# Why Terminal Value Can Mislead Small Business Valuations

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***Most valuation models assume your business will grow forever. But is that realistic for small, owner-operated companies?***

## The Two Main Valuation Approaches

If you ask financial professionals, there are countless variations in how to conduct a business valuation—often shaped by experience. However, the foundational principles generally stem from two core methods:

1. ***The Intrinsic Valuation Method***
2. ***The Relative Valuation Method***

Most commonly, financial professionals, investment banks, private equity firms, and advisors use a blend of both—cross-referencing the base model (typically the DCF, or intrinsic valuation model) against market comparables or average industry multiples for the business being valued.

In this article, we'll explore these two approaches and highlight a common confusion point: **terminal value**. Surprisingly, even seasoned professionals sometimes misunderstand the theory behind terminal value and its technical reasoning. Running a financial model and understanding the mechanics is one thing—but grasping the underlying theory is what sets true professionals apart.

My goal here is to explain this concept clearly, provide examples, and offer practical insights you can apply in real-world scenarios. We'll cover what a terminal value is, when it should be used, and why it often shouldn't be used for small, private businesses. In fact, in lower-middle-market valuations, terminal value frequently **overinflates valuations**, creates unrealistic exit expectations, and can even derail deals that initially seemed promising.

### What Is Terminal Value?

Terminal Value (TV) is an estimate of a business's worth beyond the forecast period in a valuation model. When building a financial model—whether using a Discounted Cash Flow (DCF) approach or incorporating the Gordon Growth Model (GGM)—we typically forecast 5 years based on 3–5 years of historical financial data provided by the company. In some cases, if historical data is extensive, we may forecast out 10 years. The strength of any valuation improves when historical data and assumptions are detailed. Breaking financials into monthly statements allows for more accurate assumptions, accounts for seasonality, and provides a clearer picture of business health—leading to better outcomes and informed decisions.

Because forecasting cash flows indefinitely would be impractical and inaccurate, we use a terminal value calculation to capture all future cash flows beyond the forecast horizon. This is often done using a **perpetuity growth approach**, which assumes the business continues operating indefinitely. Terminal value is then added to the enterprise valuation in a DCF or GGM model.

There are two common formulas for terminal value. The first is the **Gordon Growth Model**, which assumes cash flows grow at a constant rate forever:

$$TV = \frac{FCF_{n+1}}{r - g}$$

Here, $FCF_{n+1}$is the cash flow in the first year after the forecast period, $r$is the discount rate, and $g$ is the perpetual growth rate—usually tied to long-term GDP or inflation (typically 1–3%). This method is widely used for large corporations or public companies with stable, predictable growth.

The second is the **Zero-Growth Perpetuity**, which assumes cash flows remain constant forever:

$$TV = \frac{C}{r}$$

Where $C$is the constant cash flow and $r$is the discount rate. This approach is typically reserved for fixed payment streams like preferred stock or perpetual bonds and is rarely appropriate for operating businesses.

For large corporations, terminal value can be plausible—but it often accounts for **60–80% of the total valuation**. This is why, if you've ever applied terminal growth calculations to a private lower- or middle-market business, the valuation often comes out extremely high. The resulting multiple (Enterprise Value ÷ EBITDA) looks unrealistic compared to market comparables, creating inflated expectations and sometimes killing deals that seemed promising at the start.

## The Reality Check: Why Perpetuity Assumptions Fail in Lower-Middle Market Deals

Now, let's go over a few reasons why terminal value should be avoided when deriving valuations for private lower-middle market (LMM) businesses. Below are a few reasons I believe that terminal value is not applicable in LLM valuations, and why comparable comps are not really worth anything, as most of them are public entities, or the data is skewed, or estimated based on employee counts, and "Applying revenue per employee metric is dangerous". Terminal value assumes stability, scalability, and perpetual operation—conditions rarely met in lower-middle market businesses. Instead, valuations should focus on finite-horizon cash flows, realistic exit scenarios, and market-based approaches.

