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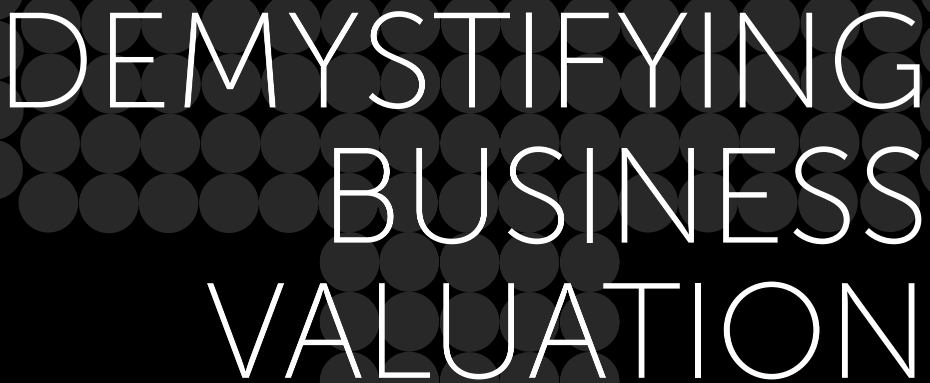

DEMYSTIFYING BUSINESS VALUATION

A guide for SME owners

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The importance of valuation

Value vs valuation

People get themselves tied up in knots about valuation, which is a distinct concept from value. A business, like anything, has multiple values at any point in time, depending on who is looking and their circumstances.

If the buyer of a business is a mum and dad team looking to escape the workforce, their perception of the value of the business for sale will be different to, say, a competitor, who is interested in the Intellectual Property that has been developed that would save them millions of dollars a year. This competitor has the added sweetener of growing revenue by acquisition and removing a competitive threat.

The former example is in a category we call financial buyers, whose main consideration is ownership at fair value and stability of return and the latter in a category we call strategic buyers, whose main consideration is maximising return.

It is almost always better valuation-wise to position one's business to appeal to strategic buyers over financial buyers. However, strategic buyers are not simply everywhere, one must work hard to be attractive to them.

Moreover, other alternatives, like managers or employees taking over ownership of the business are still buyers in a sense and would usually occupy the financial category.

A valuation on the other hand, is a report an adviser puts together after analysing a business. There are many reasons to value a business. Apart from the rigour applied (it is usually quite difficult to advise owners on how to grow the value of their business, without first valuing it), they are often used as aids to negotiations for one partner buying out another in a business, for legal restructure purposes or for raising capital.

Your business is an investment

At the end of the day, business buyers are best thought of as investors. They quite legitimately apply plenty of rigour when examining businesses for purchase, because once they commit, they have parted with hundreds of thousands, if not millions of dollars.

Moreover, like any kind of investment both perceived and actual risk play a role in price. Unresolved risks like owner reliance, key person reliance, key customer reliance are all very common value inhibitors.

What many vendors fail to keep in mind is that buyers are rarely under pressure to buy your business. If anything, their menu of investment options is almost infinite: be it in real estate, stocks, bonds, other businesses or any manner of other potential investments. It is, therefore, a difficult undertaking to sell a business, and to be forewarned is to be forearmed.

How periodic valuations help

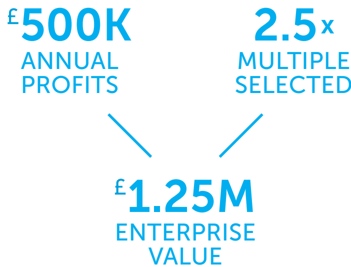
Periodic valuations are useful guideposts. They can serve to:

- Reverse-engineer what is an acceptable level of business performance given a vendor's desired sale price;
- Clarify what type of buyer is the right one to orient the business towards (over several years ideally); and
- Be used as a starting point for exploring alternative exit strategies, e.g. establishing an Employee Share Ownership Plan, whereby employees gradually take over ownership over time.

The myth of the multiple

Shortcomings of the ‘multiple approach’

Many advisers will tell you that valuing a business is all about choosing a multiple and applying it to profits, e.g.



