The Corner Office

Valuation Comparables: The Method Behind Determining Your Market Value

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In determining the value of your company, banks often rely on comparables of similar businesses. But where do those comparables come from, especially when private companies don't have to publicly disclose their financials? And is there a way that you, as a business owner, can tap into this information without having to order a full-blown appraisal?

Comparables are derived from a variety of different datasets. In this article, I'll break down two different types, and show you how comparables (and the datasets behind them) factor into your valuation.

You'll also get to see the types of valuation reports you can access, based on where you are in the selling process. You'll see how these valuations can be used to either help you sell your business or chart the course for future growth.

Without Public Records, Banks Must Rely on Each Other

If you're taking out a mortgage to finance the purchase of a new home, the value of the home needs to be established by the bank. That's an easily accessible "dataset." The sales price for a home is a matter of public record. Bankers and appraisers derive their comparables from that data.

The same methodology is used to value businesses, but there's a slight wrinkle when it comes to privately owned companies. There are no public records here, and most companies keep their financials close to the vest.

So where do banks get their numbers from when they're assessing a business? Part of it comes from a certified appraiser's assessment of a company's income and assets. But to compare a company against similar entities in the marketplace, banks rely on each other. They use pooled data from a source called RMA.

The Ultimate Question

RMA stands for the Risk Management Association. This is a not-for-profit association that serves the financial industry. Their sole purpose, as noted on their website, is "to advance the use of sound risk management principles in the financial services industry."

RMA has approximately 2,500 institutional members, and it includes banks of all sizes as well as nonbank financial institutions. RMA provides members with access to industry information, produces a variety of publications, and conducts educational seminars. Their mission is to help lenders answer the ultimate question: "If I lend money, am I going to get paid back?"

Pooling Financial Data

While members of RMA are likely competing against each other for loans and accounts, they understand the value of working together in one critical area: Pooling data on the financials of companies that have applied for financing.

The pooled data does not include personal information — just the financials of the company. The data is aggregated and summarized, and allows financial institutions to compare similar businesses, both in size and industry.

Why pool the data? As we mentioned before, privately held businesses don't need to make their financials public. And if you have little or no information on publicly held businesses in a particular niche industry, you're going to be hard-pressed to find a reliable dataset for company values.

RMA provides that data, but they're not alone. Companies like Bizcomps and IBA Market Data are also used by lenders to evaluate your business. In our experience, however, RMA forms the crux of a lender's decision for small and mid-sized privately held businesses.

Datasets Used by Business Brokers and Owners

Bankers use the RMA datasets in conjunction with an appraisal to determine the value of your business. But what if you're a business broker or an owner who wants a sense of how your company stacks up against the rest of the industry, and you don't want to go with a full-blown appraisal?

Companies who provide small business owners and business brokers low-cost access to a comparables database gathered from national, regional and local SBA lenders across the United States, such as a company like PeerComps, could be your solution.

These types of datasets include small- to mid-market companies, typically with $1 million to $5 million in revenue. Over 9,000 businesses are included, encompassing all major industry classifications and even includes specialized industries such as professional practices, franchises and online businesses.

This is the low-cost alternative to spending $1,000 or more on a certified appraisal. For owners and business brokers, it's an ideal pre-screening tool — a litmus test to determine what type of value your business could command on the marketplace. But it's just the first step.

Two Types of Valuations

Dataset companies are a great springboard for comparing yourself against the marketplace. But you may decide you want a more in-depth look internally, and for that you can opt for a valuation to find out exactly what you need to do to either grow your business or get your house in order.

For example, the right valuation will reveal areas where you can improve your business in the short-term, such as tightening up your accounts receivable and inventory control so you have a better working capital scenario.

There are two types of accredited valuations: a Calculation of Value, which is a basic valuation, or the more extensive appraisal, which is called the Complete Summary.

A Calculation of Value gives you a sense of the marketplace and where you stand, and may include an income, asset, or market-based approach. The Complete Summary is much more in-depth, and follows uniform standards of professional appraisal practices. It's intended for larger businesses with multiple intended users, such as a board or a partner.

For the majority of businesses, the Calculation of Value provides you with precisely what you need. It doesn't follow every uniform standard or the in-depth information as the extensive Complete Summary.

Either valuation will include:

1. **Financial analysis:** The trends based on your historical financial performance, adjusted income statements, profitability and financial risk. It helps the appraiser assess your business compared to the competition.
2. **Operational analysis:** The operational factors includes the kind of market you serve, your business's reliance on you (the owner), and your staff structure.

These two factors determine the bulk of your business's total risk. They are then compared with market, industrial and economical analysis — that's where the RMA data is used.

Looking Beyond the Appraisal: The Art and Science of Valuation

Numbers don't lie, but they don't necessarily always present the complete picture. When you're analyzing datasets or a valuation, you must have a thorough understanding of the strengths and weaknesses of a particular business.

It might look good on paper, but is it entirely dependent on the owner for success? What is the company culture like — is the morale waning? Does the management motivate and integrate employee participation into company growth?

Datasets will produce the numbers, but it's only when you set foot in the company, and speak to its team, that you get a sense of what's behind those financials. That's the art of this business: The human factor. Judging it requires years of experience — an ability to synthesize the cold-hard facts of the valuation with real-world human behavior. It's not an easy task.

There is another factor that plays into a valuation: your company's vision.

Putting Yourself in the Investor's Shoes

These datasets not only help you understand how you stack up against the competition, they put you in the shoes of a potential investor. They are looking at investments from a risk management perspective.

One factor that is difficult to quantify is your vision. What is your goal for your company? How are you planning to grow a profitable niche, and why will it produce exceptional growth for an investor?

If you tap into PeerComps or other datasets to see how you stack up against the competition, don't forget to analyze the vision of others in the industry. See if your goals are just as lofty, and your vision is forward-focused.

Datasets produce the here-and-now for investors, and that's invaluable. But vision is ultimately what turbocharges your value and creates double-digit multiples.

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The Takeaway

I've provided you with a behind-the-scenes look at the types of datasets that contribute to market valuations. I've also included a number of different reports that can be derived from the different datasets, which include:

- **PeerComp/Dataset Companies:** Industry snapshot, good to see how you compare with your peers
- **Calculation of Value:** An appraisal that includes appraisal of assets and income, as well as marketplace analysis
- **Complete Summary:** An extensive appraisal, used with large companies and when multiple parties are involved

Choosing the right option will depend on where you are in the buying process. All of them should be conducted with the help of a qualified professional who has a thorough understanding of the current marketplace and can help match your business with a synergistic buyer.