Guide from

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Valuing a business

Understanding how much a business is worth - and how it can be made more valuable - is of vital importance to anyone buying, selling or simply running a business.

Business valuation hinges upon how much profit a purchaser can make, balanced by the risks involved. Past profitability and asset values are only starting points. Intangible factors, such as goodwill and intellectual property, often provide the most value.

1. Why value the business?

There are four main reasons for valuing a business.

To help you buy or sell a business.

Understanding the valuation process can help you to:

- improve its real or perceived value;
- choose a good time to buy or sell;
- negotiate better terms;
- complete a purchase more quickly.

There is a better chance of a sale being completed if both buyer and seller start with realistic expectations.

To raise equity capital.

- A valuation can help you agree a price for the new shares being issued.

To create an internal market for shares.

- For example, so that employees can buy and sell shares in the business at a fair price.

To motivate management.

Regular valuation is a good discipline. It can:

- measure and incentivise management performance;
- focus management on important issues;

- expose areas of the business which need to be changed.

2. Basic valuation criteria

Three basic criteria affect valuation.

The circumstances of the valuation.

- An ongoing business can be valued in several different ways (see ‘Valuation techniques’).
- A forced sale will drive down the value. For example, an owner-manager who has to retire due to ill health may have to accept the first offer that comes along.
- If you are winding up the business, its value will be the sum of its realisable assets, less liabilities (see ‘Asset valuation’).

How tangible the business assets are.

- A business that owns property or machinery has tangible assets.
- Many businesses have almost no tangible assets beyond office equipment. The main thing you are valuing is future profitability.

How old the business is.

- Many businesses make a loss in their first few years.
- A young business may have a negative net asset value, yet may be highly valuable in terms of future profitability.

3. Valuation techniques

It is important to remember that the true value of a business is what someone will pay for it. To arrive at this figure, buyers use various valuation methods. You usually use at least two methods to arrive at a range of values.

- Asset valuation is appropriate if your business has significant tangible assets. For example, a property business.
- The price-earnings ratio is used to value a business that is making sustainable profits.
- Entry cost values a business by reference to the cost of starting up a similar business from scratch.
- A discounted cash flow valuation is based on future cash flow. It is appropriate for businesses that have invested heavily and are forecasting steady cash flow over many years.
- Industry rules of thumb use an established, standard formula for the particular sector.

4. Asset valuation

Add up your assets, take away your liabilities, and you have the asset valuation. This method does not take account of future earnings

Use asset valuation if you have a stable, asset rich business.

- Property or manufacturing businesses are good examples.

The starting point for an asset valuation is the assets that are stated in the accounts.

- This is known as the Net Book Value (NBV) of the business.

You then refine the NBV figures for the major items, to reflect economic reality.

For example:

- property or other fixed assets which have changed in value;
- old stock which would have to be sold at a discount;
- debts to the business that are clearly not going to be paid;
- over-conservative provisions for bad debts;
- intangible items, such as software development costs, should usually be excluded.

Consider the future status of the business.

If a business is going to cease trading, it will lose value due to:

- Assets being sold off cheaply. For example, equipment sold off at auction may only achieve a fraction of its book value.
- Debt collection being more difficult.
- The cost of closing down premises.
- Redundancy payments, if applicable.

5. Price-earnings ratio

The price-earnings ratio (P/E ratio) is the value of a business divided by its profits after tax. You can value a business by multiplying its profits by an appropriate P/E ratio (see below). For example, using a P/E ratio of five for a business with post-tax profits of £100,000 gives a valuation of £500,000.

P/E ratios are used to value businesses with an established, profitable history.

- P/E ratios vary widely.

Compare your business with others.

- What are your quoted competitors' P/E ratios? Newspapers' financial pages give historic P/E ratios for quoted companies.
- What price have similar businesses been sold for?

Quoted companies have a higher P/E ratio.

- Quoted company shares are much easier to buy and sell. This makes them more attractive to investors than shares in comparable unquoted businesses.

- Most P/E ratios for quoted companies vary between ten and 25, though there are exceptions.
- Typically the P/E ratio of a small unquoted company is 50% lower than that of a comparable quoted company in the same sector. Typical P/E ratios are between five and ten times annual post-tax profits.

P/E ratios are affected by commercial conditions.

