Valuing your business for sale

At some stage, most owners will want to sell their business – but placing a value on it is not easy. John Hawkey looks at the three main methods of valuing your business.

'How did your take-over talks go?'

So you have decided you want to sell your business. But how on earth do you go about valuing it?

When considering an exit strategy, it is important to understand the value of your business, as the sale price will influence both *when* you sell, and your post-sale plans – including any retirement plans.

To plan with clarity, it helps to know both the current value of your business and its probable future value, assuming a successful implementation of your exit strategy plan.

Business valuation is an art and not a science, because valuation methods involve subjective judgements. Valuations are opinions of what a business might be worth on the day of valuation.

From the seller's point of view, the most important valuation opinion is that of a potential purchaser; and no article on business valuation is complete without the old chestnut that a business is only worth what a buyer is prepared to pay.

Three valuation methods

The three methods most commonly used to value smaller businesses are as follows:

- The price-earnings ratio method;
- The super profits method;
- Industry 'yardsticks'.

In valuations the circumstances should always be clarified – for example, on a 'going concern' or on a 'fire sale' basis. In this article we assume the valuation is on a going concern basis.

Price to earnings ratio method

The price to earnings (p/e) ratio method is the most widely used valuation method for businesses of all sizes.

The concept is simple enough. First you must calculate your future maintainable profits. Secondly, you must multiply that by an accepted price to earnings ratio for your type and size of business.

Future Maintainable Profits

To calculate your Future Maintainable Profits (FMP), you must first:

- Adjust the published profits to arrive at what is known as 'real profit';
- Decide what combination of real profits, both historic and future, should be used.

The words 'real profit' are used to distinguish published profit (that is profit that appears in your business's books of account) from the profit the business would be making if normal business expenses were included and abnormal ones excluded.

Generally speaking, one arrives at real profit by removing from published profit the following:

- Non-business (or private) income and expenses;
- Non-recurring items;
- Income and expenses from non-related entities, or activities.

Calculating the FMP figure is a matter of judgement – an average of the last three year's real profits and the next two year's projected profits (if available) is a good starting point.

If future profit projections are not available, you should average the real profits for the last five years, if possible.

Business valuation is about capitalising future returns, and recent profits are a better indication of future returns than earlier profits – or, indeed, projected profits. As a result, it is common to use an average weighted in favour of the most recent profits when establishing your FMP.

This is done by multiplying your most recent profits by a factor determined by the number of years' profits you wish to include.

If, for example, you are using five years' profits, your most recent year's results would be multiplied by five, as this is the most accurate guide to real performance.

The previous year would be multiplied by a factor of four, the year before that by a factor of three, and so on. The final figure is then divided by the total of the multiplying factors (15 in this case) to arrive at a meaningful average. (See panel on facing page.)

For this valuation method, the FMP is calculated *after* tax.

Deciding the correct p/e ratio

You now need to establish the p/e ratio appropriate for your business valuation – that is, a capitalisation rate that truly reflects its profit risk and growth potential.

Another way of looking at this is to ask: 'How many years of after-tax profit is a reasonable return on the purchase price?' The number of years is the p/e ratio.

This is a slightly technical area in which you

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For example, under Selling a business, you will find:

- *Selling your business – alone or with a broker.*

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might wish to obtain expert advice. However, there are some basic pointers in choosing the appropriate p/e for your business.

Private business p/e indices: Various bodies publish indices of historic p/e values. For example, you could refer to the BDO Stoy Hayward/Thompson Financial Private Company Price Index, which gives year-on-year p/e ratios for larger private companies.

London Stock Exchange: To find out what p/e ratios are applicable for public companies in your industry sector, refer to the Financial Times. Generally, p/e ratios for public companies are about twice those of larger (more that £10 million turnover) private companies, and three to four times those of smaller private businesses.

US guide: Financial Policy of Corporations (Dewing) provides the following guidelines for choosing a p/e ratio for private businesses in the US.

