

Market Approach: Determining the Appropriateness of Transactional and Public Market Statistics in Business Valuation



April 2025

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The market-based approach uses guideline transactions in the marketplace, publicly traded companies, and sometimes internal market metrics to determine appropriate factors to apply to a business (i.e., multiple of revenue, multiple of EBITDA, multiple of discretionary earnings, etc.).

In this article, we will dive into the application of a market-based approach for the valuation of small businesses, but first, let's review a few common underlying methods within the market-based approach.

Guideline Company Method: In the guideline company method, the valuation of the subject company is determined by comparing it to similar publicly traded companies. A ratio of value to any number of different financial metrics is derived, and then applied to the subject company. For example: if Public Company ABC has an enterprise value of \$1 million, and revenue of \$250,000, then the multiple of enterprise value to revenue would be 4.0. If the subject company is comparable, and the revenue of the subject company is \$500,000, then using the same ratio will lead to an equity value of \$2 million. (Side note: a sample of only one guideline company would typically be inappropriate.)

Guideline Transaction Method: In the guideline transaction method, a review of transactions in the marketplace will be undertaken. Using the acquisition of target companies that are similar to the subject company, then a similar ratio can be derived and applied to the subject company to determine the appropriate market value.

Prior Transaction Method: This method can be applied when a transaction has taken place within the subject company. For example, if Partner A bought out Partner B and the transaction was an arms-length transaction that occurred not too distant from the current valuation date, then the price of the transaction might be used to determine the current valuation.

Benefits of Market-Based Approach

The market-based approach has some advantages over other valuation approaches. For one, the method is reliant on actual transactions that have taken place in the market. Rather than using a hypothetical income-based approach to value the business, the valuation can use the financial results of the business combined with the application of a marketplace ratio to determine the value. The market-based approach is also reflective of current market pricing conditions if using the guideline public company method. As the values of publicly traded companies are ever-changing typically from an active ongoing market for those stocks, a valuation using current market conditions can be determined. However, while the market-based approach has advantages, the applicability to small business valuations can be fraught with cautionary issues.





Market-Based Approach (with Caution) – Challenges in Small Business Valuation

The most important component of applying the market approach is ensuring that the analyst is using sufficiently similar market information. By way of definition, market approach methods require similar businesses, ownership interests, securities, and/or other assets that have transacted. When valuing a small business, the task of finding the appropriate apple to compare the subject company to can be a steep uphill challenge, including some of the reasons identified here:

- Small businesses often lack diversity of offerings and markets served, whereas the market statistics might not
- Small businesses may have significant reliance on the owner, or a few employees, whereas the market statistics might not
- The financial information maintained in small businesses may be inconsistent or incomplete
- There may be significant difficulty in attracting buyers of some small businesses, whereas market statistics reflect companies that were able to successfully transact or are freely traded on the public market

Simply because the subject company does the same type of work as another company in no way makes it applicable for the market approach.

For example, imagine if you are doing a valuation of footwear retail location in Burlington, Vermont with average annual revenue of approximately \$1.4 million. Under the guideline public company method, an appraiser could look at a company such as Foot Locker Inc (NYSE: FL) and use the value of Foot Locker to derive a value of the Burlington store.

While both companies operate in the same broad industry (e.g., footwear retail), the vast differences in operations, management structure, risk, access to resources, diversification, and several other factors render the comparison comical.

Using the same example company, the appraiser may also look to the guideline transaction method, which identifies prior transactions of merged or acquired companies. Often, appraisers use databases reflecting information regarding the transactions (this is information contributed by intermediaries, found in public disclosures, etc.). However, a deeper dive into the data of the transaction may lead to characteristics of the transaction that are not conducive for appropriate application. For example, below are some of the common areas where guideline transaction data may lead to inappropriate applications:



- **Nature of the acquisition:** Beware of motivations for the transactions. For example, in a strategic purchase, the acquirer may pay more than fair market value for the target company in order to achieve a strategic goal (example: acquiring a competitor, access to another region, accelerating growth by expanding complimentary offerings, etc.).
- **Date of the transaction:** As we sit here in early 2025, using a transaction that took place during, or soon after COVID-19 can be a big red flag. Understanding the date the transaction took place and the nature of the economy and industry at the time of the transaction can lead to very different characteristics than the subject company and valuation date being applied in your situation.
- **Availability of transactional terms, structure, and items included/excluded from each deal:** The terms and structure of a deal is often reflected in the price purchase allocation (“PPA”). This allocation helps determine the value of different assets, such as inventory, equipment, and intellectual property, for accounting and tax purposes. A lack of PPA data in a guideline transaction can lead to inaccurate values for intangible and tangible assets in a valuation.

Therefore, it is important for the analyst to understand the breakdown of considerations paid, any contingencies, whether some, or all, assets and liabilities were transacted, and other more granular components to the acquisition being reviewed. The next time you hear someone say they know the value of their business because they just heard Company XYZ sold for 2.5 times earnings, there may be plenty of underlying deal considerations that are reflective in the multiple.

- **Vague target business descriptions:** Transactions that reflect vague business descriptions can lead to analysts using transactions for companies that do not reflect that of the subject company. For example, imagine you are trying to value a limousine company that provides corporate and event (proms, weddings, etc.) transportation. If the guideline transaction data for the target company simply lists “Transportation Services” as the business description, this may lead to inaccurate comparability. Maybe the business is in the tour bus industry, school busses, or taxicab industry, none of which aligns with the subject company’s business.

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The prior transaction method may be applied in situations where an arm's-length transaction took place in the subject company within a reasonable window of time to the valuation date. The transaction may have occurred as a result of a gifting of shares, a buyout of a partner, acquisition of major business unit (or the entire business itself), a round of financing, or a various other internal transactional metrics. In addition to the price paid, it is critical to understand the purpose of the purchase, the players involved, and any terms of the deal.

Taking the Next Step to the Market

While the market-based approach offers a practical method for valuing business, it is essential to approach it with caution. Ensuring accurate comparability and understanding the data of each transaction is critical when determining a credible valuation. When performed right, this method can provide valuable insights and a robust framework for business valuations of privately held businesses. However, frequently, this data remains unseen in small business appraisals due to difficulty of credibly implementing it into the process.



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