Benefit from getting huge discounts by purchasing Template Bundles! You can save from 30% up to more than 80% OFF with select Bundles!

Search... (type and wait 5s)



Knowledge Base Valuation

Search Knowledge Base

SEARCH

Knowledge Base > Valuation > Valuation Methods > Capitalized Earnings > A Guide to Understanding Capitalized Earnings Valuation

A Guide to Understanding Capitalized Earnings Valuation

● 233 🖒 0 🐶 0 July 11, 2023

Table of Content

1. The Idea of Capitalizing Earnings
1.1. Difference Between Capitalized Earnings & Discounted Cash Flow (DCF)
2. How Does Capitalized Rate Business Valuation Work
2.1. Step 1 - Estimate the Discount Rate
2.2. Step 2 - Historic Profits Analysis
2.3. Step 3 – Normalize Earnings
2.4. Step 4 – Estimate Sustainable Earnings
2.5. Step 5 - Determine Sustainable Profits After-Tax
2.6. Step 6 - Capitalize Earnings
2.7. Step 7 - Calculate Equity Value from Enterprise Value
3. Capitalized Earnings Valuation Method Examples
3.1. Scenario No. 1: Valuation of XZY Corporation
3.2. Scenario No. 2: Increasing the Discount Rate to 15%
3.3. Scenario No. 3: Eternal Business Growth of 3% per year

Sections Dividend Discount Model (DDM) **H** Valuation Methods Net Asset Value (NAV) Capitalized Earnings Gordon Growth Model (GGM) ★ Valuation Multiples Valuation Drivers 🖍 Cap Rate I Discount Rate Terminal Value Valuation Scenarios

Search... (type an

When Should Capitalized Earnings Valuation Be Used?

Pros & Cons of the Capitalized Earnings Method

3.1. Pros 3.2. Cons

Reasonably Estimate Your Company's Fair Market Value



Share On: **f** 🍠 in 🖗 💟

Related Articles

How does the Capitalized Earnings Method work?

Recent Blog Posts

A Step-By-Step Guide on How to Calculate Property Tax



Benefit from getting huge discounts by purchasing Template Bundles! You can save from 30% up to more than 80% OFF with select Bundles!

Search... (type and wait 5s)



Let's start with a quote from Philip Fisher, a renowned American stock investor:

"Even a great company can be priced too high if there's a lot of glamour attached to it."

In essence, the saying highlights the importance of considering the true underlying value of a company rather than solely relying on its reputation or perceived glamour. A high valuation of a business based on excessive glamour may not accurately reflect the company's financial performance or prospects, potentially leading to an overpriced investment.

If you are looking for a fair and quick income valuation approach, capitalized earnings valuation, also known as capitalization rate business valuation, can be your solution. It reasonably estimates the company's worth based on its estimated earnings. This approach is widely used in financial analysis and valuation because it provides a straightforward and quick way to estimate the value of a company.

The Idea of Capitalizing Earnings

Capitalized Rate Business Valuation is an income valuation approach used to determine the value of a business based on its expected future earnings. It involves using two key elements: normalized earnings and the capitalization rate formula.

- **Normalized earnings** refer to a business's average or representative earnings over a specific period, typically adjusted for irregular or one-time factors that might distort the earnings. This adjustment helps to provide a more accurate representation of the sustainable earnings potential of the business. A capitalization rate business valuation typically uses the last three years historical financial statements to project them.
- The **capitalization rate formula** converts the normalized earnings into a present value by applying a rate of return or capitalization rate. It represents the rate of return an investor would expect to receive on their investment in the business. It considers factors such as the risk associated with the business, prevailing interest rates, and the expected earnings growth rate. The weighted average cost of capital (WACC) is commonly used as the discount or capitalization rate. It is because it represents the average rate of return required by a company's investors (both debt and equity) to compensate for the risk associated with investing in that company.

