

Understanding the value of your business: A guide for business owners

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In the world of closely held businesses, retirement planning often takes a backseat to investing more capital in the business. However, it is essential for business owners to understand the value of their company, both now and in the future, to make informed financial decisions. Whether it's for retirement planning or efficient transfer planning, having a solid grasp of the value of your business is crucial.

The importance of knowing your 'magic number'

One of the most critical factors in the success or failure of a financial plan for business owners is the "magic number" – the proceeds from selling the business that are necessary to meet all critical financial goals. Without knowing this number and how it relates to the current value of the business, business owners risk making blind decisions that may not be in their best interest. Whether you need to rely on a sale for retirement or have accumulated sufficient assets outside the business, understanding the value of your company allows for more efficient and proactive transfer planning.

What constitutes value in the marketplace?

To understand the value of your company, it's important to know how potential buyers will value your business. Many owners mistakenly believe that the value of their company is directly correlated with the effort they have put into it. However, prospective buyers are primarily interested in the company's risk profile and return potential, which are the foundation of how the value of the business is defined. The return potential of a company directly affects its value. The higher the return potential, the higher the value, and vice versa. Similarly, the risks associated with the expected return also impact the value of the company. These risks can be internal, such as customer concentration or limited management team, or external, such as the economic or regulatory environment.

Considering the future performance of your business

Buyers not only evaluate a company based on its historical financial information but also consider how the company and industry will change over time. For example, a printing company may have positive historical financial statements, but with the continued shift towards digital media, its future performance may be drastically different. Buyers take into account the potential for growth or decline when determining the value of a business.

Valuation approaches: Three methods to measure value

Appraisers and finance professionals use various methods to measure the value of a business. These methods are similar to how buyers define value in the marketplace. Understanding these approaches can help business owners drive their decisions to support a more favorable valuation when the time comes to exit the business. The three common approaches to valuation are:

1. **Market approach:** This approach determines the value of a business by comparing it to similar companies that have recently been sold. It considers factors such as industry trends, market conditions, and the financial performance of comparable businesses.
2. **Income approach:** The income approach values a business based on its ability to generate future income. It takes into account the expected cash flows and applies a discount rate to determine the present value of those cash flows.

3. **Asset approach:** The asset approach values a business based on the fair market value of its assets and liabilities. It considers tangible assets, such as real estate and equipment, as well as intangible assets like intellectual property or brand value.

Driving business decisions and personal financial planning

Knowing the value of your company empowers you to make informed business decisions and take a proactive approach to personal financial planning. With a clear understanding of the value, you can align your strategies and investments to drive a more favorable valuation when it's time to exit the business. Additionally, it allows you to plan for retirement or transfer of ownership in a more organized and efficient manner.

How Wipfli can help

Our team can help you not only understand the value of your business, but increase that valuation to help you achieve your goals. We provide M&A transaction support and succession planning. Learn more on our [business valuations services web page](#).