FINANCE UPDATES
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HB Dobbin
FINANCIAL PLANNING

VALUING A BUSINESS

Whether seeking to sell up or secure investment.

In most lives, there comes a moment when we think about what needs to change to ensure the future will be financially secure.

Sometimes, it's because of a complete change of course – redundancy, for example, or a change in marital status. Or it might just be the appealing thought of easing up a little and taking some time to pursue a long-held dream.

Whether it is to finally switch off and start the transition into retirement or to fund another venture, business owners face some particularly acute challenges.

Leaving a job can be emotional. Leaving a company you've built yourself, into which you've sunk years of your life and a lot of sweat, is a hundred times more so.

Once you've made that difficult decision, where do you start when it comes to putting a business up for sale and what steps do you need to take to realise its true value?

Valuing a business is not like putting a price on a house where you can compare a neighbouring three-bed to give you a figure.

Buyers of a business purchase more than that – they often take on staff, equipment, brand reputation and cashflow.

And, of course, there's the question of legacy and succession – is a member of your family in line to inherit or buy out the firm, or do you want to find someone from outside you can trust to continue what you started?

These added responsibilities can all make it harder to sell a business and while they are usually valued by their bottom line, there are other things to consider.

CIRCUMSTANCES

The circumstances involved with valuing your business directly affect its asking price, with voluntary sales likely to be worth more than forced sales.

For example, the need to pay off creditors or being in poor health may force the asking price down if you want a quick sale.

Alternatively, you may have a clear figure in mind to help fund a comfortable retirement or provide for your loved ones.

Research from *Which?* estimates that around £42,000 a year would be needed to fund a luxury lifestyle that includes long-haul holidays and a new car every five years.

Plan when you would ideally like to sell your business: it could be a certain age, a sales objective or a time limit on how much longer you want to run the business.

Outside of selling your business, you could value it for investment purposes – to help settle on a price to issue new shares in trading companies, for example.

Valuations could develop an internal market for shares or to focus the attentions of under-performing management.

Several variables affect your business's value, but ultimately it is only worth what a buyer is willing to pay for it.

To reach this figure, you can use various different valuation techniques. A potential buyer or investor will usually use some of these techniques, too.

TANGIBLE OR INTANGIBLE ASSETS?

Some businesses are considerably easier to value than others.

A construction business, for example, may have more tangible assets like plant and machinery, which in turn would make it easier to place a value on its head.

Conversely, the key assets of an accountancy practice or firm of solicitors would tend to be less tangible, lying in the skills and experience of key staff and the hard-won client roster.

This typically could include the brand, customer relations, contracts or lists, goodwill or intellectual property.

Increasingly, you also need to place a value on things like good customer reviews on reputable sites like Facebook or Google.

In general, a company's valuation is often based on its potential to generate cashflow in the future, particularly when it comes to valuing intangible assets.

DISCOUNTED CASHFLOW

Estimating the value of a business using cashflow needs credible forecasts that capture all income, direct costs, operating costs, marketing expenditure, and working capital.

Depending on the nature of the business, there may be many other aspects to consider.

This process is known as discounted cashflow, which aims to value a company today based on projections of how much money it will generate in the future.

Should any threat or risk be perceived to affect your business in the future, its value will drop to compensate the buyer for any future risks to their investment.

Management credibility also comes into the forecast, while there may be key employees who generate large volumes of business through their contacts and customer relationships that need to be factored in.

MULTIPLES APPROACH

The multiples approach towards valuing a company is based on the concept that similar assets sell at similar prices.

It suits more established, larger businesses with stable growth on the back of sustained periods of positive earnings.

A multiple is usually a ratio which is calculated by dividing an asset's market value, or estimated value, by a similar metric on another company's financial statement.

It assumes a ratio applies to competitor companies and is used to determine a company's value based on the value of another.

Metrics available include a single number that indicates a company's expected growth and is multiplied by a certain metric to give an enterprise or equity value.

Buyers or investors also use this method to conduct their due diligence, to give them a clear picture of what is and what is not a fair price to pay for a company.

ENTRY VALUATION

The entry valuation technique values your business by estimating how much it would cost to launch a new startup.

It considers the costs of hiring staff, training them up, delivering services or products, and building a customer base and assets.

This is the most common approach a buyer or investor would use to reach the value of a promising startup.

SUITABLE TECHNIQUES

Which valuation technique best suits your business or company depends largely on the sector or industry it operates in.

For instance, valuing assets may be suitable for a country club located on an in-demand stretch of coastal land.

Tangible assets could be found in the hotel, spa, and the land, which may be sought after by property developers. Despite any losses the company makes, its value could be found fairly easily.

A firm of architects, to provide a contrasting example, may have next to no tangible assets but is forecast to generate £500,000 in profit for 2020/21, making either discounted cashflow or multiples the most suitable valuation technique.

The value of the architectural business stems from its future cashflow, rather than a bricks-and-mortar office it rents, therefore valuing tangible assets would be a fairly pointless technique for valuing this type of business.

Talk to us about financial planning.