

# VALUATION METHODOLOGY: INCOME APPROACH

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For advisors who have built or are building an organization past a book of clients, the concept of equity value and how to measure it can be arduous. While there are many methods for valuing a business and no shortage of industry press espousing a variety of multiples which business owners (often inaccurately) use to value their life's work, the prudent advisor, after identifying the need for their valuation (the "why") will first stop to consider who is the likely acquirer of the equity they are attempting to build, how the equity will be transferred, and what benefits an owner of that equity interest will receive. After the "why," "who," and "what" are established, we can select the appropriate method for valuing the firm's equity, or the "how" – but never before the first three elements have been determined.

There are many purposes for the "why" in a valuation. Situations vary, but by and large the purposes for a valuation are generally categorized as either tax or non-tax reasons. Both are applicable for the financial services. For instance, a business owner may need to value the entirety of their business for an external sale in the marketplace (a non-tax application) or may need to value a fractional interest in his or her business in conjunction with a tax filing resulting from the gifting of shares to an employee or family member (a tax application). The most common "why" for valuation in our industry is benchmarking. Many prudent advisors we work with want to understand how the decisions they make move the needle for their business, and how they can influence the trajectory of their valuation to accomplish their goals.

The "who" can be a complicated answer. For business owners who have no intention of selling and have no internal prospective equity owners, a hypothetical contemplated transaction may seem like a frivolous concept. However, benchmarking internal expectations of value to anything other than what a reasonable third-party could or would pay for the business can be misleading in future planning for the business owner, which often leads to misaligned expectations and money left on the table.

For those advisors who know a transaction is imminent, be it external or internal, understanding their baseline equity value is important for three reasons:

1. **An internal sale**, understanding the value of equity can help set share price and provides a good basis for negotiation.
2. **An external sale** to a strategic buyer (which is commonplace of external M&A in our industry), the firm's equity value provides the seller with a "floor" for their negotiations, so they understand where the value of what they've built ends and where a premium being paid for their business begins.
3. **Benchmarking** that value along the way allows the owner of the business to understand what drives their equity value and prove a track record of value growth to the prospective buyer. The "who" in valuation also considers the method of transfer for the property being valued, or the deal terms under which the contemplated sale (hypothetical or otherwise) will occur.

The “what” is a bit easier to establish conceptually. Value in any independent financial advisory business resides in the anticipated future benefits that an owner of the business could receive. As it pertains to equity ownership within an organization, these benefits are generally the owner’s ability to receive income from profit distributions/dividends and experience the increase in value of their respective equity ownership in the business as growth continues, also known as capital appreciation.

Given this example of “why,” “who,” and “what,” the Income Approach to valuation is a useful tool to determining value on the basis of the Company’s cash flow generating capabilities and future growth.

The Income Approach is based on the concept that a business’s value lies in the present value of the anticipated future economic benefits that the company will produce for its owner(s). In all variants of the Income Approach, the value of the forecasted economic benefits is adjusted for risk and the time value of money using either a capitalization rate or discounting process. There are two commonly used methods of valuation under the Income Approach: Capitalization of Future Benefits Method or the Discounted Future Benefits Method. In the context of valuing financial services businesses, the “future benefits” of distributions and capital appreciation mentioned above are typically measured using a projection of earnings or free cash flow.

## CASH FLOW VS. EARNINGS BENEFIT STREAMS

Most business owners are familiar with levels of earnings, such as Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), Earnings Before Interest and Taxes (EBIT), Earnings Before Owner Compensation (EBOC), and Gross Revenues. These specific benefit streams are commonly applied in the context of the Market Approach, as they are typically capitalized using pricing multiples derived from transaction data from comparable businesses. In the context of an income approach to valuation, cash flow is usually a more suitable tool for capturing the benefits an equity owner in a business would anticipate. As opposed to an earnings benefit stream, which measures various levels of profitability within a business, cash flow measures the flow of a dollar from the top line of the business down to the various stakeholders in the business, which can include both debtors and investors. In *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, Gary R. Trugman compares cash flow to a measure of earnings as follows:

*“A valuation analyst will frequently find that using cash flow is a better measure of the company’s earning capacity. This is particularly true when a more realistic picture is being sought of the amount of money that will be available to pay to the owners of the business as a return on their investment. Many profitable companies go out of business, but it is rare that we see a business with solid cash flow go under.”<sup>1</sup>*

<sup>1</sup> Trugman, Gary R., *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, 4th Edition. (Durham, NC: AICPA, 2012).