The Einstein Principle

> “Make everything as simple as possible, but not simpler.”
>
> ALBERT EINSTEIN

The truth is, it’s not quite this simple. Such a blanket approach neglects:

- What happens to cash held and debt owed by your business when you sell/exit;
- How you are rewarded if your business is balance sheet “efficient,” (it generates a lot of business and profit without carrying excess net assets);
- The effect of strategic valuation in industries in which businesses change hands frequently, compared with other industries; and,
- How you are compensated if your business contains tangible assets which form a baseline value all on their own.

The great benefit of such a method is its simplicity and transparency.

However, it is frequently difficult to locate this kind of data to begin with, since business owners are naturally quite protective of their privacy. This difficulty is even more pronounced in niche businesses.

Moreover, it is often difficult to determine what the multiple applies to; an average of the last few years, the most recently completed financial year, a weighted average, and so on.

The nuts and bolts of valuation

Market-based

Methods under this category of valuation most closely resemble the multiples approach.

Some companies publish multiple ranges by industry e.g. bakeries 0.8X – 1.5X of profits.

These ranges have the benefit of being based on actual transactions that have taken place in the real world.

The trouble with this is that it becomes a very subjective exercise in choosing what multiple is appropriate.

Following on from our example, let's say you own a bakery generating £250K in profit a year.

The data would suggest it is worth somewhere between £200K and £375K. That is a large range!

Moreover, your bakery might have just won a serious contract with a major corporate customer or is anticipating a serious uptick in foot traffic owing to several apartment buildings near to your location having been recently completed. How does the multiple reflect all of that? It probably doesn't!

Income-based

For us, income-based assessment is far and away the best means of valuing almost any business.

Valuations of this nature tend to involve a prediction of future profits, and there are a variety of ways of doing this.

They also tend to involve a calculation that measures the risk in the specific business being valued and encapsulates this level of risk in the valuation.

Asset-based

There are a variety of circumstances when it is more appropriate to value a business on the assets it contains (sometimes referred to as sum-of-the-parts).

Most often, this tends to be when a business is being sold with the intent to close it, or when the asset base itself is more valuable than what the business can legitimately command under an income-based valuation.

Look to the data

	Sales	EBIT	Operating Assets	Enterprise Valuation	"Goodwill"	Multiple	Valuation method
Specialist manufacturer	£9,630,000	£710,000	£970,000	£2,360,000	£1,390,000	3.32	Income
Equipment hire	£39,500,000	£9,430,000	£17,120,000	£35,550,000	£18,430,000	3.77	Income
Car Hire	£1,900,000	£430,000	£2,110,000	£2,100,000	-£10,000	4.88	Asset
Real estate	£2,700,000	£810,000	£1,290,000	£3,300,000	£2,010,000	4.07	Market
Fire Protection Services	£35,920,000	£5,370,000	£6,230,000	£20,700,000	£14,470,000	3.85	Income
Insurance brokerage	£17,280,000	£2,520,000	£4,730,000	£18,100,000	£13,370,000	7.18	Income
IT Consultant	£23,310,000	£5,520,000	£1,410,000	£36,670,000	£35,260,000	6.64	Income
Specialist manufacturer	£4,060,000	£120,000	£1,790,000	£3,500,000	£1,710,000	29.17	Income
Specialist manufacturer	£14,560,000	£700,000	£5,750,000	£6,850,000	£1,100,000	9.79	Income
Wholesaler	£5,140,000	-£130,000	£80,000	£3,000,000	£2,920,000	-23.08	Asset
Wholesaler	£9,470,000	£960,000	£3,060,000	£3,800,000	£740,000	3.96	Income
Real estate	£11,790,000	£3,630,000	-£1,070,000	£14,100,000	£15,170,000	3.88	Income

The above table is a select cross-section of the 600 real-life businesses which have been formally appraised by us across the last 10 years.

A few things to observe:

- A "normal" range of multiples when using the income method is 3 – 4X EBIT (or profit).
- Some businesses, like real estate businesses, have an abundance of reliable market data to look to for a market-based multiple, but many industries do not.
- The car-hire and wholesaler businesses are good examples of where profits are quite low, but there is still an asset basis to value the business, making the multiple seem high.
- Goodwill is not something added to the operating assets, rather something that is derived.

