How to value a business

Navigating the complex world of corporate finance valuations

EntrepreneursHub

© Entrepreneurs Hub Ltd 2024

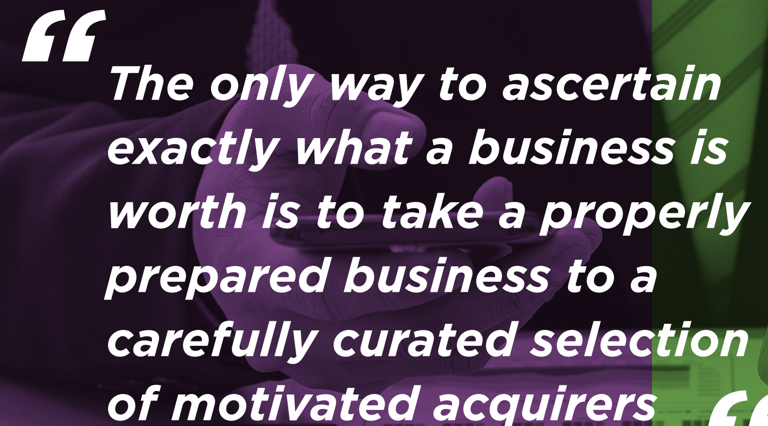
Navigating the complex world of corporate finance valuations

Valuation is a topic that divides the world of mergers and acquisitions. It can be a contentious issue – acquirers might think the seller is overstating the company value, while sellers may think the buyer is being unduly pessimistic. The truth is, as always, somewhere in between.

Of course, the broad aim of a seller is to get as much as reasonably possible for their business, while a buyer will be trying to pay as little as they can reasonably get away with. This is why it's advisable to work with an experienced third party to stand in the gap and help bring negotiations to a conclusion that is satisfactory for all parties.

But even among corporate finance advisors you will find a difference of approach when it comes to establishing what the likely value of the business might be. Here we must, of course, declare an interest… as one of those advisors, we would obviously advocate for our methodology. However, we hope that this guide will not only explain how we approach the topic of valuation but also the very solid rationale behind the methods we employ.

Before we go any further, there is one major caveat that must be understood, one that applies to any third-party advisor. Because we are not the ones who will be buying your business, any figures given to you by a third-party advisor should only be understood as educated estimates. The only way to ascertain exactly what a business is worth is to take a properly prepared business to a carefully curated selection of motivated acquirers – but that's another topic.



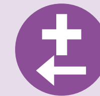
Step 1: Gathering Intel

For lots of very good reasons, valuing a business should not simply be an accounting formula – but we will come on to that later. For now, accounting is exactly where you need to start – here are the things you will need to help you undertake a valuation exercise:

Three full years of company accounts. This is generally accepted to be the minimum amount of data to be able to assess patterns and trends and get a full picture of the recent performance of the business.

Management accounts and forecasts. In addition to your published annual accounts, it is worth taking into consideration your year-to-date performance as well as any plans and forecasts you have. Crucially, where is the trend line heading – continued growth, better growth, or are things levelling off?

Profit adjustments. It's easy enough to retrieve profit figures from your accounts, but in order to do realistic calculations we must ask ourselves if that profit figure is truly representative of the performance of the business. You can make a number of adjustments, depending on how you run your business, but it's worth noting that adjustments may have a positive or negative effect on profits.



A common example of an add back: you may pay a salary to your spouse who is a Director, but a new owner would not incur this cost so this cost can be added back, increasing the profit.

A common example of an add forward: on the other hand, you may pay yourself a small salary and take the majority of your earnings from dividends. A new owner is likely to need to recruit a CEO or MD to fulfil the operational role you perform. A commensurate salary cost would therefore need to be added forward, reducing the profit.

The above is a simple example, but the real calculation can be much more complex and require a great deal of experience in judging what would be considered reasonable adjustments, and what wouldn't.

Industry average multiples. It's important to understand what companies in your sector have been acquired for in the past. In the absence of a credible offer, it is the best indication of where values might fall. Usually this is expressed as a multiple of EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization). For example, a company with a profit of £1m was bought for £5m which would give you a multiple of 5.

Health warning 1:

As a very rough rule of thumb across all industries 5 is a good place to start and many people won't go beyond this. The reason being is that arriving at a more accurate figure is very challenging. Finding and interpreting published figures is a minefield that only an experienced M&A research professional can accomplish with any degree of confidence.

Health warning 2:

There is no guarantee that your business will attract a multiple of 7, even if every other business in your sector was sold for 7 times EBITDA. Every business is unique, as are buyers and the circumstances around the deal. It does give you a very useful benchmark but should be viewed with caution.