Capitalization of earnings takes into account the time value of money, which means that a dollar earned in the future is worth less than a dollar earned today. By capitalizing future earnings, the valuation incorporates the discounted value of all cumulative earnings until infinity at their discounted net present values.

What Are the Benefits of Using Excel Over Other Tools?

Unravelling the Development of a Solar Photovoltaic Power Plant

Recently Viewed

Recently Viewed Templates



Peter Graf Coffee Shop – The Customer-Centric Financial...

Starting a Coffee Shop without a financial plan is like driving a car blindfolded. You wouldn't do ... Read more

Purchase

Excluding 7.7% tax



Capitalization of earnings focuses on sustainable earnings rather than short-term fluctuations. It assumes that the company will continue to generate a certain amount of earnings forever. A company with stable earnings is needed to estimate such a level of required normalized earnings reliably. It makes the capitalized earnings valuation approach less suitable for companies with high volatility in their earnings but more suitable for stable income-producing companies.

Free Excel Model – \$0.00 Version 1

Add to wish list



Download FREE Capitalized Earnings Valuation Model Template

eFinancialsMode Is Financial Model for Mobile App | Mobile App Busine... The Mobile App Financial Plan Template in Excel allows you to develop financial projections when Iau... Read more

Back to Top



- . .
- Earnings vs. Cash Flow Focus: Capitalization rate business valuation focuses on the company's historical or projected earnings, specifically the net income or earnings after taxes. Discounted Cash Flow analysis focuses on the company's cash flows, specifically the free cash flows generated by the business.
- Fluctuations of Earnings and Cash Flows: The capitalized earnings valuation approach requires companies with stable positive earnings. DCF analysis is better suited to value companies with stronger free cash flow and earnings volatilities.
- Cost of Capital: In business valuation, the cost of capital refers to the rate of return required by capital providers to compensate them for the risk associated with investing in a particular business. The capitalized Earnings and DCF methods aim to estimate a company's enterprise value. Therefore, we can use the same cost of capital.
- Sensitivity to Assumptions: A capitalization rate business, in general, uses fewer assumptions, therefore, is relatively more sensitive to any change in key assumptions (especially impacting the estimated level of normalized earnings) since it affects all forecast years. In DCF, it depends on how the forecast model is built and if the assumption affects only a few years or has a major impact on the terminal value estimate.

In conclusion, both methods have their strengths and weaknesses, and the choice between them depends on factors such as the nature of the business, the availability of budget data, and the objective of the business valuation.





Purchase

Excluding 7.7% tax



Submit Rating

^V Check Our Boutique Hotel
 ⁱ Financial Proje... read

° more

е

u s This financial model can be used to value any Init... read more

Submit Rating

Get Your Restaurant Financial Model Temp... read more



Back to Top

t



How Does Capitalized Rate Business Valuation Work

The basic formula for a capitalization rate business valuation is expected normalized earnings divided by the capitalization rate. The following steps can be used to calculate a company's worth when applying this income valuation approach:





valuation because it calculates the average rate of return a company needs to earn to satisfy its capital providers.

Back to Top

Step 2 – Historic Profits Analysis

Analyze the 3-year historic profits at the Earnings Before Interest and Taxes (EBIT) level. Analyzing three years of historic profits at the EBIT level in historical financial statements helps identify trends, patterns, and factors influencing the company's earnings over time. It allows us to estimate better the level of normalized earnings applicable to the future. Please note EBIT deducts not only cash costs but also depreciation which can be viewed as a proxy for investments over time.

Back to Top

Step 3 – Normalize Earnings

The third step in a capitalization rate business valuation is determining the estimated normalized earnings potential of the business subject to this valuation. Calculating normalized earnings involves identifying and eliminating non-recurring or one-off items that may have distorted the true picture of a company's earnings. These may include gains or losses from the sale of assets, onetime legal settlements, restructuring costs, or any other unusual income or expense items. By eliminating these effects impacting historical financial statements, historic profits are adjusted to reflect the earnings that would have been generated without such extraordinary effects.

