Valuation of a Business

ITO Accounting

Introduction

There is no topic about which greater differences of informed opinion may exist than the value of a business or shares in a private company.

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Overview

Introduction

The value of a business is naturally influenced by the willingness of a vendor to sell and a purchaser to buy. It is usually assumed that fair value is a price at which a willing but not anxious purchaser might acquire the business from a willing but not anxious vendor.

It is always worthwhile exploring the factors that motivate the buyer and the seller.

Factors that influence a buyer

Factors that influence a buyer include:

- Employment – it is typical for redundant employees to seek to 'buy' a job
- Security – those who have experienced redundancy or vulnerability in employment often seek to become self employed
- Challenge – it is common for people to reach a time in their life where they want a new challenge
- Growth – many people identify the opportunity to grow a business and achieve a significant return on investment
- Lifestyle – the buyer might be attracted to flexible working hours
- Perception – the buyer may be attracted by the status that self employment may create
- Master of own destiny – the opportunity
- Specialist knowledge or passion in an industry – the buyer may have a particular skill in that industry or be very passionate about it

Factors that motivate a seller

Factors that motivate a seller include:

- Financial or liquidity problems
- The business has failed to live up to expectations
- A genuine desire to retire
- Health problems
- Succession to the next generation
- Adverse market conditions
- Impending competition
- Marriage/relationship breakdown
- The desire to pursue another opportunity

Valuation Methods

In assessing business or share valuations, the following usual methods are considered:

- Capitalisation of future maintainable earnings
- Capitalisation of future dividends
- Discounted cash flow
- Net assets value
- Liquidation value
- Tangible assets plus goodwill based on super profits

Developing the succession plan

Two key questions

Two key questions need to be considered early on in the planning stages.

1. What needs to be done to prepare the business for succession?
2. What can be done based on the timetable agreed?

It may well be that the succession plan needs to be 'fast tracked' for whatever reason, be it health of the owner, the owner's procrastination or sudden desire to 'quit' the business, or even an unanticipated approach from a competitor who expresses a keen desire to acquire the business.

Given that we don't always have the luxury of the ideal succession time frame on our side, it's useful to establish the 'early yardage' factors that we should prioritise.

Four key areas

There are four key areas to consider when grooming a business:

1. Structuring
2. Housekeeping
3. Risk management
4. Value enhancement

What you can achieve in the preparation stage primarily depends on the time frame chosen.

If less than a year is available to complete succession, it is likely that only housekeeping matters will be able to be addressed. To achieve a sustainable value difference probably requires a minimum of three years in most businesses.

So, in a short time frame, where should we focus?

1. Complete the diagnostic analysis of financial and non financial matters
2. Complete an internal due diligence of business risks through self examination
3. Implement actions to remove any obstacles to succession planning success
4. Identify any surface enhancements that can be made to the business to improve its saleability and value

Valuing the business

Valuing the business is a fundamental element in the succession process.

Not only does an early valuation provide an opinion to the business owner, it also reality tests the owner's view on business value. It is very common for there to be a gap, sometimes significant, between the owner's expectations as to value, and the commercial realities of what the market is prepared to and therefore likely to pay. This valuation expectation gap is best flushed out very early in the succession planning process as it often sets a 'stake in the ground' for the beginning of a business improvement programme.

Valuation methods summarised

Method	When Appropriate
Capitalisation of future maintainable earnings ▪ Based on a future maintainable earnings stream to which a capitalisation rate is applied ▪ Results of the business for the past five years should be obtained ▪ Results should be adjusted for abnormal and extraordinary items which distort earnings ▪ Forecasts for the next two years should be obtained ▪ The capitalisation rate will be determined by risk	▪ Suitable when valuing large or controlling interests in a company ▪ Applied when the historical earnings pattern is sufficiently stable and predictable of the earnings that can be expected in future, or where forecasts are reliable enough to allow reasonable estimates of future earnings to be made ▪ If a company has a history of losses, declining profits or liquidity problems, this method should not be used
Capitalisation of future dividends ▪ This method requires an assessment of maintainable dividends and a dividend yield appropriate for that business	▪ Normally applied when valuing small or minority shareholdings ▪ Shareholder has no real say in the company and therefore no control over dividend policy ▪ This method is not appropriate if the company doesn't have a history of paying dividends
Discounted cash flow ▪ This method uses realistic forecasts of future cash flows, usually over a period of at least ten years ▪ This method requires a formal business model and discounts free cash flows after excluding depreciation and accounting for expenditure on capital items ▪ Items influencing the discount rate will include current interest rates and any general or particular future uncertainty	▪ This method is suitable where the future performance is likely to be significantly different from past performance, or where cash flows are expected to fluctuate substantially over time
Net assets value ▪ This method requires all tangible assets to be valued and liabilities deducted to arrive at a net tangible assets value	▪ This method is appropriate where a sole trader or professional practitioner is selling net assets plus goodwill

Liquidation value ▪ Net assets are valued and adjusted for liquidation costs, losses and profits on realisation of stock, debtors and other assets, and tax on undistributed profits	▪ Appropriate where liquidation is contemplated or possible because of size of shareholding (minimum of 75%)
Tangible assets plus goodwill based on super profits ▪ This method assesses the net value of assets to be sold. Goodwill is added to arrive at the total sale price ▪ This method values an earnings stream plus net tangible assets	▪ This method is appropriate where assets are generally readily realisable ▪ Typically used for sole traders

Goodwill

Valuation

The valuation of goodwill is generally focused on past, present and future factors.

Goodwill is only present when there is an excess of earnings over and above what a reasonable return would be expected on the net tangible assets employed.

Factors affecting a goodwill valuation include:

- Location
- Owner's skills
- Employees' skill
- Public image and branding
- Dependability
- Quality
- Administration and systems
- Products and services
- Profit maintenance
- Certainty of growth

Super profits

A super profits approach is often used when valuing goodwill. An established method for calculating goodwill on this basis is as follows:

- Determine the net value of the business assets (tangibles)
- Multiply this by a rate of return you could expect to earn by investing elsewhere
- Add a reasonable salary for the owner(s)
- This gives us a minimum acceptable return. If the business is not achieving this level of profit, any goodwill value is questionable
- Calculate the average profit for the last few years, before tax and remuneration of the owner(s)
- Subtract the minimum acceptable return from the average profit calculated above
- The resulting amount is the 'super profit'
- Deduct taxation
- Apply a profit multiplier, appropriate for the situation. The more established the business, the higher the multiplier. For example, a well-established business might attract a multiplier of five, whereas a new business might attract a multiplier of only one