MOVING ON SERIES

Business Valuation Methods

By David Bird

"The capitalization of future maintainable earnings method is the most common way of valuing an existing business in good order."

Factors affecting value

In property, the generic valuation guide is dollars per square metre for various neighborhoods, but other factors need to be considered when assessing an individual property. In business the generic valuation guide is the earnings multiple for industries and business size. However, other factors need to be considered when assessing an individual business.

Type of Income
While a dollar is a dollar, when it comes to assessing a business, different income sources have different values. What potential owners are looking for is some assurance that this year's income can be repeated or improved into the future.

Profit Margins
Profit margins are an indication of the level of demand for a service, as well as the level of competition the business is facing. A low margin business also has a reduced margin for error, and therefore a higher risk.

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The principles of valuing a business and components of a business are well established. The seller wants to get as much as possible, the buyer wants to pay as little as possible, and the value lies somewhere in between. In very simple terms the value is the best price you can get at a given time. However this is not always an accurate guide, for example at a given time, there may be no buyers or investors who have expressed an interest and in this case one should not therefore conclude that the business is worth nothing. So how can you arrive at a reasonable asking price? Most businesses will request a valuation from their accountant or business advisor. There are four generally accepted methods for business valuation.

Valuing a going concern

The capitalization of future maintainable earnings method is the most common way of valuing an existing business in good order, as it usually aligns reasonably well with the expectations of potential purchasers. This method involves multiplying an estimate of future maintainable earnings by the capitalization rate. The capitalization rate varies between industries and businesses and is usually expressed as a multiple of price/earnings ratio (PE).

Valuing new businesses

The discounted cash flow method is usually used to value new or immature businesses or a business in which there is considerable variation in income or expenditure expectations. This method estimates future cash flows and then applies a discount rate. The discount rate increases with the level of risk and the estimated time taken for the business to reach maintainable earnings.

Valuing the sum of the parts

The notional realization of assets is used to value a business which is not expected to continue in its current form. This is the case where the potential purchasers are interested in utilizing only parts of the business, so that various elements of the business are purchased by different parties. For example, an agri-business may be dispersed in three separate sales: land; stock; and equipment.

Industry valuations

In some industries there is a sufficient number of business sales on an ongoing basis for a rule-of-thumb valuation to be applied to a business. For example, in publishing, magazines have historically been valued at around 6 times earnings and accounting practices have historically been valued at approximately 4 times earnings.

Combining valuation methods

Combining valuation methods is generally nonsense. One cannot reasonably take a value based on an earnings multiple and then add the value of the assets - regardless of whether they are plant, stock, equipment or goodwill. To illustrate this point, it is the equivalent of looking at the PE Ratio of a publicly listed company, multiplying the earnings by the ratio to obtain the value, then adding the net assets to arrive at the price.

Comparing valuations by different methods

Comparing valuations by different methods can be quite informative, and a useful crosscheck of business value. If one method reveals a higher valuation than another, then it may

Factors affecting value

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Stability

A potential owner of a business is buying its future not its past and therefore there is a high degree of uncertainty. A business with a long and steady track record is a potentially more reliable generator of future income than one that has just started in the same industry. As such it may be valued at a higher earnings multiple.

Stability may also be an external factor. For example, agriculture can be affected by weather patterns, while import and export business can be affected by currency fluctuations.

Competitive advantage

The key concern of the potential owner in this regard is the question of what is stopping a competitor doing what I am doing and eating into my customer base and income streams. As a general rule of thumb, having something that is difficult to replicate adds value to the business. Industry lifecycle

Each lifecycle stage will be regarded as having more or less value to different investors. As such it represents a factor that affects the earnings multiples applied to particular business in particular industries, but one without a consistent application.

Reliance on owner-operator

Many SME businesses are reliant on the owner-operator. As a general rule of thumb, the less a business is reliant on the owner-operator the higher the value of the earnings multiple.

reveal something about the business. Here are some examples:

- If the notional realization of assets valuation is greater than the earning multiple valuation, it implies that the business is either over capitalized or underperforming.
- If the discounted cash flow valuation is greater than the earnings multiple valuation, it may imply that the business is expected to substantially increase profits.
- If the industry valuation is less than the earnings multiple valuation, it implies that the business is either over valued, or an industry leader.

Comparing valuations of different businesses

As a potential owner or investor, it is important to realize that the fundamental business value rests on its ability to generate income for its owners into the future. If all things are equal then the earnings multiple facilitates this. However all things are rarely equal, and so variations in earnings multiples are inevitable.

The essence of earnings multiple valuation is that it enables an owner or investor to compare different investment opportunities based on the level of income they will generate. Other factors will also be considered (refer to breakout box). These account for some of the variation in earnings multiples between businesses and industries. However it is the ability to make cross-comparisons that make the earnings multiple so useful. It is no coincidence that the publicly listed company equivalent, the PE Ratio, is so commonly used. It is also why the BizExchange Index is based on this.

The BizExchange Index is a quarterly publication that researches and tables the current market valuation of privately owned businesses in Australia segmented by industry and size of organisation. While there are a number of key findings in the BizExchange Index, two are very relevant for current business owners. Firstly, the vast majority of businesses are sold for less than four times their annual earnings before interest and tax - which is much less than many expect. Secondly, the overall trend is downward as a generation of baby boomer owners moves into retirement putting more than 40% of Australia's businesses into the market over the next ten years.

MOVING ON SERIES

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Some of the titles in this series includes:

- Getting out on top
- Succession Planning
- Preparing a Business for Sale

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David Bird is the chairman of BizExchange, an independent online marketplace of businesses for sale and looking for investment. The BizExchange Index is available free of charge from www.bizexchange.com.au