Business Valuation Methods

Not surprisingly, there can be any number of reasons why business valuations need to be carried out; eg a business owner selling part or all their shares, a buyer purchasing a business, the death of an owner, the drawing up a will, business planning, exit strategies, divorce or it might just be because the owner wants to know what he or she is worth. Whatever the reason, there are several methods of valuing a business, one or two of which could be used, depending on the type of business to be valued:-

- **Multiples of earnings –** The "multiple earnings" approach uses an established market based **Price/Earnings (P/E) Ratio** (also known as **PER**) and is suitable for those businesses with a record of profit generation. It involves multiplying adjusted after tax profit by an industry sector related multiplier. In order to arrive at a meaningful post-tax profit figure, it will be necessary for certain adjustments to be made, which are known as "Normalising Adjustments". The Valuer will need to scrutinise the accounts in order to establish if there were any income or expense items that were considered to be either of an extraordinary or non-recurring nature or higher than would be reasonably expected, in order to calculate maintainable profits. Very often, the multiplier will be linked to quoted Companies listed Financial Times FTSE 100, 250 and AIM markets delivering broadly similar services to the business being valued but with a discount of 50% to 60% (possibly more) applied for a non-listed Company, usually depending on the level of risk and transactional values for similar businesses sold. For smaller businesses, a reasonably established practice amongst Valuers, is to use a P/E multiple of 5 x PBT as a starting point and then move the multiple up or down as circumstances demand.

- **Earnings Before Interest, Tax, Depreciation & Amortisation (EBITDA)** – used to determine the business's ability to generate sustainable operating cash flows (rather than earnings) and to this figure is applied a multiple. In effect, the EBITDA method is an attempt to value the business based on an operating profit, before any entries relating to the capital structure of the business are put through, such as interest on loan repayments. The EBITDA figure will be normalised, where normalising adjustments ("add-backs") should take into account items such as: below fair market rates for sales, purchases or expenses, owners salary or bonuses that are not at a fair market rate, repairs and maintenance charges that should have been capitalised (eg improvements), non-recurring expenditure, including but not limited to professional and legal fees, patent & trade mark fees, donations, employee bonuses etc, stock levels that are too high for one reason or another; plus add-backs the other way, such as substantial capital spending and additional salaries and benefits or additional expenses. The EBITDA multiple in the valuation process is often based on an industry based average, calculated on a sample of similar businesses sold used for comparison purposes with the Company under evaluation. It can also be an arbitrary decision and for small company valuations where it is usual for the multiplier to be between 3 and 5.

- **Net Asset basis valuations** – for those businesses that are well established and have substantial tangible assets but possibly low earnings, eg. property companies and investment companies. This valuation method is also often used for small to medium sized

businesses, where their profitability is relatively low. This approach will include calculating the net realisable value of all the assets held by the business and deducting the liabilities. Adjustments are often made to reflect their current market value by seeking to place a value on goodwill (an intangible asset). This is normally calculated as a multiple of sustainable profits after tax; the most common multiplier being three times net profit. Some normalising adjustments to the profit figure may have to be taken into account, where for instance, business owners of small to medium sized businesses pay themselves a salary above or below market rates.

- **Entry Cost** – This is the predicted cost to set up a similar business to the one being valued. This method of valuing the business would include the cost of developing a customer base and reputation, recruiting and training specialized staff, purchasing assets and licences and developing products and services.

- **Discounted Cash Flow** – this valuation method (sometimes known as the **DCF basis**) is suitable for those businesses which have been established for many years and where they have invested heavily, with a stable earnings record. It primarily looks at cash flows generated by the business, rather than profit. Projections are made for five to fifteen years in order to work out the potential in-flows after tax. A discount factor is applied to reflect levels of risk, inflation and interest rates and then aggregated with the residual continuing value or terminal value of the business to provide an overall value. This is a very technical method of valuing a business and depends on a raft of assumptions for a long period of time.

- **Industry Rules of Thumb** – is the use of an established standard formula for a particular sector. For instance, a "sales or fees multiple" approach is often used in valuing businesses that generate regular ongoing revenue from an existing client base and may include consultancies, professional businesses, brokerages, agencies etc. This may also be known as the **GRF method** (Gross Recurring Fees). The multiples of earnings or GRF method will involve applying an established industry multiplier to the adjusted annual sales or fee income.

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Stirling Business Solutions Ltd provides an independent valuation service, where business valuations are undertaken by an independent FCCA, FCA or ACA fully qualified Accountant. To request a business valuation report, contact details are:-

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