Business Appraisal and Valuation - What is your business worth?

We generally think about valuing businesses when we are looking to buy or sell them or are involved in a litigation process where it is necessary to value a loss to the business or a share. When completed, business owners are often surprised that the value others attribute to their business is not as high as they would have thought. This is largely due to business owners often valuing their business taking into account what it has taken them to build it and the efforts they have put in. An investor or the court are, however, interested in the future potential/loss of the business and this is the value they attribute.

In this month's ebrief, brought to you by Jane Fowler, Managing Director of Aquila Advisory, the boutique forensic accounting company, we will look at:

1. **The techniques used by investors and business appraisers to value businesses, and**
2. **The ways owners can enhance the value of the business, not just for sale but to improve their own results going forward.**

Not all owners are looking for an exit; the need for a business valuation could be a negotiation with the bank to improve finance terms, or merely to get the most out of the business for their own wealth position.

Valuation techniques

It is true to say that the value of a business is ultimately determined by what someone will pay for it! That said, there are other techniques to valuing a business than taking it to the wire in a sales deal. So how do we go about valuing a business?

1. Multiple Values

In applying this method, profits are adjusted to eliminate one-off factors, such as exceptional costs. Any changes that might be expected after the business is sold are also factored in. For example, if the current owner has been working without a salary, taking drawings as and when he/she can, and will need replacing with a paid manager or director. These adjustments provide an estimate of 'normalised' or sustainable after tax earnings. The valuation of the business is calculated as a multiple of these post tax earnings.

A small unquoted business is generally valued at a multiple of somewhere between five to ten times its annual post-tax earnings, although there are industry specific variables. The multiple used depends heavily on the size of the business and its growth potential. Smaller businesses tend to be valued using lower multiples.

This valuation method is commonly used for growing businesses with a track record of profitability.

2. Asset Values

This method is appropriate if the business has significant tangible assets, for example, a property company. Crudely put, you add up the total of the assets, subtract the liabilities and hey presto you have an asset value.

Obviously if you simply take the values included in the balance sheet of any business you end up with what's called the 'net book value' generally based on historic cost, less depreciation/provisions. To be a meaningful valuation you need to refine the net book value figure of the major items to reflect the economic reality. This will include up to date valuations of fixed assets and a detailed review of stock/debtors and attached provisions.

This method of valuation takes no account of any future earnings and would generally exclude intangible assets such as software development costs and goodwill, unless a good case could be made for their inclusion.

3. Price/Earnings ratio

The price earnings ratio (P/E ratio) is the value of the business divided by its profits after tax. At first glance this looks like a circular argument… P/E ratios are used to determine the value of a business and yet you need to know the value of the business to divide it by its profit after tax to reach the P/E ratio. This is true, so rather than using a P/E ratio based on the business being valued, a valuer will use the P/E ratio of another business or the industry sector as a base line.

The most reliable P/E ratio to use is that of a quoted company. They generally reflect an up to date share value as the shares are freely available to buy and sell. Remember at the start I said the best way to value a business was to see what someone would pay for it.

A typical P/E ratio for a quoted company with excellent prospects and a healthy profitability is around 20. Quoted companies have a higher P/E ratio. Their shares are readily available to buy and sell which makes them more attractive to investors than comparable unquoted companies where investors may find it more difficult to exit their investment. Therefore a comparable but unquoted company would generally have a P/E ratio 50% lower than that of a quoted company.

P/E ratios are also 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. For these reasons this method of valuation is appropriate if the business is making sustainable profits.

4. Entry cost

This method values a business by reference to the cost of starting up a similar business from scratch. It would be used to value businesses such as retail outlets, print shops, cafes and restaurants etc, where there is scope for new entrants into a marketplace. An entry cost valuation reflects what this process would cost.

To make an entry cost valuation, an appraiser would calculate the cost of the business of, amongst other things:

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

Factor in any cost savings that could be made. For example:

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

In this method of valuation, due consideration needs to be given to cost and effort of building the client base.

5. Discounted Cash flow

This calculation is based on future cash flow. It is appropriate for businesses that have invested heavily and are forecasting steady cash flow over many years.

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

It is used for cash-generating businesses that are stable and mature. 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 (ie £1 received today is worth more than £1 received next year or indeed in 15 years time).

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

6. Industry Rule of Thumb

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

In some industry sectors, buying and selling businesses is common. This leads to the development of an industry-rule of thumb. The rules of thumb are dependent on factors other than profits. 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

Buyers will work out what the business is worth to them.

For example a computer maintenance business with 10,000 contracts but no profits may attract an offer of £100 per contract from a larger competitor with spare capacity.

Enhancing the value of your business

The valuation models detailed above, deal only with those items that attract a tangible financial value. The key source of value in your business may be something that cannot itself be measured, merely estimated.