1. Owner Dependency
2. Limited Growth Horizon
3. Lack of Succession Planning
4. Illiquidity & Marketability Discounts
5. Unreliable Long-Term Forecasts
6. Exit Multiples Are Hard to Benchmark
7. Business Lifecycle Reality

**Owners Dependency**

In most small businesses, or LMM entities, the owner is the lifeblood of the business, and has been for decades. When the owner is relied upon within day-to-day operations and maintaining relationships with vendors and large clients, this creates what we call "Key-Man Risk".

A lot of times, private businesses are owned by a family, and has been running the same model, and psychology for decades, perpetual assumptions that would be used within a terminal value would fail to sustain past forecasts

if the business cannot easily transition without the founder/owner, with the addition of possible relationships being severed if the new owners not aligned with the status quo. There is a massive risk, especially if it is a vendor, and customer concentration risks, which compound with the key-person risk. For this reason, the terminal value is not realistic.

**Limited Growth Horizon**

Lower-middle market (LMM) businesses face numerous growth limitations, including—but not limited to—market saturation, resource constraints, competitive pressures, operational capacity limits, regulatory and licensing barriers, customer concentration, and economic cyclicality.

Most private LMM businesses operate in small geographic or niche markets, which often cap expansion. In many cases, especially in less populated areas, the business captures most of the local demand and then stalls in terms of organic revenue growth. Frequently, when analyzing an LMM business that has maintained the same numbers for years, you'll find the owner has already gained market share, does little to no marketing, and sustains a comfortable lifestyle without scaling into new geographic regions. While this works for a "lifestyle business," it does not support higher valuations or exit planning—and provides no logical basis for adding terminal value in a cash flow valuation.

**Resource constraints**—such as working capital, talent, and technology—require proactive strategies to overcome. Securing capital or attracting quality talent is essential for expanding a business's footprint and increasing value. More often than not, when owners seek working capital, they fail to disclose that they've been denied loans or credit lines due to stalled growth or cash flow issues. They expect miracles, but lenders typically won't leverage a business that has flatlined for five years. If financing is approved, it's often limited to 10% of topline revenue, assuming other credit metrics are acceptable. Private lenders operate similarly, unless the owner resorts to merchant cash advances (MCAs), which can cripple a small business trying to grow. From a valuation perspective, these constraints make growth assumptions unrealistic. Worse, selling to a quality investor becomes difficult because buyers often want to leverage the business—typically at 50% of enterprise value—to free up capital for growth. In these situations, sell-side challenges arise, and most investors will pass. Rarely, an all-cash buyer may proceed if they see strong bolt-on potential. Overall, growth is minimal, and terminal value is not plausible.

Competitive pressure from larger corporations further limits growth by eroding purchasing power and compressing margins. **Operational capacity** is another major scalability issue, often caused by lack of infrastructure and systems, creating bottlenecks. **Customer concentration** and **regulatory or licensing barriers**—such as compliance costs and geographic restrictions—also limit expansion potential, leading to stalled growth.

Finally, **economic cyclicality** plays a significant role in perpetuity and terminal value projections. LMM businesses are more exposed to economic downturns, and even local politics or economic shifts can stall growth, making long-term projections highly speculative.

**Lack of Succession Planning**

One of the most common issues is the absence of an exit plan or succession strategy. Considering the amount of blood, sweat, and hard work it takes to build a successful business, it's mind-blowing how many private LMM business owners fail to plan for an exit. Most only start thinking about it when they're ready to sell. Unfortunately, like most things in life, planning is key to success.

From a valuation perspective, a lack of clear continuity and exit planning undermines the assumption of infinite operations, making perpetuity unrealistic and voiding any terminal value calculations. In many cases, the business doesn't even have a liquidity plan.

On the buyer's side, poor exit planning creates significant transitional risk: Who will stay with the business? Will I be left holding the bag if employees leave, vendors disappear, or customers react negatively to an unexpected sale? These disruptions create disorganization that kills future growth. Without a plan, terminal value (TV) is not applicable—there is no growth trajectory, and in some cases, the business could fail entirely if the buyer lacks experience.