Back to Top

Step 4 – Estimate Sustainable Earnings

As a forward-looking valuation method, the capitalization of earnings requires us to estimate normalized earnings applicable to the future. In most cases, we use the 3-year historical average of normalized earnings as a proxy for the expected level of sustainable profits going forward.

We intend to smooth out short-term fluctuations and determine a more stable estimation of relevant earnings for our analysis. By averaging earnings over multiple years, the impact of exceptional events, such as a particularly good or bad year, is reduced. It allows a more balanced representation of the company's performance across different cycle stages.

However, if we believe that past results might not be a reliable proxy for estimating future earnings, we could also make our own estimation or only use 1 or 2 years of historical data or make additional adjustments. Therefore, the estimation requires some professional judgment of a business valuation expert and, in the end, reflects a subjective opinion on value.

Back to Top

Step 5 – Determine Sustainable Profits After-Tax

The next step in the capitalized earnings income valuation approach is determining sustainable profits after tax. It is achieved by deducting pro-forma income taxes from the company's normalized earnings before interest and taxes (EBIT). To calculate the sustainable profits after tax, you would multiply the normalized EBIT by (1 – income tax rate). The company's income tax rate can be determined by either analyzing historic profits or researching the applicable income tax rates of the jurisdictions in which the company operates.

Back to Top

Step 6 – Capitalize Earnings

The capitalization rate business valuation uses the Gordon Growth Model to estimate the company's enterprise value. The corresponding valuation formula to determine a company's enterprise value would be:



Enterprise Value = EBIT *(1-t) / (WACC - g)

Where:

EBIT represents a company's operating income





σαυκ ιυ τυρ

Step 7 – Calculate Equity Value from Enterprise Value

You might have noted that we have calculated the company's enterprise value by capitalized earnings. Now we need to obtain the company's equity value. We can do this by deducting and adding the following balance sheet positions as per the company's valuation date:

Enterprise Value

- Financial Debt
- + Cash
- + Non-Operating Assets

Equity Value



by eFinancialModels Pharma Biotech Valuation Model Template (Risk-Adjusted) e Average rating: v Average rating: v The Pharma Biotech Valuation Model Template



eFinancialModels

SaaS Financial Model
Average rating:

The SaaS financial model template offers a



by Street Fox Advisors

O

Ν

е

Х

Private Equity Fund Mode (Investor Cashflows) Average rating: Submit Rating

Private Equity Financial Model to analyze fund cas... read more



Back to Top

Back to Top

Capitalized Earnings Valuation Method Examples



Scenario No. 1: Valuation of XZY Corporation

Suppose you are considering investing in a company called XYZ Corporation and want to determine its value using the Capitalized Earnings Valuation method. You have gathered the necessary financial information and made some assumptions as follows:





Assumptions			Financial Projection	Unit	2020	2021	2022	Normalized
					-Year 2	-Year 1	Year 0	
Model Version		1.4	Revenue	USD	300.000	350.000	380.000	343.33
Currency		USD	Revenue Growth %	%	0.0%	16.7%	8.6%	
Valuation Date		31-Dec-22						
ast Financial Year	Year	2022	Direct Cost	USD	-150,000	-200,000	-190,000	
			Gross Profit	USD	150,000	150,000	190,000	
Nersunt Date Minishand Av	areas Cost of Conit		Grass Profit Margin %	%	50.0%	42.9%	50.0%	
And the second	erage cost of capit		OPEX	USD	-140,000	-110,000	-170,000	
Veight			EBITDA	USD	10,000	40,000	20,000	
quity	%	75.0%	EBITDA Margin %	%	3.3%	11.4%	5.3%	
Debt	%	25.0%						
Total	%	100.0%	Depreciation	USD	-2,000	-3,000	-4,000	
			EBIT	USD	8,000	37,000	16,000	
ost of Equity		(*************************************	EBIT Margin %	%	2.7%	10.6%	4.2%	
lisk free interest rate	%	3.0%						
eta (unlevered)	×	1.5×	Extraordinary Items	USD	5,000	3,000	4,000	
leta (levered)	×	2.0x	Interest	USD	-1,600	-1,400	-1,100	
Market Risk Premium	%	5.0%	EBT	USD	11,400	38,600	18,900	
quity Risk Premium	%	10.0%	EBT Margin %	96	3.8%	11.0%	5.0%	
Cont of Faulty	70	1.5%	Incomo Tav	LISD	2 400	7 920	2 940	
ost of Equity	70	14.3%	Net Income	USD	-2,400	20 790	15 060	
ost of Debt			Net Income Margin %	96	3,000	8 8%	4.0%	
isk free interest rate	%	3.0%	Net meane margin to	70	2.070	0.070	4.070	
ebt Risk Premium	96	2.5%	Effective Tax Rate	96	21.1%	20.3%	20.3%	
re-Tax Cost of Debt	96	5.5%	Last Implied Interest Rate	96			2.2%	
ax Rate	%	20.0%						
ost of Debt	%	4.4%	Normalized Earnings	Unit	2020	2021	2022	Normalized
					-Year 2	-Year 1	Year 0	
Veighted Average Cost of Ca	pital 96	10.9%	Reported FBIT	LISD	8.000	37.000	16 000	
Veighted Debt	%	1.1%	Reported EBIT Margin %	%	2.7%	10.6%	4.2%	
					le contra de la co			
Discount Rate (WACC)	%	12.0%	Adjusting Excess Lease for Office Space	USD	20,000			
			Owners Salary was below market	USD	-25,000			
			Supply Issues lead to temporary increase in prices	USD		25,000		
Color Codes			Owners Salary was above market	USD			15,000	
	N. N. N. N. N. N. N.		Consulting Related to Restructuring Costs	USD		75 000	20,000	
nput nput linked to other input			Total Adjustments	USD	-5,000	25,000	35,000	
Calculation			Adjusted EBIT	USD	3,000	62,000	51,000	38,667
			Adjusted EBIT Margin %	%	1.0%	17.7%	13.4%	11.3%
					,			
erms & Abbreviations			Pro Forma Taxes	%	20.0%			-7,73
BITDA Familian h-f-	re Interest Tau		Normalized Profit After Tax	USD				30,93
Depreciation	and Amortization		Capitalized Earnings Valuation					
BIT Earnings befo	re Interest, Taxes,							
BT Earnings befo	re Taxes		Normalized Profit After Tax	USD				30,93
OPEX Operating Exp	penses		Discount Rate (WACC)	%			-	12.09
MACC MILLER I	Con al Const		Growth Rate					1.09
weighted Ave	rage Cost of Capit	ai	Enterprise Value	USD				281.85
			Financial Debt	USD	50,000			-50.00
			Cash	USD	20,000			20.00
			Non-Operating Assets	USD	30,000			30,000
		1						

Powered by www.eFinancialModels.com

This Capitalized Earnings (Simple Business Valuation) template above used the last three years of historical financials to estimate the approximate value of the business. It auto-calculates Company XYZ's normalized earnings, Enterprise Value, and Equity Value. In the sample above, the Enterprise Value is currently \$ 281,853.

Back to Top

Scenario No. 2: Increasing the Discount Rate to 15%

Let us use the same assumptions in Scenario No. 1 and change the discount rate to 15%. Using the Simple Capitalized Earnings Valuation Template, here are the results:

A second state of the seco								
Assumptions			Financial Projection	Unit	-Year 2	-Year 1	Year 0	Normalized
Model Version		1.4	Revenue	USD	300,000	350,000	380,000	343,333
Currency		USD	Revenue Growth %	%	0.0%	16.7%	8.6%	
Valuation Date	¥.	31-Dec-22	Direct Cost	LICD	150.000	200.000	100.000	
Last Financial Year	rear	2022	Gross Profit		-150,000	-200,000	-190,000	
	****************		Gross Profit Marain %	%	50.0%	42 9%	50.0%	
Discount Rate - Weighted Ave	erage Cost of Capit	tal (WACC)	Gross (rojn margin /o		50.070	461070	30.070	
			OPEX	USD	-140,000	-110,000	-170,000	
Weight			EBITDA	USD	10,000	40,000	20,000	
Equity	%	75.0%	EBITDA Margin %	%	3.3%	11.4%	5.3%	
Debt	%	25.0%						
Total	%	100.0%	Depreciation	USD	-2,000	-3,000	-4,000	
	_		EBIT	USD	8,000	37,000	16,000	
Cost of Equity	04	2.09/	EBIT Wargin %	70	2.1%	10.6%	4.2%	
Reta (unlevered)	70	3.0%	Extraordinary Items	USD	5.000	3.000	4 000	
Beta (levered)	x	2.0x	Interest	USD	-1.600	-1.400	-1.100	
Market Risk Premium	%	5.0%	EBT	USD	11.400	38,600	18,900	
Equity Risk Premium	%	10.0%	EBT Margin %	%	3.8%	11.0%	5.0%	
Other Risk Premium	%	1.5%				*************		
Cost of Equity	%	14.5%	Income Tax	USD	-2,400	-7,820	-3,840	
	_		Net Income	USD	9,000	30,780	15,060	
Cost of Debt			Net Income Margin %	%	3.0%	8.8%	4.0%	
Risk free interest rate	%	3.0%	Clf and Top Date	04	21 10/	20.20	20 20/	
Debt Risk Premium	76	Z.3%	Effective Tax Rate	70	21.1%	20.3%	20.3%	
Tax Rate	%	20.0%	Lust implied interest rate	70			2.270	
Cost of Debt	%	4.4%	Normalized Earnings	Unit	2020	2021	2022	Normalized
					-Year 2	-Year 1	Year 0	
Weighted Average Cost of Ca	pital							
Weighted Equity	%	10.9%	Reported EBIT	USD	8,000	37,000	16,000	
Weighted Debt	%	1.1%	Reported EBIT Margin %	%	2.7%	10.6%	4.2%	
Discourt Data (MACC)	0/	15.00/	Adjusting Europe Lange for Office Server	LICD	20,000			
Discount Rate (WACC)	70	15.0%	Owners Salary was below market	USD	20,000			
			Supply Issues lead to temporary increase in prices	USD	20,000	25.000		
Color Codes			Owners Salary was above market	USD	000000000000000000000000000000000000000		15,000	
a di			Consulting Related to Restructuring Costs	USD			20,000	
Input			Total Adjustments	USD	-5,000	25,000	35,000	
Input linked to other input								
Calculation			Adjusted EBIT	USD	3,000	62,000	51,000	38,667
			Adjusted EBIT Margin %	%	1.0%	17.7%	13.4%	11.3%
Terms & Abbraviations			Pro Forma Taxor	94	20.0%			7 722
Terms & Abbreviacions			Normalized Profit After Tax	USD	20.070			30,933
EBITDA Earnings befo	re Interest, Taxes,							00,000
Depreciation	and Amortization		Capitalized Earnings Valuation					
EBIT Earnings befo	re Interest, Taxes,							
EBT Earnings befo	re Taxes		Normalized Profit After Tax	USD				30,933
OPEX Operating Exp	benses		Discount Rate (WACC)	%			-	15.0%
	C	1	Growth Rate					1.0%
WALL Weighted Ave	rage Cost of Capit	a	Enterprice Value	USD				220.052
			Enterprise value	LISD	50,000			-50,000
			Cash	USD	20.000			20,000
			Non-Operating Assets	USD	30,000			30,000
					have a second second second			





www.eFinancialModels.com



+0

Scenario No. 3: Eternal Business Growth of 3% per year

Again, let us use the same assumptions in Scenario No. 1 and change the growth rate to 3%. Using the Simple Capitalized Earnings Valuation Template, here are the results:

Assumptions			Financial Projection	Ünit	2020	2021	2022	Normalize
					-Year 2	-Year 1	Year 0	
Model Version		1.4	Revenue	USD	300,000	350,000	380,000	343,33
Currency		USD	Revenue Growth %	96	0.0%	16.7%	8.6%	
Valuation Date		31-Dec-22						
Last Financial Year	Year	2022	Direct Cost	USD	-150,000	-200,000	-190,000	
			Gross Profit	USD	150,000	150,000	190,000	
Discount Rate - Weighted Av	erage Cost of Car	ital (WACC)	Gross Profit Margin %	96	50,0%	42.9%	50.0%	
			OPEX	USD	-140,000	-110,000	-170,000	
Neight			EBITDA	USD	10,000	40,000	20,000	
quity	96	75.0%	EBITDA Margin %	96	3.3%	11.4%	5.3%	
Debt	%	25.0%	With distance of	1100	a ana	3 000	1 000	
otal	76	100.0%	Depreciation	USD	-2,000	-3,000	-4,000	
Part of Faulty			EBIT Marris 90	USD	8,000	37,000	16,000	
lisk free interest rate	96	3.0%	water inter gill 20		£. 8 70	10.075	414.70	
leta (unlevered)	×	1.5×	Extraordinary Items	USD	5,000	3,000	4,000	
Beta (levered)	x	2.0x	Interest	USD	-1,600	-1,400	-1,100	
Aarket Risk Premium	96	5.0%	EBT	USD	11,400	38,600	18,900	
quity Risk Premium	%	10.0%	EBT Margin %	-96	3,8%	11.0%	5.0%	
ther Risk Premium	96	1.5%						
ost of Equity	%	14.5%	Income Tax	USD	-2,400	-7,820	-3,840	
CONTRACTOR OF STREET, ST.	_		Net Income	USD	9,000	30,780	15,060	
ost of Debt	24	2.0%	Net income Margin %	30	3.0%	8.8%	4.0%	
oht Rick Promium	90 64	3.0%	Effective Tay Pate	94	21.14	70.2%	20.28	
re-Tax Cost of Debt	96	5.5%	Last Implied Interest Rate	96	21.190	20.3%	2.2%	
ax Rate	96	20.0%	and the second the second second				a.a.10	
ost of Debt	%	4.4%	Normalized Earnings	Unit	2020	2021	2022	Normaliz
					-Year 2	-Year 1	Year 0	
Velghted Average Cost of C	apital							
Weighted Equity	96	10.9%	Reported EBIT	USD	8,000	37,000	16,000	
Veighted Debt	96	1.1%	Reported EBIT Margin %	96	.2.7%	10.6%	4.2%	
Scount Rate (WACC)	96	12.0%	Adjusting Excess Lease for Office Space	LISD	20.000		1	
nacount nute (mree)		ALIO/V	Owners Salary was below market	USD	-25,000			
	and the second sec		Supply Issues lead to temporary increase in prices	USD		25,000		
olor Codes			Owners Salary was above market	USD			15,000	
			Consulting Related to Restructuring Costs	USD			20,000	
nput			Total Adjustments	USD	-5,000	25,000	35,000	
alculation			Adjusted EBIT	USD	3.000	62.000	51.000	38.6
			Adjusted EBIT Margin %	96	1.0%	17.7%	13.4%	11.3
erms & Abbreviations			Pro Forma Taxes	%	20.0%			-7,7
			Normalized Profit After Tax	USD				30,9
BITDA Earnings bef	and Amortization		Canitalized Farnings Valuation	a sector sector sector				
BIT Earnings hef	ore Interest. Taxes		capitalities carinings valuation					
BT Earnings bef	ore Taxes		Normalized Profit After Tax	USD				30,9
PEX Operating Ex	penses		Discount Rate (WACC)	%				12.0
			Growth Rate					3.
VACC Weighted Av	erage Cost of Cap	ital	Estemplan Value	1160				
			Enterprise Value	USD	STORES			344,6
			Cash	USD	20,000			-50,0
			Non-Operating Assets	USD	30,000			30.0

Here, the Enterprise Value and Equity Value increased to \$344.661. When the growth rate is higher, it indicates that the asset or investment has the potential to generate larger future cash flows. As a result, the expected cash flows in the future are higher, and when discounted back to the present, they have a greater value.

