Application of the Market Approach in Business Valuations

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Business valuation reports are often long and complicated and involve technically detailed descriptions, causing them to be somewhat difficult reading. Valuation reports can exceed 100 pages, summarizing Excel models that can easily span 50 to 100 individual worksheets. On a conceptual level, business valuations combine elements of accounting, finance, economics, tax, law, management, operational efficiency, organizational behavior, industry-specific topics, and other subjects. Summarizing all of these topics into a valuation report can result in a document that is difficult to follow and a narrative thread that is easily lost.

Within this flood of information, important information may become obscured, whether intentionally or unintentionally. Even relatively simple processes may become quite complicated.

There are three basic business valuation approaches: (1) the income approach, (2) the market approach, and (3) the asset-based approach. Within each valuation approach, there are multiple valuation methods. Valuation analysts often apply more than one method from more than one approach to value a business. This article describes the application of the market approach, including its strengths and weaknesses, to assist you when formulating your strategy.

In its simplest form, the market approach is fairly straightforward: the valuation analyst estimates business value by looking at the selling price of similar businesses. However, thorough valuations often describe the market approach in much deeper detail. This rigorous analysis is warranted as seemingly minor elements of the market approach often result in large differences in value. Companies with higher levels of profit typically attract a higher multiple, transaction terms may influence the selling price, seller motivations also impact the selling price, and two similar industries may have very different M&A patterns.

Among all this data, valuation report readers, such as attorneys and finders-of-fact in litigated disputes, may become confused and frustrated. To help clear up this confusion, in this discussion, we distill the market approach to its simplest form to provide high-level clarity regarding its application. We also discuss the strengths and weaknesses of the market approach from our perspective and experience in valuing businesses for litigated matters. Knowing these strengths and weaknesses may be helpful when formulating your approach.

Application of the Market Approach

The market approach is often applied in valuations for litigated matters. If you have ever had a house appraised, you have a level of familiarity with the market approach. When real estate appraisers value a house, they look for similar houses (i.e., comparables, or "comps") that have sold and calculate the price per square foot of these comparables. They then select a reasonable price per square foot from the range indicated by the comparables and multiply this figure by the square footage of the house being valued, indicating its value.

The market approach in business valuations follows the same basic procedures. However, price per square foot is not a meaningful indicator of business value. Extremely valuable businesses may have small facilities, and less valuable companies may have sprawling facilities. Therefore, instead of using a price per square foot, the valuation analyst uses more relevant denominators, such as annual revenue or profit.

There are two primary market approach methods: the guideline completed transaction method and the guideline public company method. The guideline completed transaction method relies on the prices of recently sold similar companies. The guideline public company method uses the stock prices of similar publicly traded companies. By summing up the market value of all outstanding stock and debt, valuation analysts calculate the total value of publicly traded companies from the disparate ownership interests.

In both the guideline completed transaction method and the guideline public company method, the analyst performs the following steps:

		House 1	House 2	House 3	House 2	House 5
Sales Price		$350,000	$320,000	$360,000	$380,000	$315,000
Square Footage	÷	2,200	2,100	2,300	2,400	1,900
Price/Square Foot		$159.09	$152.38	$156.52	$158.33	$165.79
Selected Price/Square Foot		$160.00				
Subject House Square Footage	×	2,200				
Value of Subject House		$ 352,000				

		$$$$$ Business 1	$$$$$ Business 2	$$$$$ Business 3	$$$$$ Business 4	$$$$$ Business 5
Selling Price		$10,000,000	$12,000,000	$9,000,000	$15,000,000	$7,000,000
EBITDA	÷	2,000,000	3,000,000	2,000,000	2,000,000	1,500,000
EBITDA Multiple (Selling Price ÷ EBITDA)		5.0x	4.0x	4.5x	7.5x	4.7x
Selected EBITDA Multiple		5.0x				
Subject Company EBITDA	×	2,500,000				
Value of Subject Company		$ 12,500,000				

1. Identify sales of similar companies or calculate the value of similar publicly traded companies.
2. Calculate relevant valuation multiples by dividing the value of each guideline company by a denominator such as revenue, operating income, EBITDA, or other value drivers.
3. Select an appropriate valuation multiple(s) from the range of indicated multiples and multiply it by the subject company financial fundamentals, indicating business value.

There are many nuances to valuing a business using the market approach, but these steps summarize the basic market approach framework.

While valuation reports may be complicated, it is reasonable, after having read the valuation report, to expect to have a general understanding of how the company was valued. If an expert witness is unable to communicate their findings in a decipherable manner, it is possible that they either don't understand it themselves or they have something to hide.

Strengths

The market approach has many strengths to consider when formulating your dispute strategy.

The market approach may provide a very compelling indication of value. Fair value is defined in the Maine Revised Statutes as "using customary and current valuation concepts and techniques generally employed for similar businesses in

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the context of the transaction requiring appraisal."[1] The foundational definition for customary and current valuation concepts for closely held businesses is drawn from Revenue Ruling 59-60, which defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller…"[2] The market approach can provide a convincing indication of value because it is based on exactly that—an actual transaction involving people buying and selling similar businesses. Therefore, finders-of-fact may find the market approach to be relatable and to make intuitive sense, given the standard of value.

