RYE
RURAL YOUTH ENTREPRENEURSHIP

2

Methods of Valuing a Business

GROWTH MODULE

2 Methods of Valuing a Business

There are many different reasons why a business might be valued, including to sell or buy it, or to raise finance. Buyers and sellers will inevitably have different objectives (usually minimising or maximising the price). However, the real value of a business can ultimately only be determined by the price that a buyer is prepared to pay and a seller is prepared to ac-

Net asset valuation

This is the simplest way of valuing a business and is particularly appropriate for a business with significant tangible assets operating in a relatively stable market. The net assets figure, equal to the net worth, is shown on a business's balance sheet. In theory, if everything was sold at the value recorded on the balance sheet, the amount of money raised (minus any liabilities) would be equal to the net assets.

The net assets figure may need to be adjusted to reflect the true value of the business assets. For instance, buildings may be worth more than shown on the balance sheet, while equipment, such as computers, may be worth less due to its low second-hand market value. A business may also have intangible assets such as intellectual property (IP) rights and goodwill, which are more difficult to value. For types of business that are heavily dependent on their assets to generate income, the net asset method often proves a good basis for valuation. However, this type of valuation can also be used to set a minimum valuation for all types of business. If it is possible to determine the market value of a firm's assets, it is then possible to identify what the business is worth if it ceases trading and its assets are sold off.

Multiple of net earnings (P/E ratios)

A business can also be valued using its average historical net earnings (net profits after tax). This valuation assumes the business will continue to generate these average profits into the future, and the valuation is based on a multiple of these earnings.

Although this form of valuation appears to be fairly straightforward, there are a number of factors to consider when calculating average net earnings and the actual P/E ratio to use. When calculating the average net earnings for a business, it is necessary to exclude exceptional and non-recurring income and expenditure as this may have distorted one year's trading results or the future earnings potential of the business.

Industry-related valuations

In some industry sectors, business valuations can be derived from factors other than asset valuations or net earnings figures.

Industry-standard formulae

Certain types of business which are bought and sold on a regular basis, can be valued based on accepted critical factors to business success

Cost of Entry

Another method of valuing a business is by calculating the cost of setting up a similar venture from scratch. Costs that need to be considered include hiring and training staff, buying equipment, developing the products or services, and marketing them to existing or new customers. It is also necessary to factor in the time it will take to carry this out, and to determine the perceived risks of this approach. This cost can then be compared with the advantages, namely the goodwill value, of buying an existing business that has an established reputation and customer base.

Market Consolidation

In some mature markets, an individual business may have little value based on its financial performance, but it can have considerable value to a competitor because of the pool of loyal customers that the business may have built up. In these circumstances, a buyer will look at the potential income stream from these customers, whom they may be able to service through their existing business, or with a considerably lower cost base than the current operation incurs. A valuation can then be calculated based on the firm's turnover or expected gross profit contribution.

Multiple of Revenue

If a business is not yet making a profit, for example, because it is still very young and becoming established, it is possible to use a multiple of revenue rather than a multiple of earnings - although this is even less precise since there is no guarantee that the business will ever show a profit.

Other Factors to Consider

A business that has effective management information and control systems, particularly if it has tight control of its finances, will lower its exposure to risk. This can add significantly to the perceived value of the business.

2 Methods of Valuing a Business

There are several other factors to consider when valuing a business. These may be difficult to quantify, and they can either add significant value to a business or reduce its value by highlighting risks to a potential purchaser. These include:

Market and external factors	
1	What is happening in the market in which the business operates?
2	What are the trends affecting the sector? Important considerations include size, growth, changes in technology, regulations, and any
3	Does the business have a growing or declining market share?
4	Who are the company's competitors, where are they located, and
5	Are there similar companies being advertised for sale, and do they

Customers and suppliers	
1	Is the business dependent on one or two major customers to the extent that it could suffer a major loss of income if a contract is lost?
2	Or does it have a diverse customer database that means the business could sustain some loss of customers?
3	Does the business generate recurring income from its customers, or does it rely on one-off sales from new customers?
4	Does the business have good relationships with its suppliers? Does it have a large choice of suppliers, or is the business dependent on one or two key firms?
5	Does the business have robust contracts with key customers and suppliers?

Business organisation	
1	Is there a stable workforce, and are the employees well trained?
2	Does the business have established processes and systems that reduce dependence on one or two individuals? This factor can sometimes be a problem, particularly with sales or creative firms where a large part of the value of the business lies with the owner or other key employees.
3	Are the assets owned by the business well maintained?
4	Is there clear ownership over intangible assets such as intellectual property, or are there formal agreements in place for licensing and patent rights?