### Exit Multiples Are Hard to Benchmark

Exit multiples can provide a general idea of potential value, but they should never be used on their own for lower-middle market businesses. Sparse comparable transaction data for small, niche businesses makes exit multiple-based terminal value highly unreliable. While industry averages can offer directional insight, they often reflect companies with scale, liquidity, and growth potential that the subject business simply doesn't have. Relying solely on these benchmarks can lead to inflated valuations and unrealistic expectations.

For example, imagine a rural specialty manufacturer with $3M in revenue. If you apply a 6x EBITDA multiple pulled from a national industry average, you're assuming the same risk profile and scalability as much larger firms. In reality, the business may face owner dependency, limited growth, and regional constraints—factors that justify a much lower multiple. Using the industry average without adjusting for these realities misleads both sellers and buyers. Multiples can be a reference point, but they must be paired with a detailed analysis of risk, growth limitations, and market conditions.

### Business Lifecycle Reality

Many LMM businesses are not perpetual going concerns—they are often sold, merged, or wound down after a finite period. Most buyers in this space acquire as a **bolt-on** to strengthen their existing platform, with the intent to roll up and exit within **5–7 years**, not operate the business indefinitely. Terminal value assumes perpetuity, which creates a false narrative about long-term growth and stability. Including TV in a valuation can massively distort projected sale values, leading to unrealistic expectations and failed negotiations.

For example, consider a family-owned HVAC company that dominates its local market. Once the owner retires, the business may be sold to a regional competitor as a bolt-on acquisition. The buyer's goal is to integrate the customer base and eliminate overhead—not to grow the acquired entity forever. When terminal value inflates the valuation, owners often over-invest in equipment or marketing, thinking it will pay off at exit. In extreme cases, owners believe the inflated valuation will cover **exorbitant debt** and leave them with cash in hand. The reality check? Most deals are **cash-free, debt-free**, meaning all cash is swept after netting out debt obligations. This misunderstanding can lead to financial strain and disappointment. Terminal value isn't just unrealistic—it can create dangerous assumptions that harm both the seller and the deal.

## How Terminal Value Skews Enterprise Value in DCF

### Proper DCF Without Terminal Value

Now, let's take a look at a construction company's discounted cash flow (DCF) and how the valuation plays out as a "pure DCF," excluding the terminal value calculation—exactly how a Lower Middle Market (LMM) company should be evaluated. In this example, we've forecasted five years based on five years of historical performance, and the value is derived solely from the sum of future cash flows discounted to present value. This approach provides a realistic baseline because the valuation below is based entirely on cash flow, with no assumptions about perpetual growth or exit multiples—assumptions that are typically reserved for large or public entities, not LMM businesses.

**VALUATION ~ DISCOUNTED CASH FLOW METHOD**

*Private Construction Company* - **REDACTED**

| Fiscal Year ~ Period (t) | 2020H | 2021H | 2022H | 2023H | 2024H | TTM_NOV25 | 2025P | 2026P | 2027P | 2028P | 2029P |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **EBITDA** | $3,125,368 | $3,451,991 | $3,770,679 | $4,076,053 | $4,469,638 | $4,856,529 | $5,320,721 | $5,819,069 | $6,348,669 | $6,869,772 | $7,386,419 |
| EBIT | 3,125,368 | 3,451,991 | 3,770,679 | 4,076,053 | 4,469,638 | 4,856,529 | 5,320,721 | 5,819,069 | 6,348,669 | 6,869,772 | 7,386,419 |
| *Tax Rate (Private Company)* | *18.4%* | *19.8%* | *21.1%* | *24.6%* | *25.9%* | *26.5%* | *27.0%* | *27.0%* | *27.0%* | *27.0%* | *27.0%* |
| EBIT (1-t) | 2,550,300 | 2,769,187 | 2,975,066 | 3,073,344 | 3,312,002 | 3,569,549 | 3,884,126 | 4,247,920 | 4,634,528 | 5,014,934 | 5,392,086 |
| Depreciation & Amortization | 765,658 | 925,232 | 977,661 | 1,035,099 | 1,055,911 | 1,147,305 | 1,236,128 | 1,539,999 | 1,612,845 | 1,774,619 | 1,704,958 |
| Change in Net Working Capital | 0 | (391,948) | (382,425) | (366,449) | (472,301) | (464,270) | (24,957) | (548,183) | (582,560) | (573,214) | (568,312) |
| Capital Expenditures | (418,697) | (988,767) | (853,354) | (1,069,444) | (1,194,586) | (803,803) | (936,305) | (1,517,350) | (1,535,820) | 1,518,678 | 1,136,624 |
| **Unlevered Free Cash Flow (ULCF)** | **2,897,261** | **2,313,705** | **2,716,947** | **2,672,550** | **2,701,025** | **3,448,782** | **4,158,991** | **3,722,387** | **4,128,993** | **7,735,017** | **7,665,356** |

