Business Valuations using Price/Earnings (P/E) Ratios

The Price/Earnings ratio or P/E ratio or PER is a ratio for valuing a company that measures its current share price, relative to its per share net earnings. This method is often used to value companies with an established profitable history. As this method is used to achieve valuations for quoted companies, it can also be used to value unquoted businesses. To give an example, if a company was making post-tax profits of £200,000 and you were offered £1,000,000 for it, that would equate to a P/E ratio of 5 (£1,000,000/£200,000). Quoted companies generally have a higher P/E ratio where, for example, a typical P/E ratio for a large growing quoted company with excellent prospects may well be in excess of 20.

Quoted company shares are much easier to buy and sell and are perceived as being less risky than unquoted companies, which makes them more attractive to investors than shares in comparable unquoted companies. As a consequence, the P/E ratio of a small unquoted company can be, on average of 50% lower than that of a comparable quoted company in the same industry sector, the amount of discount depending on any perceived trading risk. Generally, the higher the risk, the greater the discount. A 30% discount would infer a low average level of risk with high growth potential, whilst a 70% discount would indicate an above average risk element for a potential buyer to give consideration to. However, any unrecorded intangible assets present within the business, may possibly improve the valuation further.

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 or lower than would be reasonably expected. Checks for instance, should be made on both the level and sources of income received, together with the itemised schedules of cost of sales and administration expenses in the financial information submitted. From these, the Valuer would make the "Normalising Adjustments" typically adding back or deducting Directors Remuneration (if the total amount earned was either in excess of, or below the rate considered reasonable for the size of the company and duties/responsibilities associated with the appointment); other add-backs might include professional fees, legal fees, recruitment fees etc as these frequently arise through some particular situation, not likely to recur. Bank charges would only be added back if they were excessive due perhaps to the presence of factoring/invoice discounting or an uncompetitive bank pricing structure, or some exceptional event in the financial year that is not likely to recur. Depreciation is not a normalising adjustment, unless the charges stated in the accounts are not in line with normal accounting practices. Once the adjusted profit before tax figure has been arrived at, a nominal Corporation Tax charge is applied, in order to arrive at an adjusted "Maintainable Post Tax Net Profit", to which the P/E multiplier can then be applied.

To give an example of an (unquoted) company valuation, a business trading within the UK Industrial Engineering Sector where quoted companies on the Financial Times FTSE 100, 250 and AIM markets delivering broadly similar services to the business, could be trading with an overall Sector P/E ratio of say 19.27 as at the time of preparing the report. For a smaller unquoted company, the P/E ratio would be around 9.6 based on the figures as stated in the Financial Times FTSE tables having deducted an appropriate discount of 50%. For smaller SME businesses, it may be necessary to research similar businesses sold to determine a more realistic multiple. Any multiple determined may be adjusted to take account of any unrecorded intangible assets such as:-

- The current value placed on any UK and international trade names or patents and trade-marks etc.
- Any customer and supplier goodwill that has been built up over the many trading years together with any key business relationships
- Niche market placement

Very often, although it may be possible to value a business "on paper" other factors may affect the final outcome such as:-

- The perceived potential loss of a key member of staff which could have an impact on the future direction of the Company and its financial performance. Any potential buyer may wish to negotiate some form of handover or continuity with key staff to ensure a smooth transmission into new ownership.
- The loss of any key sales accounts following the transfer of ownership may well be perceived as having an effect on the future trading position of the Company. Any potential buyer may want some form of assurance regarding continuity with the key account clients. If the Company was to be put up for sale, a potential buyer may be keen to have some guarantee as to the future trading position.
- The spread of turnover, especially where a large percentage of business is being generated from just a small percentage of clients.
- The transaction values and multiples of similar sized businesses sold.

The advantage of the Price/Earnings valuation technique is that the value can be directly related to other businesses trading within the same industry sector and that the method takes into account the profitability of the business, generated from the assets and investment made within the business, as recorded on the balance sheet. It should be noted however, that where businesses have "surplus cash" over and above the amount required for Working Capital that this will not normally form part of the Valuation. Surplus cash would need to be dealt with separately if the business is due to be sold or at least sold with "cash for cash" added to any offer. The Price/Earnings valuation method is not suitable for businesses with a high value balance sheet and low profits.

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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:-

Stirling, Business Transfer Specialists, One Victoria Square, Birmingham, B1 1BD

Tel: 0121-314 5575
Web: www.stirling-uk.com
Email: info@stirling-uk.com