gbfinancials limited

Chartered Management Accountants

6 Cartwright Court, Cartwright Way
Bardon Hill, Leicestershire. LE67 1UE

Tel: 01530 519500 / 07973 815213
Fax: 01530 519555

Director: Gary Beesley FCMA MAAT
gary@gb-financials.co.uk

Business Valuation

It is often said that the only reason to form a company is to sell it!

In order to sell it, its worth to potential purchasers at the same time as maximising its value to the business owner needs to be demonstrated. Business owners should keep this in mind at all times when formulating strategy and identifying opportunities.

Like any risk versus reward decision, the worth of a business to a purchaser depends upon how much can be made from it compared to the risks involved in acquiring it. Past profitability and asset values are important, but only form the starting point in valuation activities. More relevant are the intangible factors such as:

- Key business relationships.
- Management stability.
- Restrictive covenants.
- Risks.
- Strong cashflow.
- Intellectual property rights, patents and trademarks.

Reasons for valuing a business.

There are five main reasons for obtaining a business valuation.

1. **To help buy or sell a business.**

   1.1. By understanding the valuation process it can enable a business owner to:

   1.1.1. Take steps to improve the real or perceived value of the business.

   1.1.2. Decide the best time to buy or sell a business.

   1.1.3. Negotiate better terms.

   1.1.4. Complete a purchase more quickly.

   1.2. There is a better chance of a sale being completed if both the buyer and seller enter the process with realistic expectations.

2. **To assist in getting others to invest in the business particularly through equity.**

   2.1. A valuation of the business can help in agreeing a share price for new shares being issued.

3. **To create a market for shares.**

   3.1. A valuation can help buying or selling shares in a business at a fair price particularly when for example, an owner manager wishes to retire and sell his shares.

4. **As a vehicle in helping to provide motivation for management.**

   4.1. Regular valuations of a company are a good discipline, which can provide a measurement basis for management performance by showing how they are increasing the value of the company.

Gary Beesley is CIMA practising Certificate holder

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Registered office: 6 Cartwright Court, Carwright Way, Bardon Hill, Leicestershire. LE67 1UE

5. **To enable management to focus on important issues.**

5.1. Help to identify areas of the business which need changing.

All companies that are listed on a stock exchange have the quoted share price as a constant indicator of how well a company is doing. Unlisted companies need to do this in a slightly different way.

Factors that affect the valuation of a business

1. **The circumstances of a valuation**

1.1. A business with a trading future can be valued in a number of ways.

1.2. A forced sale will down value a company. For example, an owner manager needing to retire through ill health may have to accept an unsuitable offer. This is known as a "fire sale."

1.3. If the business is being wound up, its value will be the net of the value of the assets less liabilities outstanding.

2. **The value of the assets of the business.**

2.1. A business owning property or machinery will have substantial tangible assets.

2.2. Often businesses have no tangible assets beyond the value of its office equipment. This is particularly true of many service companies.

3. **The age of the business.**

3.1. A fairly new business may well have a negative net asset value but have an extremely high valuation in terms of future profitability especially where there are substantial long term contracts in place

Valuation Methods

The true value of a business is what the purchaser is willing to pay for it. This is a glib and obvious proposition and in determining this figure, a buyer will use various and often a combination of valuation methods. The main valuation methods are based upon:

1. **Asset valuation**

1.1. This method would be appropriate if the business for sale has significant tangible assets.

1.2. The value of all the assets are added together and then the total of the liabilities are deducted from this to produce an asset valuation. The starting point for an asset valuation is to take the assets that are stated in the latest accounts, which are then adjusted to reflect economic reality.

2. **Price/Earnings (P/E) ratio**

2.1. It would be common to use this method where a business is making sustainable profits achieved over a number of years.

2.2. The P/E ratio is calculated as the value of a business divided by its profits after tax. Once the appropriate P/E ratio has been established, it is multiplied by the business's most recent profits, its average profits over a number of years, or on the calculated future profits.

2.3. P/E ratios are normally used to value businesses with an established history.

2.4. Quoted companies will have a higher P/E ratio than unquoted ones. This is because their shares are much easier to buy and sell as there is a ready market; thus making them more attractive to potential investors.

2.5. P/E ratios are often adjusted by commercial circumstances; for example a higher forecast profit growth will result in a higher P/E ratio, as will businesses which have consistently earned profits.

3. Discounted future cash flows

3.1. This calculation is appropriate for businesses forecasting an increasing cashflow in future years. This method is very technical and relies heavily on assumptions regarding long term business conditions.

3.2. The main uses of this method are for stable and established cash generating businesses.

3.3. Where a business can demonstrate its long term prospects, this method underlines the business's solid future prospects.

4. Costs of Entry

4.1. This method values the business by comparing the costs involved to start up a similar business from scratch. Costs included in the valuation would include purchasing assets, developing products and processes, staff recruitment and training and marketing to build a customer base. Once evaluated, the business can make a comparative assessment, based on a more realistic view of the cheaper alternatives.