Value control

The Iron Law of the Market

I think it is an apt reminder that there are things in the world we control, and things we do not. Wisdom is knowing the difference.

One of the reasons Succession Plus works with business owners is because of their unique ability and desire to control their world for the better.

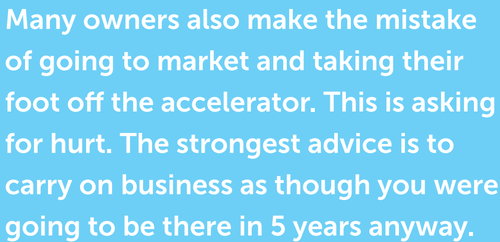
If you are anything like the typical business owner, your business represents well over half your overall net worth. You would likely agree that its value is something worth actively controlling.

You can control it. As with anything, the trick is knowing how.

Control your profits

In my experience, it is best to think of Value Control as a multi-year endeavour, and profit is almost uniformly one of the most important measures in measuring and controlling business value.

Often, buyers will need 3–4 years of recent trading history to look at when formulating an opinion about a price to offer.



Control your reinvestment

There is an oft-used phrase in the owner community that "the business is my super". This is reflective of the optimistic mindset entrepreneurs typically have. What it translates to, is that instead of accumulating savings in superannuation and other non-business assets, owners will often redirect those resources straight back into the business (reinvestment). Some reinvestment is appropriate, but there is such a thing as excess.

When combined with excessive owner dependence, or sudden absence around retirement age due to illness, for example, the result can be the business value evaporating altogether.

Where accountants and financial planners in particular can help, is proactively assisting the owner to gradually build non-business assets over time.

The M&A community has a useful phrase, as well.

"The least desperate party wins the negotiation."

That is to say, if an owner has a financial shield outside of their business, it is easier for them to remain calm during negotiations and fend off buyers' efforts to seek concessions on price and terms.

Control your Balance Sheet

It never ceases to amaze how advisers routinely neglect the Balance Sheet when talking about business value.

Your business may be worth £1M based on its profit, and so may the next business. But if yours is in a deep debt position and the other is sitting on a pile of cash, it's unlikely you will receive the same net proceeds in your wallet.

Many other factors need attention on the Balance Sheet, that all too often only become apparent by the time a buyer is negotiating and they are deep into Due Diligence.

Due Diligence damage control

It often proves worthwhile to conduct a serious dry run at Due Diligence nice and early. That is: simulating the circumstances under which a large liquidity event would happen.

How would your business measure up if it were placed under the microscope by a party with a vested interested in knocking you down on price?

- Can you prove profit forecasting and back it up with results?
- Are your stock levels properly documented (not tax-driven)?
- Are your employment records squeaky clean?
- Does your business contain legacy issues like opaque share classes or preference shares?
- Can you evidence management meetings going back several years?

These are precisely the sorts of "skeletons in the closet" advisers talk about. Controlling them is the same thing as controlling the likelihood of sale and the circumstances under which it happens.

Controlling the big picture

Far too many businesses don't search out quality advice early. They may eventually sell, but not without a bout of 'Wishes Syndrome'.

- "I wish I knew if I'd restructured early enough I could have saved tax when I sold."
- I wish I'd had a proper conversation about the value of my business years earlier."
- "I wish I had started preparing earlier."
- "I wish I knew I could get some chips off the table via an Employee Share Ownership Plan before I went to market."

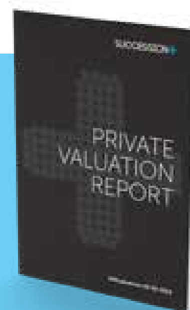
It's a false economy to skimp on quality advice.

The best advisers can see and quantify the consequences of not just action, but also inaction, far in advance. They can help you avoid unintended consequences.

Accessing the right kind of help is something that will do wonders for your value control.

A business sale is what every other sale has been leading towards.

Let Succession Plus help you get it right from the start.



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