How to Value a Business

DRIVING LIFELONG PROSPERITY **2017**

The valuation of unquoted companies is not an exact science but depends upon relevant factors, taking into account common sense, informed judgement and reasonableness. When valuing a business, advisers look at:

- historic and forecast performance - cash flow, turnover and profitability; and
- recent deals in sector (benchmarking); risk and the market/economic conditions.

VALUATION METHODS

There are traditionally four methods adopted for the valuation of privately owned businesses: price earnings (P/E) based valuations, net asset based valuations, dividend yield based valuations and discounted cash flow based valuations.

For the majority of privately owned companies, dividends paid are either minimal or form part of a salary sacrifice arrangement (remuneration planning). A dividends yield approach is therefore generally not considered appropriate.

With regard to a discounted cash flow approach, whilst most companies have management information, few produce sufficiently detailed forecast cash flow information (at least three to five years of reliable information is required). A cash flow based valuation is therefore normally only used in a limited number of cases, or as a sense check for a PE based valuation.

The net asset method is simple to use, but is really only appropriate when dealing with property development companies, companies where future revenues are uncertain, or in instances where an earning based valuation produces a valuation which is less than a company's net asset valuation (value of assets in use).

The P/E approach is generally used when valuing the whole of the issued share capital of a company. The valuation is based on future 'maintainable earnings', calculated as pre-tax historical results, adjusted for exceptional and non recurring income and expenses. An appropriate P/E ratio for that industry group is then applied to the post-tax result to derive a valuation.

For smaller entities, earnings before interest and tax (EBIT) or earnings before interest, tax, depreciation and amortisation (EBITDA), ratios are often preferred to P/E ratios as they exclude the impact of leverage (debt finance) and unique taxation features. Where such ratios are adopted, valuations tend to be performed on a debt/cash free basis.

The choice between EBITDA and EBIT often depends on the industry in which the company operates. Where depreciation and amortisation levels are similar to annual capital expenditure, EBIT is often the appropriate measure. When capital expenditure is significant, infrequent and varies from depreciation, EBITDA is often the preferred performance measure.

RATIOS

The multiple/ratio applied when valuing a business reflects 'risk'. Factors to be considered in assessing risk include:

- size of company;
- industry sector;
- dependency on business owner;
- sustainability of competitive advantage;
- growth and profit trends;
- business disciplines and practices; and
- the market/economic factors.

Companies with a Blue Chip client base, reputable brand name and technical / innovative products and solutions generally attract higher multiples; intangible benefits attract a premium.

MAINTAINABLE EARNINGS

Maintainable earnings are generally calculated by reference to a company's historical and forecast results and reflect the expected sustainable level of business profits. When considering these, a number of 'normalisation' adjustments are considered.

Normalisation adjustments often include:

- adjustment to owner/manager remuneration, to reflect a commercial level;
- add back and/or deduction of non-recurring/exceptional income and expenses; and
- reversal of the effect of inappropriate accounting policies e.g. stock obsolescence provisions etc.

DEBT/CASH FREE

If a business is to be acquired 'debt free', most parties will intend that all external debts (i.e. bank debts) will be repaid on completion. If debt is retained in a business on sale/exit, consideration is normally reduced on a pound for pound basis.

The term 'cash free' does not mean that a seller is entitled to all cash at completion. Instead, it refers to 'spare' or 'surplus' cash being extracted by the sellers, normally by way of an increase in the purchase consideration.

In the majority of cases, a 'normalised' cash position is calculated, with amounts in excess or less than the calculated amount comprising either a surplus or deficit, resulting in either an increase or decrease to the assumed business valuation.

In practice, a combination of methods are used, e.g. a multiple of profits, with an adjustment for excess cash and/or investment property.

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