- Higher forecast profit growth means a higher P/E ratio.
- Businesses with repeat earnings are safer investments, so they are generally awarded higher P/E ratios.

Adjust the post-tax profit figure to give a true sustainable picture.

How to calculate profit

If you are considering buying a business, work out what the true profitability is.

Compare the owner's stated profits with the audited figures.

- Question any differences.

Look for costs that could be reduced under your ownership.

For example:

- consultancy fees;
- payments to the owner and to other shareholders;
- unnecessary property leases;
- whether alternative suppliers would be cheaper;
- excessive overheads.

Check how the accounts have been worked out.

- If necessary, restate the accounts using your own accounting policies. This will often result in a significantly different profit figure.
- For example, money spent on software development might have been capitalised by the owner. You might consider that it should have been treated as a cost.

When looking at future profits, bear in mind the costs of achieving them.

These may include:

- servicing increased borrowings;
- depreciation of investment in plant, machinery, or new technology;
- redundancy payments.

The arrival of new management often leads to major changes that may mean higher costs and lower productivity in the first year.

6. Entry cost valuation

Rather than buy a business, you could start a similar venture from scratch. An entry cost valuation reflects what this would cost.

Start by assessing the main costs.

Calculate the costs to the business of:

- raising the necessary finance;
- purchasing its assets;
- developing its products;
- recruiting and training the employees;
- building up a customer base.

Factor in any cost savings you could make.

For example, by:

- using better technology;
- locating in a less expensive area.

The entry cost valuation can then be based on cheaper alternatives, which is more realistic.

7. Discounted cash flow

This method is the most technical way of valuing a business. It depends heavily upon assumptions about long-term business conditions.

Discounted cash flow valuation is used for cash-generating businesses that are stable and mature.

- Discounted cash flow relies on confidence about the long-term prospects for the business.
- For example, a water company with a local monopoly might expect relatively predictable cash flows.

The valuation is based on expected future cash flow.

- Cash flows are forecast several years into the future, plus a residual value at the end of the forecasting period.
- The value today of each future cash flow is calculated using a discount rate which takes account of the risk and the time value of money. (£1 received today is worth more than £1 received in a year's time.)

8. Industry rules of thumb

In some industry sectors, buying and selling businesses is common. This leads to the development of industry-wide rules of thumb.

Rules of thumb are based on factors other than profit.

For example:

- turnover for a specific type of business;
- the number of customers;
- the number of outlets.

Buyers work out what the business is worth to them.

- Take the example of a computer maintenance business with 10,000 contracts but no profits. A larger competitor might offer £100 per contract to buy the business. This is because it could merge the two businesses, cut costs and make large profits.

9. Intangible issues

The key source of value of your business may be something that cannot be measured.

Strong relationships with key customers or suppliers may be critical.

- For example, if a business holds the UK licence (or UK distributorship) for a product that is expected to be successful, the value of the business will increase accordingly.

Management stability may be crucial, if the purchaser does not have a strong team.

If the owner-manager or other key people are going to leave, the business may be worth far less. For example:

- the profitability of an advertising agency may collapse if a key creative person leaves;
- if key salespeople leave, they may take important customers with them.

Check any restrictive covenants contained in employees' contracts. The covenants could add value if the employees form an integral part of the business. But they could also damage the value if a potential buyer intends to radically change the staffing arrangements.

The more risks there are from a purchaser's perspective, the lower the value will be.

There are specific actions you can take with a view to building a more valuable business:

- Set up excellent management information systems, including management accounts. Good systems make nasty surprises unlikely.
- Tie in key customers and suppliers through contracts and mutual dependence.
- Minimise exposure to exchange rate fluctuations and other external factors.

Signpost

- Find an ACCA accountancy firm for business valuation advice.
- Ask a business transfer agent for a free valuation of a business you want to sell through Daltonsbusiness.

Expert quotes

"Valuing a business is an art form, not necessarily a science." - Brian Hayden, Hayden Associates

"The fortunes, and therefore value, of a small business can deteriorate rapidly. This risk should always be reflected in the valuation of small businesses." - Paddy McCGwire, Silverpeak

"A business' value does not always equal all its assets, but rather the profit and cash flow that those assets can generate." - Brian Hayden, Hayden Associates

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