- Old established business, with large assets and excellent goodwill: a p/e ratio of 10.
- Well-established business, but requiring considerable management skills: p/e 8.
- Well-established business, but subject to shifts in general economic conditions and products vulnerable to depressions: p/e 7.
- Business requiring small capital investment, but above average executive ability to manage: p/e 5.
- Small industrial business, highly competitive, relatively small capital (ones which virtually anyone could run): p/e 4.
- Business which depends on special, often unusual skills of one, or a group of managers, small capital, highly competitive, high mortality: p/e 2.
- Personal service businesses, requiring virtually no capital. Management has special skills and intensive knowledge of business. Earnings reflect his skill and it is questionable whether it could continue without him: p/e 1.

P/e ratios for UK private companies: As a generality, in the UK current multiples for larger private companies are in the range from 6 to 12, whilst for smaller companies they range from 2 to 6.

Comparable sales: Ask a company broker, with knowledge of your industry sector, what p/e ratios were used for recent sales of businesses of your size in your industry.

Valuing a business using the p/e ratio

- Establish the Future Maintainable Profits of the business after taxation.
- Select the appropriate p/e ratio (or capitalisation rate).
- Multiply FMP by the p/e ratio multiple selected, to arrive at business value.
- Where you have assets on your books not necessary to generate profits – perhaps you own your own office premises – that you intend to sell with the business, add the value of these surplus assets to the business value to arrive at total value.

Asset value

It is important to be clear about the difference between asset value and business value. In this example, we have valued the business as a going concern; that is a whole collection of business assets, tangible and intangible, together in their current business use.

But the market value of assets alone can be more or less than the value of the business in which they are currently being used; and where they are worth more, you should consider whether the business should sell its assets and close down, or if some of the assets should be sold and the business continued without them.

Goodwill value

To calculate the business goodwill in this method, subtract the net tangible asset value from the total business value.

Value of minority shareholdings

To value each share of your company, it is obvious that you could divide the total value of the company by the number of shares on issue.

However, in private companies a minority shareholding will not necessarily have the same value pro rata as the value of the total shareholding, because a minority shareholding is often difficult to sell.

The ‘super profits’ method

Under the p/e method we arrived at the total value of the business and calculated goodwill value by deducting net tangible asset value from it.

The super profits method arrives at the value of a business by calculating the goodwill value and the net asset value separately, and then adding the two values together.

Step one in this method is to establish the business’s ‘super profits’.

Super profit is an expression used to clarify the confusion between the total amount taken out of a business by the owners (which includes a wages and salaries element, as a reward for work), and what really is profit.

The super profit is the profit after deducting an industry-accepted wage for a manager undertaking the owner’s work.

Price-earnings example

Try this quick sample calculation to see how a valuation works using the p/e method.

- **Step 1:** Assume real profits were: 1998, £22,000; 1999, £22,000; 2000, £18,000; 2001, £25,000; and 2002, £26,000.
  The FMP is (assuming we weight the profits): (22,000 x 1) +(22,000 x 2) +(18,000 x 3) + (25,000 x 4) + (26,000 x 5) ÷ 15 = £23,333.
- **Step 2:** Assume an appropriate p/e is 4
- **Step 3:** Business value is £23,333 x 4 = £93,332
- **Step 4:** Assume you have no surplus assets, so total value is £93,332 ❖

Contact

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'Super profits' example

Try this quick sample calculation to see how a valuation works using the 'super profits' method.