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 business' value 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, an advertising agency would be heavily reliant on its creative personnel, a products company on its key salespeople.

Another factor that can have a significant bearing on the value attributed to a business is how well owners/directors manage the business and the associated risks.

Below are some examples for risks that affect a businesses value and mitigating factors that can protect or enhance the value.

Business Risks	Value Enhancement
Loss of key personnel	Check any restrictive covenants contained in the employees' contracts. The covenants could add value if the employees form an integral part of the business. But be selective - they could also damage the value if a potential buyer intends to radically change the staffing arrangements, so use them sparingly, and ask yourself who does your business really rely upon?
Poor financial information and lack of controls	Set up excellent management information systems, including management accounts. A good discipline for all businesses as strong financial information helps us make the right business decisions and attract better financial support. Strong management information systems also give a purchaser confidence that there would not be any unpleasant surprises
Reliance on key customers or suppliers	If I were to ask you what would happen if your top customer/supplier went bust or went elsewhere and your answer isn't 'not much,' then you have too strong a reliance on that customer/supplier. You could seek to tie in key customers and suppliers through contracts and mutual dependence. However, a better option would be to diversify your customer/supplier base. To diversify your customer base, invest in marketing, to both new and existing customers. Offer promotional deals to attract people to you. If you have a customer that comes to you for one particular product or service, offer them discounts in other areas, attracting them to try something new. Not only will the existing business benefit from this initiative, if selling your business you are more able to demonstrate the future potential of your business by showing the new sales that have been generated from new and existing customers.
Growth prospects	It is obvious to say 'the better your growth potential, the more your business is worth,' but that doesn't make it less true. Increasing your customer base as set out above is one way another is reviewing and updating your products/services. Every product has a life cycle; heading towards oblivion if not kept up dated and 'relevant'. Take the humble sausage; we all love them! We used to be satisfied with a pork sausage, then we wondered what the fat content was, we looked for flavours, first being adventurous with Cumberland and Lincolnshire and then our heads got turned with Sage and Apple, Wild Boar, Chilli etc. Now we want to know if the Pig was bred outdoors, was the

	sausage sourced locally, has the farmer received a fair share of the sales value, was the pig happy. You get the picture! Nothing is as easy as it used to be. The consumer has become more complex and, to keep up and grow, businesses need to anticipate the consumers needs before they do or better still create the demand for something they didn't even know they needed, like an iPad. Showing year on year growth and products/services that are continually developing to serve future needs can add substantial value to a business, not to mention improve the quality of the earnings for the current owner.
Loss of Intellectual Property	If your business is dependent on revenue earned from developing products, tangible or intangible, protect them. Ensure it is clear in the employment contracts that any Intellectual Property created whilst employed, either internally or in conjunction with others, is owned by the company and not the individual. Use restrictive covenants to protect the company from leaving and setting up on their own and taking your customers/contacts with them. [The length of term a covenant can be enforced will depend on what would be a reasonable length of time for your business to protect itself and establish your credibility following the loss of a key person.] You can also protect your assets through registering Trademarks and Patents. Although it is not enough just to register them you also need to police that they are not being infringed.
Cost of financing	Regularly review your banking relationship and financial package. Many businesses seek additional financial support from banks when times are tough or expansion is needed and this can lead to finance costs being higher, as banks protect themselves against their investment in you. As times improve or expansion plans pay off and your business becomes more financially secure, go back to the bank and renegotiate a better deal for yourself and your business. The risk to the bank is less and therefore so should the cost of bank financing. Nothing puts a potential acquirer or investor of a business off faster than having to take on a costly finance package.

Business Appraisal and Valuation - In conclusion

The value of your business is not something just to be considered when you wish to exit the business. To really get the most out of your business, looking at ways to enhance its value should be an on going process.

For those looking to exit in the not to distant future, here are a few tips:

1. **Plan ahead** – the more time you have, the easier it will be to show your business in the best possible light. Concentrate on boosting short-term results to get the best possible profit record, before you offer your business.
2. **Think about timing** – if possible put your business up for sale when business conditions are good, and when business valuations are high. You'll also be in a stronger position if you are under pressure to sell immediately.
3. **Stimulate competition** – market your business to attract potential purchasers. The price will be higher if there are competing purchasers.
4. **Structure of deal** – a structured deal may increase the price the purchaser is willing to pay. For example, you might commit to continuing to manage the business for a year or two, or link the price to future earnings – reducing the purchaser's risk. Being willing to defer part of the purchase payment may also encourage purchasers.
5. **Plan for tax** – making sure the deal is tax-effective for you can have a dramatic impact on the net value you receive.

At Aquila Advisory, we work with businesses across all sectors, helping them to efficiently plan for exit.

So contact us today for a free initial consultation and to find out how we can help you enhance the value of your business for sale and improve results going forward.

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