

Corporate Law Briefings

Valuing your business

Valuation methods

There are several standard techniques that can be used to provide a benchmark valuation for your business. Using several different valuation methods can help you come up with a range of valuations for your business.

It's important to realise that these valuations, and the amount a purchaser is in fact likely to be prepared to pay, may be substantially lower than the value you place on your business.

1. Multiple of profits

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 salary and will need replacing with a paid manager. These adjustments provide an estimate of 'normalised' or sustainable after-tax earnings.

The valuation of the business is calculated as a multiple of these earnings. The multiple used is often in the region of four to eight times earnings, but depends heavily on the size of the business and its growth prospects. 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 valuation

Your accounts will show the net book value of the business - total assets less total liabilities. For a sale valuation, these book figures need to be adjusted to reflect current values. For example, property or other fixed assets may be worth more or less than the book value. If the purchaser is likely to sell off assets, assets such as stock may be worth significantly less than their book value; there may also be extra liabilities such as redundancy payments for employees.

This valuation method is commonly used for businesses with high levels of assets (such as many property and manufacturing businesses) and for businesses that have poor growth prospects or are going to be wound up.

3. Entry valuation

This valuation method attempts to assess how much it would cost to create a similar business from scratch, rather than buying your business. The valuation includes the costs of purchasing assets, developing products or services, recruiting and training staff, and building up a customer base.

Entry valuation can help trade purchasers decide whether buying your business is the right option for them. For example, a pharmaceutical company might want to choose between buying a biotechnology business and investing more in its own research and development operations.

4. Discounted cash flow

Discounted cash flow valuation uses estimates of future cash flow to value your business. The further into the future the cash flow is, the more heavily it is discounted - as £1 today is worth more than £1 in five years' time.

The value calculated is very sensitive to the discount rate used. Purchasers of small businesses typically use a discount rate between 15 and 25 per cent.

This valuation method can be used for businesses with stable, predictable cash flows going into the future, such as utilities.

5. Rule of thumb

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Different industries also have their own rules of thumb that can be used to calculate a value. For example, many retail businesses are valued as a multiple of turnover. Other common valuation methods are based on the number of customers or the number of outlets.

Industry rules of thumb like these are often used in sectors where buying and selling of businesses is common. A valuation like this may well be used by a buyer who expects to significantly change the way your business operates - and to be able to achieve industry-standard levels of profitability.

Factors influencing value

The value of your particular business is likely to be affected by several factors:

- **growth prospects** - the better your growth prospects, the more your business is worth
- **risk** - the smaller the business, the higher the risks tend to be and the less a purchaser will pay; small, owner-managed businesses are particularly risky for a new owner to take over
- **special features** - skilled employees, intellectual property or other special strengths of your business will increase its value
- **opportunities** - your business will be worth more to a purchaser who can increase profits (for example by cutting costs, or selling your product to their existing customers)
- **cost of financing** - a purchaser is likely to pay less if their cost of financing the purchase is high
- **supply and demand** - your business may be worth more if it is unique, or if there are several buyers looking to purchase that kind of business

Achieving a high sales value

Do what you can to make your business as valuable as possible.

- **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.
- **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 negotiating position if you aren't under pressure to sell immediately.
- **Reduce business risk** - if you are over-dependent on a few customers, try to diversify your customer base. If one or two employees are crucial to the success of your business, consider ways to tie them in. If trade marks or other intellectual property are important to your business, make sure they are properly protected.
- **Sort out systems** - strong management information systems give the purchaser confidence that there won't be any unpleasant surprises.
- **Stimulate competition** - market your business to attract potential purchasers. The price will be higher if there are competing purchasers.
- **Structure the 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.
- **Plan for tax** - making sure the deal is tax-effective for you can have a dramatic impact on the net value you receive

Our legal adviser can offer specialist knowledge and negotiating skills to help you.