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SPOTLIGHT ON:

**Business valuation:
Knowing your company's worth**





ESSENTIAL KNOWLEDGE FOR ACCURATE MARKET ASSESSMENTS

Understanding your business's value is more than a number on a balance sheet – it's a crucial indicator of your company's health and future potential. Whether considering a sale, seeking investment or planning strategic moves, a precise valuation provides robust information.

With this spotlight, we aim to guide you through the essentials of business valuation, helping you realise your company's worth in clear terms.



WHY BUSINESS VALUATION MATTERS

First, let's address why knowing your business's value is essential. This figure is critical for entrepreneurs and business owners when making sales, mergers, acquisitions or raising capital decisions. Investors and lenders use this data to gauge the risk and potential investment return. Moreover, understanding your company's valuation can help in strategic planning, tax planning and legal matters.

Additionally, a precise valuation helps set realistic employee expectations regarding stock options and ownership stakes. For companies that offer shares to their employees, a current and accurate valuation ensures that employers and employees clearly understand what those shares are truly worth. This transparency can strengthen alignment between company objectives and employee efforts, enhancing productivity and motivation. It also aids in recruitment

and retention, providing a competitive edge by attracting top talent who see the potential for growth and financial reward.

Furthermore, regular business valuations are instrumental during insurance assessments and claims. Having an up-to-date valuation allows companies to ensure adequate coverage to protect against losses, whether from physical assets, business interruptions or other risks. This proactive approach can significantly mitigate financial impacts when unexpected events occur, providing a buffer that helps maintain business stability and continuity. Proper valuation also simplifies negotiations with insurance providers, ensuring that coverage terms are fair and reflect the business's current worth.

THE FOUNDATIONS OF BUSINESS VALUATION

Business valuation is grounded in several methodologies, each serving different purposes and business types. The three most common approaches are the asset-based, earning-value and market-value methods.

ASSET-BASED APPROACH

This method calculates your company's total net asset value by subtracting the value of liabilities from the value of assets. It's straightforward and practical for companies with significant physical assets.

The asset-based approach can offer substantial benefits during financial restructuring or in situations requiring a clear assessment of tangible assets. This method provides a solid foundation for negotiations with creditors or during bankruptcy proceedings, where tangible asset values are crucial for equitable settlements. Stakeholders can make more

informed decisions by offering a clear picture of the company's physical asset base, potentially leading to more favourable negotiation outcomes. This method also serves well for older, established companies looking to streamline operations or divest non-essential assets, aiding in strategic decision-making to enhance financial efficiency.

However, the asset-based approach can fail to reflect the full potential of future earnings, particularly for businesses in rapidly growing industries or those with significant intangible assets such as brand loyalty, customer relationships or proprietary technology. For these companies, an asset-based valuation may significantly underestimate the market value, especially if their income is more about leveraging such intangibles than capital-heavy operations. This limitation makes it imperative for such businesses to consider other valuation methods that can comprehensively analyse their true market potential.

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EARNING-VALUE APPROACH

Often considered the most reflective of a company's economic reality, this method focuses on earning potential. The earning-value approach, particularly through the discounted cashflow (DCF) method, forecasts future cashflows and discounts them back to their present value.

The earning-value approach excels in situations where future operations are critical in determining a company's value. This is especially beneficial for startups and high-growth companies where past financials may not indicate future potential. By focusing on projected future cashflows, this method helps these companies demonstrate their value based on growth forecasts and upcoming profitability. This can be crucial in attracting venture capital or other forms of investment, as it outlines a growth trajectory that can yield high returns, making it an attractive prospect for forward-thinking investors.

The earning-value approach also comes with significant challenges. It heavily depends on the forecasts' accuracy, making it susceptible to errors due to overly optimistic assumptions or unforeseen market shifts. Changes in economic conditions, competitive actions or regulatory environments can all drastically alter future cashflows compared to predictions. This method also requires a deep understanding of financial modelling and market dynamics, which can be a barrier for businesses without access to skilled financial analysts. As such, while providing a potentially lucrative view of future worth, it carries a higher risk of miscalculation.

MARKET-VALUE APPROACH

This method involves valuing your business based on the selling price of similar businesses in the market.

The market-value approach is particularly advantageous for business owners looking to sell or merge, providing an immediately relatable figure based on actual market transactions. This method can streamline the negotiation process by setting a market-tested discussion benchmark.

It also reflects current investor sentiment and market conditions, offering a real-time snapshot of what investors are willing to pay for similar businesses. This can be invaluable for business owners who want to ensure they receive fair market value based on current trends rather than historical financials that may not fully capture the current economic climate.

