have paid a premium price because it overestimated cost-saving or revenue-building synergies from the transaction. Related parties also may pay above- or below-market prices.

These factors can skew the results, so it's important to investigate the details of each comparable in the sample. Some private transaction databases provide more details than others.

Pros and cons

Once all relevant pricing multiples have been computed and analyzed, business valuation professionals evaluate the pros and cons of each multiple based on the nature of the business, its industry and case facts. For instance, the price-to-net-sales multiple may be preferred, because profit metrics are inconsistently defined and subject to manipulation. This is especially relevant in divorce or shareholder disputes when a controlling shareholder might have an incentive to downplay (or exaggerate) financial results to help understate (or inflate) the value of a business interest.

On the other hand, EBITDA multiples may be preferred when the subject company is subject to different tax rates or has a different capital structure than the comparables do. Price-to-book-value may make more sense when valuing an asset-holding company or an asset-intensive business in which book values reasonably approximate current market values.

When valuing small businesses (under $5 million in annual revenues), price-to-discretionary-income may be more meaningful. This multiple is often used in small company mergers and acquisitions, resulting in familiar industry rules of thumb. It also addresses the general desire of small businesses to reduce income tax expenses.

Detailed reports

Though the market approach seems objective and straightforward, selecting a pricing multiple adds an element of professional judgment into the valuation equation. So, business valuation professionals should be ready to explain and defend the pricing multiple (or multiples) selected based on quantitative and qualitative factors. In addition, their reports should explain why other pricing multiples and outliers were eliminated from the expert's analyses.

If your business valuation expert's written report doesn't fully explain the analyses, don't be afraid to ask for more details to be added before the report is finalized. Or you may want additional questions to be asked during deposition or trial to add credibility to his or her conclusion.

Do you have a
Question?
or want to speak to
Michael B. Lehner
CPA/ABV, CFE, ASA

zbt Certified Public Accounting & Consulting, LLC

Michael B. Lehner, CPA/ABV, CFE, ASA
732.412.3825
mlehner@zbtcpa.com
www.linkedin.com/in/michaellehnercpa
@MLehnerCPA
BusinessValuationNJ
www.zbtcpa.com