Combining Valuation Methods to Unlock Company Value

Abstract

Investors to employ a combination of valuation methods in today's dynamic business environment to provide a more comprehensive analysis, helps managing risks, adapts to market changes, supports decision-making, and enhances the reliability and validity of the valuation results.

In the world of business, there often comes a point when company owners need external funding to take their ventures to the next level. Whether it's for scaling operations, expanding the workforce, or entering international markets, external funding can provide valuable support. However, in today's investment landscape, it's crucial for investors and entrepreneurs to have a deep understanding of valuation methods and the associated pitfalls. To unlock the true value of a company, it is increasingly important to combine various valuation approaches.

Among the most common used methods, bench-marking, discounted cash flow (DCF), and intangible asset analysis have gained significant attention. While there are numerous other methods available, we will focus on these as they have proven to be the most useful and effective. It is worth noting that valuation practices can vary across different regions of the world and exploring additional methods like the Venture Capital (VC) method, the Berkus method, the book value method, or the scorecard method can provide further insights.

The discounted cash flow method (DCF) is a widely employed valuation technique that estimates the value of an investment, based on future cash flows. This approach assumes that the company will experience steady growth over the coming years or that the investor will exit the investment after a certain period. The present value of future cash flows is calculated using a discount rate. However, when applying the DCF method to startup companies, there are challenges. Startups often have high valuations based on projections of future earnings, which can be seen as wishful thinking and, in some cases, even as unrealistic bias projections. Since the DCF method relies on evaluating past cash flows to forecast future profits, it is less suitable for pre-revenue companies with inconsistent earnings.

The DCF method is most effective for companies with stable revenues in established markets, where there is some level of certainty regarding overall market growth and business development. However, in the current business environment, relying solely on DCF can paint an optimistic picture that may not align with reality if expected high growth is not achieved.

Intangible asset valuation has become increasingly significant in today's business landscape. While tangible assets used to account for the majority of a company's value, the focus has shifted to knowledge-intensive assets known as intangible assets (IA). These assets include intellectual property, key personnel, and research and development work. In fact, it is estimated that approximately 80% of a company's growth and revenue-generating assets are now intangible. Recognizing the significance of IA is crucial, but

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measuring only the intangible value is insufficient to understand a company's overall worth.

Combining the IA method with **benchmarking** provides a more comprehensive valuation approach. Technology companies for instance, heavily rely on knowledge-intensive assets, which significantly contribute to their overall value. Therefore, using the IA method as the primary valuation tool and leveraging benchmarking data to understand how the company compares to others in the market is a more logical approach.

By incorporating a combination of valuation techniques, including both traditional and innovative methods, you can adapt to changing market dynamics and capture unique characteristics or future potential that may not be captured by a single approach. Different stakeholders may have different perspectives and preferences, and a combination of valuation methods provides a broader range of insights, facilitating more informed decision-making. It allows decision-makers (both sellers and buyers) to consider multiple perspectives and weigh the results from different valuation approaches.

In practice, a combination of valuation methods often yields the most accurate results. For example, if you own an established technology company that offers a unique solution, combining the DCF and IA methods would be the ideal choice. This is because your company likely has a steady revenue stream, but its success depends heavily on the knowledge (technology) and performance of your staff, as well as your network of committed customers. While benchmark analysis can provide a reference point by comparing your company to similar ones in the market, it should not be the sole determinant of value.

For buyers, it's all about making well-informed decisions. By utilizing a combination of valuation methods, you gain a comprehensive understanding of the asset's worth. Each method brings its own unique perspective, shedding light on different aspects such as cash flows, market comparable, and future growth potential. This multi-dimensional approach empowers them to assess the investment from all angles, ensuring that they're not missing out on any critical insights. Armed with this knowledge, they can negotiate with confidence, knowing that they've explored every avenue to arrive at a fair value.

For sellers, the goal is to extract maximum value from their assets. Presenting a buyer with a comprehensive valuation, backed by multiple methods, strengthens their position and instills confidence. It demonstrates that they've gone the extra mile to showcase the true potential of what they’re offering. Moreover, a combination of valuation methods allows the seller to highlight different aspects that might be overlooked with a single approach. Whether it's the intangible assets, market comparable, or future growth projections, a diverse valuation methodology ensures that you present a compelling case for your asset's value.

But it's not just about impressing potential buyers. The use of multiple valuation methods also provides you, the seller, with a deeper understanding of your own asset. It unveils hidden strengths and areas for improvement, enabling you to fine-tune your selling strategy. Armed with this knowledge, you can make informed decisions about timing, pricing, and marketing efforts, all aimed at maximizing your returns.

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