

Working in Practice SME Business Valuation

If a business's owners want to attract investors, raise finance, issue shares or maybe even sell the company, then knowing the true market value of the business is essential.

The price paid by a buyer or an investor in a business will be based normally on the future profits and cash flow of that business i.e. the ability to generate a return for the investment. The value will therefore be based on:

- An earnings multiple, indicating how long it would take an investor to recover the money invested.
- The strength of the balance sheet.

Earnings Multiple

The usual definition of "earnings" is Annual Pre Tax Profits adjusted downwards by a 30% tax charge and any other unusual items such as excessive owner salaries, exceptional costs or non operating income etc.

An increasingly common method of valuation is one which is referred to as EBITDA. Under this method "Earnings" are defined as, Before Interest, Tax, Depreciation and Amortization. This method will result in an inflated valuation of the business. The multiple used in arriving at the value of the business is typically 8 to 10 times the annual earnings and the profits can be historic or future depending on the age and strategy for the business.

Balance Sheet

The buyer or investor will gain some comfort in seeing large realisable Net Assets commensurate with the result of the earnings multiple calculations. However the quality of the assets is important. A huge stock of aged product whilst numerically attractive will in essence have to be written down to a more realistic valuation.

Many small businesses have almost no tangible assets except some computer equipment and office furniture.

Most start-up businesses make a loss in the early years of trading. In these examples, valuing the business based partly on asset value is not appropriate as it is the profits and future cash flow which can be derived from these assets that will generate value. In these circumstances a more subjective judgement will come into play.

Subjective Methods

When a price is agreed it will usually be based on an element of subjective judgement rather than purely numerical methods. Considerations that can fall into this category include the following which generally have some influence over the future profitability of the business:

- Strength of the brand
- Customer base
- Business contacts
- Intellectual property
- Industry sector (prospects and competition)
- Stability of the management team
- Confirmed customer orders
- The value the potential new owner feels the business is worth to them

Competitor Valuations

It is sometimes possible to secure a very favourable price from a business competitor who may see an opportunity by acquiring the business to:

- gain access to customers to obtain additional sales of their own products
- eliminate duplicated costs leading to a gross margin improvement which would flow predominantly to the bottom line as profit.
- remove a competitor thereby presenting an opportunity to increase prices

Start Up Businesses

For new businesses that have a good strategy and potential market another simple method of valuation used is a multiple of turnover or gross margin (depending on the type of business and associated direct costs). A multiple of 1 times annual turnover is often used as a benchmark.

Business link have 2 excellent guides

Buy or sell a business guidebook

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