- **Step 1:** Assume profits have been as follows (apply a simple average without weighting): 2000, £35,000; 2001, £39,000; 2002, £45,000. MSP = £(35,000 + 39,000 + 45,000) ÷ 3 = £39,666.
- **Step 2:** Goodwill value = £39,666 x1.5 = £59,499 (say £59,500).
- **Step 3:** Assume gross asset value is £55,000 and liabilities are £18,000, therefore NTA value is £37,000.
- **Step 4:** Total business value is £59,500 + £37,000 = £96,500 ❖

To calculate the value of a business using this method, take the following steps:

- Calculate the average super profits for the last three years – which we will call the maintainable super profit (MSP). Do *not* deduct taxation.
- Capitalise the MSP by a factor of between 1 and 2 to arrive at goodwill value. This is purely a convention, based on the rationale that the goodwill value of a small business represents one or two year's before-tax MSP of the business.
- Calculate the value of the net tangible assets (NTA) of the business. This is achieved by placing a gross current market value on a going concern basis on all tangible assets and by deducting any amounts owing on the assets and all other liabilities.
- Add the goodwill value to the net tangible asset value to arrive at total business value.

Industry yardsticks

In very small businesses, short-cut methods of valuation are common – often referred to as 'industry yardsticks'. These methods place a value on a business based on gross turnover (or sales) rather than on profit.

The method can be used in businesses where a fairly standard relationship exists between gross turnover and net profit, such as small professional practices or retail outlets. Here total value can be expressed in terms of a multiple of weekly or annual gross sales.

This method also has the advantage of relying on 'pure' sales figures, and not on a profit figure that can be manipulated by creative accounting.

Steps to take

- Gather together all the relevant financial information, including historical accounts, profit forecasts and balance sheet values.
- Value your business using the p/e and super profits methods explained in this article. Compare the valuations and average them.
- If your business is very small, you should compare the valuations with the relevant industry yardstick, if one exists.
- Compare your valuations with recent market sales of comparable businesses, if available. Be aware that comparable sales may not apply to your business because of the risk that profits will not be maintained ❖

NEXT MONTH
Disposing of your business through a trade sale

Now you can afford a colour laser

Epson Aculaser C900	£499+VAT
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Colour toner	£85+VAT
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A good colour printer can be a great asset for a small business. You can produce short run, even personalised colour documents without the huge expense of litho printing.

Brochures, reports, newsletters, even everyday business stationery, can be printed as needed.

Until recently the budget user was limited to inkjets, which are very fussy about paper and get expensive on consumables. Now colour laser printers have started to crash in price and offer quicker and more consistent quality, comparable to litho printing.

Laser printers give crisper quality, brighter colours and a more durable finish than inkjets on standard papers.

The speed is largely unaffected by quality or content, which is definitely not the case with inkjets. Some lasers, such as the Tally we reviewed last year, and the new Minolta-QMS Magicolor range, use an oil fuser to give a glossier finish, even on cheap paper.

We tested two new Epson laser printers – the C900, and the C1900.

Epson's AcuLaser C900 is essentially two printers in one. Firstly, it's a high performance monochrome laser, which with black toner refills costing just £30, costs pretty much the same to run as a mono-only printer.

Secondly, it's a versatile and productive good quality colour laser that performs almost as well as one at twice the price.

Both machines offer excellent 2400dpi photo-like print quality and professional text handling, and print up to 16ppm mono and 4ppm colour.

The only main differences between the two models, apart from the price, are that the C1900 has a larger 700-sheet paper bin and built-in networking.

You can also buy a Postscript version for complex graphics output.

However, the C900N, costing just £70 more than the base model, boasts a 10/100 ethernet card, and at £569 is still £126 cheaper than the C1900. So unless you need a huge paper bin, which takes up a considerable amount of space, you're better off going for the smaller model.

By comparison, the much-vaunted new Minolta-QMS Magicolor 2300 starts at £599, but this model will only run on Windows machines, whereas all the Epsons are cross-platform. And by using Windows drivers, it is more likely to tie up your PC while it spools.

You have to pay another £200 for the cross-platform Magicolor 2350, which does include Postscript and PCL output, but only in software emulation, considerably slower than a hardware fix. Toner costs are almost identical.

You pays your money, but for the average small office, the Epson C900 or C900N looks the best value for money ❖