There are two common measures of cash flow in a business: 1) net cash flow to equity, and 2) net cash flow to invested capital. Net cash flow to invested capital is a measure of the cash available to debt and equity holders in a business after all operational expenses have been paid. Net cash flow to equity (sometimes called free cash flows to equity) is a measure of the cash available to equity holders in the business after all long-term, interest-bearing debt has been serviced. Figure 13.1 is a basic calculation of both benefit streams for comparison.

**FIGURE 13.1 BUSINESS CASH FLOW CALCULATIONS**

Normalized Net Income	
+ Depreciation & Amortization	+ Depreciation & Amortization
+/- Changes in Working Capital	+/- Changes in Working Capital
- Anticipated Capital Expenditures	- Anticipated Capital Expenditures
+ After Tax Interest	+ After Tax Interest
	+/- Changes in Long-Term Debt
= Net Cash Flow to Invested Capital	= Net Cash Flow Equity

The main difference between the two benefit streams is the service of long-term debt. Net cash flow to invested capital as a general rule best represents the economic benefit to all of the providers of capital.<sup>2</sup> Therefore, it is the most commonly utilized measure of cash flow as a benefit stream. However, in instances where a company has a substantial amount of long-term debt on the books and the potential buyer is an internal equity partner, net cash flows to equity provides a more accurate representation of the benefits received by the acquirer. Again, the “who” and “what” of the valuation analysis will inform what benefit stream should be selected.

The selection of an appropriate discount rate or capitalization rate goes hand-in-hand with the selection of a benefit stream, be it earnings or cash flow. Both discount rates and capitalization rates are intended to express the rate of return required by investors in the marketplace to attract investment in businesses similar to the business being valued.

<sup>2</sup> Pratt, Shannon P., Grabowski, Roger J., and Brealey, Richard A., *Cost of Capital: Applications and Examples*, 5th Edition. (Hoboken, NJ: John Wiley & Sons, 2014), 16.

## CAPITALIZATION OF FUTURE BENEFITS

The Capitalization of Future Benefits Method is the simpler of the two methods under the income approach in form and function. The formula below illustrates the components of this method and their function:

$$V=B/R$$

In the formula above, “B” represents a defined benefit stream (e.g. gross revenue, earnings, cash flow); “R” represents the required rate of return on the benefit stream, which is represented by the capitalization rate chosen by the appraiser; and “V” represents the resulting value.

There are a few assumptions made here. First, all of the tangible and intangible assets are indistinguishable parts of the business and no attempt is made to separate their values. Second, and most importantly, the capitalization process assumes that the selected benefit stream will grow in perpetuity at a consistent rate. When growth is expected to be uniform, the selected benefit stream “B” is the first forecasted year (current year plus one year of growth).

While the basic calculation under the Capitalization of Future Benefits Method is relatively simplistic, the calculation of the benefit stream and the selection of the long-term growth rate must be made with care. Any mistake in these inputs can result in a flawed valuation result. For example, if a long-term sustainable growth rate is unreasonably high and unsupported based on the history and the knowable facts about the business, the company will likely be overvalued. Likewise, incorrect assumptions regarding the discount rate and the risk specific to the Company could cause a business to be significantly undervalued.

## DISCOUNTED BENEFIT STREAM

Unlike the Capitalization of Future Benefits Method, the Discounted Benefit Stream Method, often referred to as the Discounted Cash Flow Method, assumes that the benefit stream being analyzed will continue to grow in a non-linear pattern for a period of time until it stabilizes and then continues to grow (or decline) at a consistent rate. This method assumes that the value of the business is equal to the future cash flows or earnings of the business discounted back to present value, plus the terminal value of the business. Using this valuation method allows the appraiser to select varying growth rates for the business over the forecasted period using input from management, projections for the growth of the industry, and forecasted growth of the economy as a whole.

Similar to the Capitalization of Future Benefits Method, the Discounted Future Benefits Method requires selecting a benefit stream and a corresponding rate of return, which is represented by a discount rate, not a capitalization rate.

The key distinction between the use of a discount rate and a capitalization rate is that there is no growth assumption built in to a discount rate. Rather, the relationship between the discount rate and capitalization rate can be illustrated by the following formula:

$$\text{Discount Rate} = \text{Capitalization Rate} + \text{Long-Term Sustainable Growth Rate}$$

A crucial part of any valuation analysis made by a certified appraiser is selecting an appropriate discount rate or capitalization rate that aligns with the benefit stream being valued.

