

Bulletin

Valuing Your Business

*Valuing a business is something of an art, albeit an art backed by science!
There are many reasons why you may need to calculate the value of your business and in this bulletin we consider the range of methods available as well as some of the factors to consider during the valuation process.*

Why Value Your Business?

One of the most common reasons for valuing a business is for **sale purposes**. Initially a valuation may be performed simply for information purposes, perhaps when planning an exit route from the business. When the time for sale arrives, owners need a starting point for negotiations with a prospective buyer and a valuation will be needed.

Valuations are also commonly required for **specific share valuation reasons**. For example, share valuations for tax purposes may be required:

- on gifts or sales of shares
- on the death of a shareholder
- on events in respect of trusts which give rise to a tax charge
- for capital gains tax purposes
- when certain transactions in companies take place, for example, purchase of own shares by the company.

Share valuations may also be required:

- under provisions in a company's Articles of Association
- under shareholders' or other agreements
- in disputes between shareholders
- for financial settlements in divorce
- in insolvency and/or bankruptcy matters.

When a business needs to **raise equity capital** a valuation will help establish a price for a new share issue. Valuing a business can also help **motivate staff**. Regular valuations provide measurement criteria for management in order to help them evaluate how the business is performing. This may also extend to share valuations for entry into an employee share option scheme for example, again used to motivate and incentivise staff.

Valuation Methods

While there is a ready made market and market price for the owners of listed public limited company shares, those needing a valuation for a private company need to be more creative. Various valuation methods have developed over the years, although it must be remembered that when it comes to selling a business, the ultimate truth is that any business is only worth what someone is prepared to pay for it - and the laws of supply and demand apply! Nevertheless, the methods discussed below can be used as a starting point and basis for negotiations.

Earnings multiples

Earnings multiples are commonly used to value businesses with an established, profitable history. Often, a price earnings ratio (P/E ratio) is used, which represents the value of a business divided by its profits after tax. To obtain a valuation, this ratio is then multiplied by current profits. Here the calculation of the profit figure itself does depend on circumstances and will be adjusted for relevant factors.

A difficulty with this method for private companies is in establishing an appropriate P/E ratio to use - these vary widely. P/E ratios for quoted companies can be found in the financial press and one for a business in the same sector can be used as a general starting point. However, this needs to be discounted heavily as shares in quoted companies are much easier to buy and sell, making them more attractive to investors.

As a rule of thumb, typically the

P/E ratio of a small unquoted company is 50% lower than a comparable quoted company. Generally, small unquoted businesses are valued at somewhere between five and ten times their annual post tax profit. Of course, particular market conditions can affect this, with boom industries seeing their P/E ratios increase.

A similar method uses EBITDA (earnings before interest, tax, depreciation and amortisation), a term which essentially defines the cash profits of a business. Again an appropriate multiple is applied.

Growth potential

Good growth potential is a key attribute of a valuable business and as such this is very attractive to potential buyers. Market conditions and how a business is adapting to these are important - buyers will see their initial investment realised more quickly in a growing business.



Discounted cashflow

Generally appropriate for cash-generating, mature, stable businesses and those with good long-term prospects, this more technical method depends heavily on the assumptions made about long-term business conditions.

Essentially, the valuation is based on a cash flow forecast for a number of years forward plus a residual business value. The current value is then calculated using a discount rate, so that the value of the business can be established in today's terms.

External factors

External factors such as the state of the economy in general, as well as the particular market in which the business operates can affect valuations. Of course, the number of potential, interested buyers is also an influencing factor. Conversely, external factors such as a forced sale, perhaps due to ill health or death may mean that a quick sale is needed and as such lower offers may have to be considered.

Entry cost

This method of valuation reflects the costs involved in setting up a business from scratch. Here the costs of purchasing assets, recruiting and training staff, developing products, building up a customer base, etc are the starting point for the valuation. A prospective buyer may look to reduce this for any cost savings they believe they could make.

Asset based

This type of valuation method is most suited to businesses with a significant amount of tangible assets, for example, a stable, asset rich property or manufacturing business. The method does not however take account of future earnings and is based on the sum of assets less liabilities. The starting point for the valuation is the assets per the accounts, which will then be adjusted to reflect current market rates.

Intangible assets

Business valuations may need to consider the effect of intangible assets - they can be a significant factor. These in many cases will not appear on a balance sheet but are nevertheless fundamental to the value of the business.

Consider the strength of a brand or goodwill that may have developed, a licence held, the key people involved or the strength of customer relationships for example, and how these affect the value of the company.

Industry rules of thumb

Where buying and selling a business is common, certain industry-wide rules of thumb may develop. For example, the number of outlets for an estate agency business or recurring fees for an accountancy practice.

Circumstances

The circumstances surrounding the valuation are important factors and may affect the choice of valuation method to use. For example, a business being wound up will be valued on a break up basis. Here value must be expressed in terms of what the sum of realisable assets is, less liabilities. However, an on-going business (a 'going concern') has a range of valuation methods available.

Key Attributes of a Valuable Business

When looking to value a business for sale purposes, a seller should look at it objectively through the eyes of the potential buyer. What strengths and opportunities are identified? Conversely, what action can be taken on potential weaknesses and threats? Below are further examples of the key valuation issues to consider:

- Clear objectives. Creating a valuable business is essentially about taking strategic decisions that have a lasting, positive effect. In order to achieve this, a business must have clear objectives and a plan to achieve these.
- Good people and products. These represent the essence of a business and form a fundamental part of its strength. Does the business have a unique selling point, setting it apart from its competitors?
- Strong track record. Proven businesses with a strong track record developed over time often have a higher value. However, value, as discussed above, is also very much about growth potential.
- Profitability. Clearly potential buyers are looking for a return on their investment. High gross margin plus good levels of cash generation from profits for example reduce the risk of an investment going bad.
- Security. Generally relatively stable businesses are more valuable as they offer more security to the potential buyer. The nature of the underlying business assets can also be an important influencing factor here. A strong balance sheet with well-managed working capital does add value, as does a good quality customer base.

With any of the valuation methods discussed above, it is important to remember that valuing a business is not a precise science. In the end, any price established by the methods described above will be a matter for negotiation and more than one of the methods above will be used in the process. Ultimately, when the time for sale comes, a business is worth what someone is prepared to pay for it at that point in time.

How we can help

If you would like to find out more about the potential value of your business or need a specific share valuation we would be pleased to discuss these matters with you.

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