The income approach is the other commonly applied approach for litigated purposes. (The asset approach is not commonly applied in valuations for litigated purposes.) In the income approach, business value is estimated by discounting or capitalizing the benefit stream of a business. If the finder-of-fact is not familiar with the estimation and application of income approach variables, they may find the market approach to be more reliable. It may also be heavily reliant on projected future cash flows, which might be influenced by which side of a disagreement the parties find themselves.

Even when the income approach is applied and given more weight, the market approach can be used as an indicator of reasonability. Credibility is enhanced if a valuation analyst uses two or more different processes to get similar indications of value.

Weaknesses

The market approach is often exposed to the following weaknesses. Keep these weaknesses in mind when reviewing valuation reports.

While one of the strengths of the market approach is how well it relates conceptually to the definition of fair value and fair market value, it also highlights a potential weakness of the market approach. Many transactions occur because the acquirers expect to achieve synergistic benefits from the transaction. These synergies may be priced into the transaction, potentially inflating the transaction price above fair market value. Therefore, it is possible for the market approach to indicate investment value[3] rather than fair market value. It is also difficult to know what motivated a sale. Without knowing the intent of the buyers and sellers, it is difficult to determine how close to fair market value a transaction might be, rather than investment value.

It is often difficult to locate companies that are reasonably similar to the subject company. As with a real estate appraisal, the moment comparables are listed, the positioning begins. Real estate appraisals have any number of adjustments, based on location, materials, and features, each of which can alter the price per square foot. And the number of real estate transactions to compare to are vast when compared to business transactions. People often start businesses because they see a need that isn't being met—that is, there aren't any companies like the one they want to start. The point of a business is to be different than its competitors. While differentiation is great for creating a competitive advantage, it makes it difficult to find similar companies. Even if a market supports multiple similar businesses, these companies may not have ever sold. As a result, valuation analysts often struggle to identify guideline companies.

Identifying guideline public companies has its own set of challenges. Publicly traded companies often diversify their operations to reduce risk. By comparison, many privately held companies are undiversified. The lack of pure-play public companies may limit the number of guideline companies available to the analyst. Further, publicly traded companies are often significantly larger than privately held companies, posing additional comparability challenges. Another feature of publicly traded companies is that the shares trade in a relatively efficient market with low transaction costs. Based on the efficient market hypothesis, this allows the market to express its opinion on the value of the underlying shares. Private companies do not benefit from efficient markets. The cost of a transaction can be substantial and the timing typically infrequent.

Another common limitation when applying the market approach is the lack of data from completed transactions. Quality data from completed transactions typically comes from subscription-based databases. The price tag for access to these databases can be steep. Public company data is more readily available. There are services that make this data much easier to analyze and study and those services also come with a steep price. If a valuation analyst works on a limited budget, they may not be able to afford access to quality data. This lack of quality data may weaken the application of the market approach.

Even if a valuation analyst has access to top-tier databases, financial data may be incomplete as it may have never been disclosed by either party. Even if involved parties report financial data in databases, supporting documentation may be unavailable.

The consideration paid in completed transactions is another potential weakness in the market approach. Consideration may include stock of the acquiring party, earn outs, non-compete agreements, and other items. Adjusting these to a cash equivalent can be a subjective exercise. And where there is subjectivity, there is room for error.

Another area of subjectivity and potential errors is in the selection of valuation multiples. When valuing a house, the price per square foot of the selected comparables is typically in a much narrower range than the range of multiples when valuing a business. Analyst judgement is required to select a valuation multiple from the reported range. Often, analysts err by selecting a multiple that is not warranted by the subject company's historical and projected financial performance. (One way to mitigate this weakness is to support the selected multiple by benchmarking the subject company's financial performance to industry benchmarks.)

These potential weaknesses are important to keep top of mind when reviewing your expert witness's report. If any of these errors surface, talk to your expert witness. It is possible for an oversight to have occurred; it is also possible that your expert witness made a conscious and justifiable choice based on reasons not documented in the report.

These errors may also be present in opposing expert witness's valuation reports. Keep them in mind when formulating your dispute strategy.

Conclusion

Valuation reports are often long and technical. They can be confusing and tedious for legal counsel to read, with salient information lost through sheer volume. The market approach is one area of valuation reports that readers frequently have difficulty deciphering and digesting.

The application of the market approach can be confusing to read about in valuation reports, but at a high level, it is a straightforward three-step process. As legal counsel, you should understand the contents of valuation reports; the market approach discussion above should arm you with the tools to do so. As you review valuation reports, keep in mind the market approach strengths and weaknesses discussed above. This information will help you defend your expert witness's work, critique the work of opposing expert witnesses, and formulate your dispute strategy.

1 Maine Revised Statutes, Title 13-C: Maine Business Corporation Act, Chapter 13: Appraisal Rights, Subchapter 1: Appraisal Rights And Payment For Shares, §1301.4(b).

2 Revenue Ruling 59-60, 1959-1 CB 237; Estate Tax Regulations §20.2031-1(b); Gift Tax Regulations §25.2512-1.

3 Investment value is defined by the *International Glossary of Business Valuation Terms* as "the value to a particular investor based on individual investment requirements and expectations."

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