Back to Top

When Should Capitalized Earnings Valuation Be Used?

Capitalization rate business valuation comes in handy for certain scenarios. This method may suit the following situations well:

- Hard-to-value Assets: Some companies are more valuable for their intangible and
 - intellectual property than physical assets. Capitalized earnings valuation allows you to base value on the actual earnings power of the business rather than trying to value obscure assets.
- Limited Growth: Capitalized earnings can provide a solid valuation estimate for stable, mature companies. This method also favors companies with limited growth potential. If a business is poised for rapid expansion, capitalized earnings may undervalue it since future increased payments are not accounted for.
- Professional Practices: Capitalized earnings valuation is a preferred method for valuing professional practices like medical, dental, legal, and accounting firms. Expected earnings are often the best way to value the potential of such businesses.
- Stable Earnings: Capitalized earnings valuation works best when a company has
 demonstrated a steady stream of cash flows or revenues over the past several years. That is
 why it is often considered a suitable approach for valuing real estate investments with
 income-generating assets. If profits have been volatile, it will be difficult to determine a
 normalized level of earnings to base your valuation.
- **Tax Valuation**: A capitalization rate business valuation is best for tax valuation purposes, among other business valuation methods. Its simplicity makes it easier to calculate and understand, which can be advantageous for tax purposes where clarity and efficiency are







historical earnings make reasonable assumptions about future growth and profitability and provide a way to estimate the value of the business.





Back to Top

Pros & Cons of the Capitalized Earnings Method

Like other business valuation methods, the capitalized earnings approach has pros and cons.

Considering both sides before using the said approach to determine a company's value is essential.

Back to Top

Pros

- The capitalization rate business valuation is an easy-to-calculate, straightforward approach. It only requires two inputs: normalized earnings and the capitalization rate, making it simple to compute and understand.
- Since the valuation is based on a company's earnings, it emphasizes its ability to generate profits, which can provide a more accurate value for high-growth, profitable companies.
- The capitalized earnings method works well for valuing private companies or small businesses with little public information. It only requires the company's financial statements to determine an estimate of value.









subject to more manipulation as we can measure the cash balance easier.

- The inputs are based on a company's historical financials, which may not reflect the company's true value in the current market. Market-based valuation methods can provide a more up-to-date estimate of value.
- The capitalized earnings approach only looks at a company's current earnings. It fails to consider a company's balance sheet assets or future growth opportunities that could significantly impact value.
- The capitalized earning method may result in excess profits for companies with a high return on invested capital (ROIC), i.e., more than 20% year after year. High returns might attract competitors, and earnings may become lower. So normalized earnings estimated today might not reflect a company's earnings potential.

Remember, applying multiple methods for the most accurate.



Back to Top

Reasonably Estimate Your Company's Fair Market Value

With the right inputs for your business, the capitalized earnings valuation can reasonably estimate your company's fair market value and help determine an appropriate offer price. While it may seem complex initially, breaking it down into two main components – normalized earnings and the capitalization rate – makes it easier to understand. The capitalization rate is the key to determining an accurate business valuation using this model. Calculate it correctly using the weighted average cost of capital formula, and you'll have a solid estimate of what a business is worth to potential buyers.

Of course, no valuation method is perfect. The capitalized earnings approach works best for stable, profitable companies with a proven earnings track record. It may undervalue high-growth businesses or overvalue declining ones. Try it using a business valuation model and see what results you have! You may find that your business is worth more than you realized.



