Valuing a business

The two questions 'How much is your business worth?' and 'How can you make it more valuable?' are of paramount importance to any business owner.

This briefing is aimed at anyone buying, selling or simply running a business, who needs to understand how businesses are valued.

The worth of a business hinges upon how much profit a purchaser can make from it, balanced by the risks involved. Past profitability and asset values are only the starting points. It is often intangible factors, such as key business relationships, which provide the most value.

This briefing outlines:

- When you might need a valuation.
- Key factors affecting the value of your business.
- The standard methods of valuation.
- How to calculate profit for the purpose of valuation.

1 Why value the business?

There are four main reasons for valuing a business.

1.1 To help you **buy or sell** a business. Understanding the valuation process can help you to:

- Improve the business' 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 the buyer and seller start with realistic expectations.

1.2 To raise **equity capital**.

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

1.3 To create an **internal market** for shares.

- A valuation can help you to buy and sell shares in a business at a fair price.

1.4 To **motivate** management. Regular valuation is a good discipline. It can:

- Provide a measurement for management performance.
- Focus management on important issues.

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

2 What kind of business is it?

Three basic criteria affect valuation.

2.1 The **circumstances** of the valuation.

- An ongoing business can be valued in several different ways (see **3**).
- 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 which comes along.
- If you are winding up the business, its value will be the sum of its realisable assets, less liabilities (see **4**).

2.2 How **tangible** are the business assets?

- A business which 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.

2.3 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.

Multiple values

A small unquoted business is usually valued at between five and ten times its annual post-tax profit. Previously — most notably in the IT market — the ratio has exploded, with some valuations being drawn from multiples of 70 or more. However, the differential has closed significantly, with IT-based companies seeing the sharpest drops.

Following the so-called 'correction', commonly accepted earnings multiples to value quoted firms range from nine or ten to 25, although some exceptions remain.

The main valuation methods are based on:

3.1 Assets (see **4**).

- This method is appropriate if your business has significant tangible assets. For example, a property business.

3.2 Price/earnings ratio (see **5**).

- This method is appropriate if the business is making sustainable profits.

3.3 Entry cost (see **6**).

- This method values a business by reference to the cost of starting up a similar business from scratch.

3.4 Discounted cashflow (see **7**).

- This calculation is based on future cashflow. It is appropriate for businesses which have invested heavily and are forecasting steady cashflow over many years.

3.5 Industry **rules of thumb** (see **8**).

- This method uses an established, standard formula for the particular sector.

When valuing a business, you usually use at least two of these methods to arrive at a value.

4 Asset valuations

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

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

- Property or manufacturing businesses are good examples.

4.2 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.

4.3 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. (Or, conversely, over-conservative provisions for bad debts.)
- Intangible items, such as software development costs, should usually be excluded.

4.4 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

How to calculate profit

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

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

- Question any differences.

B Look for costs which could be **reduced** under your ownership. For example:

- Consultancy fees.
- Payments to the owner and to other shareholders.
- Unnecessary property leases.
- Supplies — is there a cheaper supplier?
- Overlapping overheads.

C Look for areas to '**restate**' (the accountancy term for changing a figure from one kind of cost to another). For example, money spent on software development may have been capitalised by the owner. You might consider that it should have been treated as a cost.

- Use your own accounting policies when calculating the business' profits. This will often result in a significantly different profit figure.

D 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 which may mean higher costs and lower productivity in the first year.

- 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.

Once you have decided on the appropriate P/E ratio to use (see below), you multiply the business' most recent profits after tax by this figure. For example, using a P/E ratio of 5 for a business with post-tax profits of £100,000 gives a P/E valuation of £500,000.

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

- P/E ratios vary widely (see box, page 2).

5.2 **Quoted companies** have a higher P/E ratio. Their shares are much easier to buy and sell. This makes them more attractive to investors than shares in comparable, unquoted businesses.

- A typical P/E ratio for a large, growing quoted company with excellent prospects might be 20.
- Typically the P/E ratio of a small, unquoted company is 50 per cent lower than that of a comparable quoted company in the same sector.

5.3 **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?

5.4 P/E ratios are **weighted** 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.

5.5 Adjust the post-tax profit figure to give a **true** sustainable picture (see box).

6 Entry cost valuation

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

6.1 To make an entry cost valuation, calculate the **cost to the business** of:

- Purchasing its assets.
- Developing its products.
- Recruiting and training the employees.
- Building up a customer base.

6.2 Then make a **comparative** assessment. Factor in any cost savings you could make. For example:

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

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

7 Discounted cashflow

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

7.1 It is used for **cash-generating** businesses which are stable and mature.

- For example, a publishing house with a large catalogue of titles, or a water company with a local monopoly.

7.2 The valuation is based on the sum of the **dividends** forecast for each of the next 15 years (at least), plus a residual value at the end of the period.

- The value today of each future dividend is calculated using a 'discount interest rate', which takes account of the risk and the time value of money (£1 received today is worth more than £1 received tomorrow).

7.3 If a business can inspire confidence in its **long-term prospects**, then this method underlines the business' solid credentials.

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.

8.1 The rules of thumb are dependent on factors **other than profit**. For example:

- Turnover for a computer maintenance business, or a mail order business.
- Number of customers for a mobile phone airtime provider.
- Number of outlets for an estate agency business.

8.2 Buyers will 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 may pay £100 per contract to buy the business. This is because it could merge the two businesses and make large profits.

9 Intangible issues

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

9.1 **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 which is expected to be successful, the business' value will increase accordingly.

9.2 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 the a 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.

9.3 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.

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