| *Discount Rate* | *16.8%* | *Period* | *1.0* | *2.0* | *3.0* | *4.0* | *5.0* |
|---|---|---|---|---|---|---|---|
| **Present Value of UFCF's** | | | **$3,562,025** | **$2,730,483** | **$2,594,007** | **$4,161,954** | **$3,532,460** |

| | |
|---|---|
| **Sum of Present Values** | **$16,580,928** |

| Enterprise Value | |
|---|---|
| **Enterprise Value** | **$16,580,928** |
| **TTM EBITDA** | **$4,856,529** |
| **Enterprise Value As Multiple of EBITDA** | **3.41x** |

| *Net working Capital Analysis* | 2020H | 2021H | 2022H | 2023H | 2024H | TTM_NOV25 | 2025P | 2026P | 2027P | 2028P | 2029P |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Current Assets | 16,251,914 | 17,950,355 | 19,607,530 | 21,195,477 | 23,242,116 | 25,253,953 | 25,362,101 | 27,737,560 | 30,261,987 | 32,745,913 | 35,208,597 |
| Current Liabilities | 12,501,472 | 13,807,965 | 15,082,716 | 16,304,213 | 17,878,551 | 19,426,118 | 19,509,309 | 21,336,585 | 23,278,452 | 25,189,164 | 27,083,537 |
| **Net Working Capital** | **$3,750,442** | **$4,142,390** | **$4,524,815** | **$4,891,264** | **$5,363,565** | **$5,827,835** | **$5,852,793** | **$6,400,975** | **$6,983,536** | **$7,556,749** | **$8,125,061** |
| **Change in NWC** | | **($391,948)** | **($382,425)** | **($366,449)** | **($472,301)** | **($464,270)** | **($24,957)** | **($548,183)** | **($582,560)** | **($573,214)** | **($568,312)** |

For LMM businesses, a proper discounted cash flow without terminal value is often the most practical and accurate approach. This method focuses exclusively on the present value of projected cash flows during the explicit forecast period, avoiding speculative assumptions about perpetual growth or exit multiples. Smaller companies typically face more volatility and less predictable long-term performance, making this conservative approach far more reliable. In the example above, the present value of unlevered free cash flows (UFCFs) totals **$16,580,928**, which translates to an **EV/EBITDA multiple of 3.41x** based on trailing twelve-month EBITDA of $4,856,529. This figure represents the true economic value of the business without inflated expectations.

## DCF With Terminal Value

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| | |
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| **Sum of Present Values** | **$16,580,928** |

| Enterprise Value | |
|---|---|
| **Enterprise Value** | **$16,580,928** |
| **TTM EBITDA** | **$4,856,529** |
| **Enterprise Value As Multiple of EBITDA** | **3.41x** |
| **Perpetuity Growth (g)** | 3.0% |
| **Terminal Value (TV)** | **$57,382,200** |
| **Total Enterprise Value** | **$73,963,129** |
| **Total Enterprise Value As Multiple of EBITDA** | **15.23x** |

