AV CHARTERED ACCOUNTANTS

COMMITTED TO YOUR BUSINESS SUCCESS

Business guide

How to value a small business

If you're buying or selling a small business, it's critical to know what the business is worth. The challenge is that what you think a business is worth, and what the person on the other side of the fence thinks it is worth, are usually two different figures.

In the end, the motivation for both buyers and sellers is always the belief that they're getting a good deal.

If you're selling your business, you're likely to be disappointed if buyers don't see the potential you do. For example, a café up for sale at $300,000 included a purpose-built wooden floor with the café's name etched in the middle. The floor alone cost $100,000 – but nobody else saw any value in the floor.

The worth of a business hinges on how much profit it will make, balanced by the risks involved. But past cash flow, profitability, and asset values are only the starting points. It's often the hard-to-measure factors such as key business relationships and goodwill that provide the most value.

Factors influencing value

There are four basic criteria that affect the value of your business.

Individual circumstances

The reasons for selling a business can affect its value. For example, a forced sale is likely to drive down the value. An owner–manager forced to sell by ill health may have to accept the first offer that comes along.

If you're closing a business, its value will be the sum of its realisable assets, less its liabilities. Often the longer you have to sell, the better the price you're likely to receive.

Tangible assets

How tangible are the business's assets? A business that owns property, machinery or stock-in-hand has tangible assets that will have some resale value. This makes the business easier to value.

Intangible assets

Many businesses have almost no tangible assets beyond office equipment; however, their intangible assets may have significant value. Some examples are a well-respected brand, customer goodwill, intellectual property (such as patents or protected designs), and potential for growth.

These intangibles can be harder to value. Your business banker or accountant may be able to give you guidance with these.

Length of time

The longer the business has been operating, the better, because it will have a proven track record and cash flow, and possibly loyal customers who provide repeat business.

Be wary of young businesses for sale (between one and two years), as they may be experiencing current popularity (like bars and cafés can do) before the market turns away.

Valuation techniques

Remember, the true value of a business is always what someone is willing to pay for it. To arrive at this figure, buyers use various valuation methods, usually to give a sense of reassurance that they are not paying too much. The main methods are as follows:

Asset valuations

Add up the assets of a business, subtract the liabilities, and you have an asset valuation – nice and simple. So if a business has $500,000 in machinery and equipment, and owes $50,000 on outstanding invoices, the asset value of the business is $450,000.

As a buyer, you could decide to just buy the assets of a business rather than take over the business as a going concern. This way, any outstanding debts or tax payments are all payable by the previous owner.

Use an asset valuation if you own, or are interested in, a stable, asset-rich business. The starting point for an asset valuation is the assets listed in the accounts. This is known as the 'net book value' (NBV) of the business.

You then refine the NBV figures for the major items, to reflect economic reality. Take into account:

- Debts to the business that are clearly not going to be paid.
- Property or other fixed assets that may have changed in value.
- Old or obsolete stock that may need to be sold at a discount.

Intangible items, such as software development costs, are usually excluded.

Price earnings ratio

The price earnings ratio (P/E ratio) is the value of a business divided by its profits after tax. For example, a company with a share price of $40 per share and earnings per share after tax of $8 would have a P/E ratio of 5 ($40/8 = 5).

When you're valuing a business, you can use this equation:

Value = Earnings after tax × P/E ratio.

Once you've decided on the appropriate P/E ratio to use, you multiply the business's most recent profits after tax by this figure. For example, using a P/E ratio of 6 for a business with post-tax profits of $100,000 gives a business valuation of $600,000.

What P/E ratio to use?

Deciding on an appropriate P/E ratio to use is not easy and you'll have to justify your choice of P/E ratio to a potential buyer (or seller) or anyone providing financial assistance.

Some industries have 'standard' P/E ratios for valuing a business, so ask your business broker or accountant if there are industry averages you can use.

Also try contacting your industry association or Chamber of Commerce for their advice on determining the most appropriate P/E ratio. Another possible source of guidance is the financial section in newspapers that gives historic P/E ratios for listed companies.

Entry cost valuation

Rather than buy a business, you could start a similar venture from scratch. An entry cost valuation reflects what this process would cost you. To make an entry cost valuation, calculate the cost to the business of:

- Purchasing or financing its assets.
- Developing products or services.
- Recruiting and training the employees.
- Building up a customer base.

This allows you to make a comparative assessment. Suppose you calculate that it would:

- Cost \$500,000 to buy the set-up equipment.
- Cost \$50,000 a month for overheads.
- Require 12 months' trading to get a customer base.

A business that already has all of the above is worth at least \$1.1m (\$500,000 for equipment, and \$600,000 overheads for 12 months).

You can now factor in any cost savings you could make, such as use of better technology, setting up in a less expensive area, or other cheaper alternatives.

Industry rules of thumb

In some industry sectors, buying and selling businesses is common. This has led to industry-wide rules of thumb. These rules of thumb are dependent on factors other than profit. For example:

- **Turnover** for a computer maintenance business or a mail-order business.
- **Number of customers** for a mobile phone airtime provider.
- **Number of outlets** for a real estate agency business.

Buyers will work out what the business is worth to them.

Take the example of a computer maintenance business with 10,000 contracts but no profits. To one buyer, the business may be worth comparatively little.

However, a larger competitor may pay \$100 per contract to buy the business. This is because it could merge the two businesses and make larger profits.

Other issues

The key source of value in a business may be something that can't easily be measured. Putting a value on intangible assets is not easy because that value can vary depending on the nature of the assets and the industry. Get advice from your business advisers, Chamber of Commerce, or industry association.

Some examples:

- **Strong relationships with key customers or suppliers**. For example, if a business holds a licence or distributorship rights across Australia for a product expected to be successful, the business's value will increase accordingly.
- **Management stability**. If the owner–manager or other key people are going to leave, the business may be worth far less. For example, the profitability of an advertising agency may collapse if a key creative person leaves. Similarly, if key salespeople leave, they may take important customers with them. Any written agreements or incentives to retain key employees could add value. But they could also damage the value if a potential buyer intends to bring in a new team.
- **Intellectual property ownership**. If the business owns the rights to patents, copyrights or well-established trademarks, these will add value to the purchase price of a business. For example, if you're selling a patented invention, you can value your business higher than a similar business selling an unprotected product.

Next steps

- Get expert advice. Talk to your accountant or a small business adviser about possible valuations of your business.
- Search online for similar businesses that are for sale to get a feel for the market.
- Determine which method of valuing your business creates the most value for you.
- Ask your business broker or accountant if they have past examples of similar businesses for sale and what they were sold for. Remember that ultimately, your business is worth whatever someone will pay for it.
- Review the IP Australia website for steps you can take to protect and enhance the value of intangible business assets such as trade marks and designs. If you're buying a business, check what intellectual property they have protected.

AV Chartered Accountants can advise you of the best strategy for your unique business needs.

T (02) 4929 5533 or **E** mail@avcharteredaccountants.com.au