On the downside, the market-value approach can be problematic in



industries that are either highly specialised or undergoing rapid changes. For businesses in these sectors, comparable market data might be scarce and quickly outdated, potentially misleading valuations. In such cases, the lack of relevant comparables can lead to a valuation that does not accurately reflect the business's unique aspects or

future prospects, either undervaluing it in a niche market or overvaluing it in a declining one.

This method's reliance on external market conditions also means it is less controlled by the business itself, subject to fluctuations in the broader economy or industry-specific disruptions.

ALTERNATIVE VALUATION METRICS: REVENUE AND EBITDA MULTIPLES

While the asset-based, earning-value, and market-value approaches offer comprehensive frameworks for valuing businesses, another straightforward and commonly used method involves applying industry average multiples to current revenue or EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortisation). This method is particularly prevalent in industries where benchmark multiples are well-established, providing a quick and less subjective means of valuation compared to methods like the DCF.

For instance, in the accountancy industry, firms often are valued at multiples ranging from 1.3 to 1.6 times their revenue or 4 to 6 times their EBITDA. These multiples provide a snapshot of the business's current financial performance, making it an attractive option for owners and investors looking for a straightforward valuation metric. It simplifies the calculation process and reduces the subjectivity involved in forecasting future earnings. However, it is important to note that while this method is easier to apply and less speculative, it does not account for the future growth potential or downturns of the business, which might be captured in more dynamic methods like the earning-value approach.



KEY DRIVERS AFFECTING BUSINESS VALUE

Several factors influence a business's value. Market conditions, industry performance, customer diversity, brand strength, financial health, revenue trends and profitability are pivotal. Economic conditions, such as interest rates and inflation, also play a significant role. For example, in sectors like technology, the speed of innovation and the competitive landscape can drastically affect a company's valuation.

Regulatory environments and legal considerations can also significantly impact a business's valuation. Changes in government policies or compliance requirements can alter operational costs and market accessibility. The quality of management and the workforce's skill level are crucial, as these can drive a company's strategic direction and operational efficiency.

Intellectual property, such as patents and trademarks, further contribute by providing competitive edges and securing long-term revenue streams. Lastly, global expansion opportunities and the ability to adapt to changing global market demands can also enhance a company's worth.

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PRACTICAL STEPS TO DETERMINE YOUR BUSINESS'S WORTH

To start valuing your business, you can follow these practical steps.

- **Gather financial statements:** You may need at least three to five years of historical financial statements, including profit-and-loss statements, balance sheets and cashflow statements.
 - **Forecast future earnings:** Use your financial data to project future earnings. Consider market trends and how changes in your business model could affect these projections.
 - **Choose the right valuation method:** Choose the most appropriate valuation method depending on your business type. You might even combine methods to get a more accurate picture.
- **Consider seeking professional advice:** Valuing a business can be complex and professional valuers can provide accuracy and insight, especially for large or unique businesses.
 - **Benchmark against other companies in the industry:** Comparing your business to similar companies within your industry can provide additional context for your valuation. This involves examining the sale prices, revenue multiples, EBITDA multiples, and other financial metrics of these companies. Benchmarking can highlight competitive advantages or challenges and help validate the assumptions made during your own valuation process. This step is particularly valuable in industries with a high degree of standardisation, where comparable financial data is readily available.



COMMON PITFALLS IN BUSINESS VALUATION

Avoid common mistakes such as overemphasising historical financial performance without considering future potential, ignoring non-financial factors like market position or brand value, and relying solely on one valuation method without considering others that might offer a fuller picture.

Neglecting the impact of external market trends and economic forecasts can lead to inaccurate valuations. It is crucial not to overlook the effect of technological advancements or shifts in consumer behaviour that could reshape the industry landscape. Misjudging the significance of competitive dynamics or failing to account for potential risks, such as supply-chain vulnerabilities or changes in consumer demand, can also skew valuation results.

Additionally, underestimating the importance of company culture and employee morale, which can significantly influence productivity and innovation, is a common oversight.

Finally, ignoring the potential for scalability or not properly valuing strategic partnerships can prevent a thorough understanding of a business's potential.

WRAPPING UP

Knowing your business's worth is a powerful tool in your strategic arsenal. You're better equipped to assess your business's true value with a clear understanding of valuation methods, key value drivers and common pitfalls. Whether planning to sell, seeking funding or simply looking to understand your business better, a well-grounded valuation is the first step towards making informed decisions that drive business success.

Remember, business valuation is not just a one-time exercise but a crucial part of ongoing business strategy. Keeping up to date with your company's value can help you make timely decisions, respond to market changes and guide your business towards long-term success.



If you need help with a business valuation, contact us today to simplify the process.