*<--- No Mid-Year Adjustment*

When we introduce terminal value, the valuation changes dramatically. The total enterprise value jumps to **$73,963,129**, with terminal value alone contributing **$57,382,200**—nearly **78% of the total valuation**. This increase also drives the implied **EV/EBITDA multiple from 3.41x to 15.23x**, which is far beyond what is typical for Lower Middle Market (LMM) businesses

Why such a massive difference? Terminal value assumes the company will grow indefinitely at a fixed rate, discounted back to today. While this method is common for large or public companies with predictable growth and liquidity, it can distort valuations for LMM businesses. These companies often face owner dependency, limited growth horizons, succession risks, and market constraints—factors that make perpetual growth assumptions unrealistic. A small tweak in the growth rate or discount rate can swing the valuation by millions, making terminal value highly sensitive and often misleading for smaller, privately held firms.

For this reason, terminal value should be used cautiously in LMM valuations. It's not that the concept is wrong—it's that the assumptions behind it rarely apply to businesses with finite lifecycles, concentrated customer bases, and operational limitations. Owners should focus on improving actual cash flows and treat terminal value as a reference point, not the primary driver of valuation.

**Why This Matters to Owners**

Terminal value can create a dangerous illusion for small business owners. When a valuation model assumes perpetual growth, it often inflates the enterprise value far beyond what the market will realistically pay. For lower-middle market businesses, this disconnect leads to:

- **Unrealistic Exit Expectations** – Owners may believe their business is worth 2–3 times more than buyers will offer, causing deals to stall or fail.
- **Misguided Investment Decisions** – Inflated valuations can prompt owners to over-invest in equipment, marketing, or expansion, expecting a payoff that never materializes.
- **Debt and Liquidity Risks** – Many owners assume a high valuation will cover debt and leave cash at closing. In reality, most deals are cash-free, debt-free, meaning debt obligations reduce net proceeds significantly.
- **Lost Opportunities** – Overpricing based on terminal value can scare away qualified buyers, leaving the business unsold or forcing a steep price cut later.

The takeaway? Terminal value is not inherently wrong—it's just misapplied in small business valuations. Owners should focus on **finite cash flows, realistic growth assumptions, and market-based multiples**, not perpetuity models designed for large corporations. A grounded valuation approach protects owners from false expectations and positions them for successful, strategic exits.

## The Valuation Mirage: Why Chasing Terminal Value Leads to Deserted Expectations

Terminal value isn't inherently wrong—it's a useful concept for large corporations with predictable growth and liquidity. But for small, owner-operated and lower-middle market (LMM) businesses, it often creates a **valuation mirage**. Why? Because perpetuity assumptions ignore the realities of these businesses:

- **Owner Dependency** – Most LMM businesses rely heavily on the owner for operations and relationships. This "key-man risk" makes infinite growth unrealistic.
- **Limited Growth Horizon** – Geographic constraints, resource limitations, and competitive pressures cap expansion potential.
- **Lack of Succession Planning** – Without a clear exit or continuity plan, the assumption of perpetual operation collapses.

- **Unreliable Exit Multiples** – Industry averages often reflect large, scalable firms—not small, niche businesses with concentrated risk.
- **Finite Lifecycle** – Most buyers in this space aim for a 5–7 year roll-up strategy, not indefinite ownership.

When terminal value is added to a DCF model, it can account for **60–80% of the total valuation**, driving implied multiples far beyond market norms. This inflates expectations, misguides investment decisions, and often kills deals.

A proper DCF **without terminal value**—focused on finite cash flows—offers a more accurate, conservative valuation aligned with reality.

If you're an owner, don't let inflated numbers dictate your strategy. Terminal value assumptions can lead to **over-investment, debt risks, and failed negotiations**. Instead, focus on **realistic valuations, operational improvements, and strategic exit planning**.

## Work With A.J. Arenburg Financial

At **A.J. Arenburg Financial**, we specialize in valuations for owner-operated and lower-middle market businesses—grounded in market realities, not perpetuity models. We're happy to provide:

✅ **Free consultation and initial review**
✅ **Market-driven valuation strategies**
✅ **Exit planning insights tailored to your goals**

**Ready to get clarity? Let's start the conversation today.**
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