# CAVEATS TO DISCOUNT RATES AND BENEFIT STREAMS

In both the Capitalization of Future Benefits and Discounted Future Benefits Methods, the selection of an appropriate benefit stream and discount rate are essential. These two elements are not selected in isolation, and both are affected by the purpose of the valuation.

In *Understanding Business Valuation*, Trugman points out some factors that warrant special consideration<sup>3</sup>:

1. **The nature** of the business and its capital structure;
2. **The purpose** and function of the appraisal; and
3. **The particular subject** of the valuation (for example, whether or not the valuation involves a controlling interest or a minority interest).

If a business is highly leveraged, choosing not to consider the business' debt service requirements may not be appropriate given the business's capital structure. Additionally, if the purpose of the appraisal is to determine the fair market value of the business's operating assets (which for the financial services industry indicates the goodwill established with an advisor's clients) in an M&A scenario, then using an after-tax benefit stream to value the company wouldn't necessarily make sense; i.e., what the seller pays in taxes is irrelevant to the transfer of the benefit stream. Finally, valuing a minority interest with no power to enact changes in a company's capital structure, using a benefit stream in which several control-level adjustments have been made in the normalization process may not be appropriate.

**FIGURE 13.2 PRE-TAX VS. POST-TAX CAPITALIZATION RATES**

Company A: Capitalization Rates		
EBITDA: \$500,000		
Effective Tax Rate = 40%		
	Pre-Tax	Post-Tax
Capitalization Rate	20%	33%
Value	\$2,500,000	\$1,500,000
\$ Difference from Proper Application	\$0	(\$1,000,000)
% Difference from Proper Application	0%	-40%

**FIGURE 13.3 APPLICATION OF PRICING MULTIPLES**

Company A: Pricing Multiples			
EBITDA: \$500,000			
	Gross Revenue	EBITDA	EBOC
Multiple	2.5	5	3.5
Value	\$1,500,000	\$2,500,000	\$1,750,000
\$ Difference from Proper Application	(\$1,250,000)	\$0	(\$750,000)
% Difference from Proper Application	-50%	0%	-30%

<sup>3</sup> Trugman, Gary R., *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, 4th Edition. (Durham, NC: AICPA, 2012).

## CAPITALIZATION RATES AND MARKET MULTIPLES

The most important consideration in selecting a capitalization rate is that the selected cap rate must align to the benefit stream from which it is derived. For example, a pre-tax capitalization rate shouldn't be applied to a post-tax or tax effected benefit stream. Similarly, a multiple derived from the relationship between a business's EBITDA and the sales price shouldn't be applied to that business's gross revenue. A brief illustration of this concept and its impacts is included in Figures 13.2 and 13.3.

Under the "Company A: Capitalization Rates" header, a pre-tax and post-tax capitalization rate has been applied to a pre-tax benefit stream (EBITDA) using our formula from earlier:  $V=B/R$ . When tax is considered, the capitalization rate yields a value on the pre-tax benefit stream that is 40% lower than the correct application of the pre-tax capitalization rate to that same benefit stream. Said another way, applying the improper post-tax capitalization rate to a pre-tax benefit stream will cause Company A to be undervalued by 40%.

There is a similar risk with using pricing multiple approaches. Under the "Company A: Pricing Multiples" header, three separate market-based pricing multiples are applied to one benefit stream. If an analyst were to apply the Gross Revenue or EBOC pricing multiple to the business's EBITDA under the Market Approach, the result would be a business that is severely undervalued.

While the numbers and calculations in Figure 13.2 have been simplified, they illustrate a critical point when applying any type of capitalization rate, pricing multiple, or discount rate. Regardless of the method selected for valuation, the applied capitalization rate, discount rate, or pricing multiple must be applied to its correlating benefit stream.



## CONCLUSION

Understanding the minutia of the Income Approach to valuation can feel daunting, but the simple truth remains: all else being equal, the more cash flow a business generates, the more value the owners of that business can and should realize. Placed in the hands of a qualified appraiser or analyst, the Income Approach is a great tool that can enable entrepreneurs to establish the value of what they have grown and turn their profits into a payout when the time comes to transition ownership within the company.

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