Health warning 3:

You will almost certainly come away with a range rather than a single multiple. The temptation is to focus on the higher end of the scale, but don't be distracted with the dream scenario. Remember the purpose of this exercise is to give you a sensible estimate, not a price.

Surplus cash calculation. This is not something your average business owner will have to hand. In fact, it is often one of the key areas where an advisor will add significant value by helping you to calculate, and crucially evidence, what proportion of your cash reserves can legitimately be claimed to be surplus. However, even if you can't arrive at a precise and evidenced figure just yet, it's worth giving it some thought at this stage. Any surplus cash can usually be extracted from the business as part of the sale and could add a significant sum to the total consideration.

Step 2: Crunching The Numbers

Once you have all of the intelligence gathered, it is time to do some maths. This is where methods of valuation often diverge and you can get some wildly different results.

The basic equation is actually very simple:

Adjusted EBITDA x MULTIPLE = ENTERPRISE VALUE

So let's look at an over-simplified example, for illustration assuming an Adjusted EBITDA figure for the current year is £2m:

You haven't done in depth research into industry multiples, so you go with a rule of thumb **5**, but you also decide to go with a range so add in a high at **6** and a low at **4**:

£2m x 4 = £8m **£2m x 5 = £10m** **£2m x 6 = £12m**

So that would now give us a valuation range of between **£8m** and **£12m**... So, is that a good estimate of what your business is likely to be worth? Well, yes and no. It's a good place to start, but it really depends on what your definition is of what your business is worth...

Ask most people for a valuation and this is what you will get, but what most business owners really want to know is how much is likely to end up in my bank account – and that's a very different question.

There are, broadly speaking, three values you need to understand:

Enterprise Value – this is the calculation on the left and is a great base figure, particularly if you are comparing valuations across industries etc...

Equity Value – also known as total consideration is the total amount paid by the acquirer. The difference between the two is known as the Equity Bridge which, simply put, takes away debt, adds surplus cash and makes a minor adjustment for any working capital discrepancy at the time of deal completion.

Realised Value – this is often the value that really matters to a seller as it represents the total amount they receive after fees and after tax.

So why do most people rely on Enterprise Value when assessing the value of a business? Well, this comes down to variables... the further you go down the list the more variables there are and the more difficult it becomes to rely on the accuracy of the answer.

Let me explain, we already said that Enterprise Value is the result of Adjusted EBITDA times a multiple range, already several assumptions and variables have gone into arriving at these two figures.

Now in order to get to Equity Value you are doing the following:

Adjusted EBITDA **(a)** x EBITDA multiple **(b)**	**a x b**	**£2m x 5**
Less: Debt and debt like items **(d)** *(Corporation tax, directors' loans, long-term debt etc.)*	**- d**	**£500k**
Plus: Free cash **(c)**	**+ c**	**£1.45m**
Plus/Less: Net Working capital adjustment	**x or (x)**	**£50k**
Average working capital over a 12-month period (working capital target), compared to actual working capital at closing date of transaction.		

Note: Working capital **= Current Assets** *(cash, stock, WIP, trade debtors etc.)* **– Current Liabilities** *(Trade creditors, liabilities, corporation tax, VAT etc)*.

EQUITY VALUE	**= (a x b) - d + c + x**	**£3m**

In our illustrative example on the left the outcome is positive with **Equity Value coming in at £1m above Enterprise Value.** However, we have introduced a significant number of variables (highlighted) to get to this figure which could have a considerable impact on the outcome.

Pause for thought: the value of valuations... having understood some of the complexity and the variables, it's tempting to question whether it's worth going through the exercise at all. But it's worth remembering, however negotiations go, the final value will be calculated in this way. So whether assessing whether the time is right to sell or assessing the real value of any offer you receive – an understanding of this equation is well worth having.

Step 3: Understanding The Limitations

As we have already suggested, a desktop calculation such as the method described above can only give you part of the picture and should come with some rather large caveats. A selection of which are explored below:

Different Motives

Some advisors would have you believe that desktop valuations are next to useless because the motive of an acquirer will ultimately determine the value they place on your business. There's an element of truth to this because someone acquiring to grow market share will typically place a lower value than someone acquiring to gain a significant competitive advantage by leveraging your unique technology, for example.

However, it is a bit of a stretch to dismiss desktop valuations so readily, especially as any serious acquirer will be using this to determine their opening offer and the acceptability of any counter offer you propose. Don't forget, an acquirer will have to justify the valuation to their board and shareholders, or in the case of listed companies the market (around a third of transactions we have advised on were acquired by listed companies).

Synergy

Another important element that is likely to have an impact on valuation is synergy gains between the buyer and seller. However, so much of this depends on who the buyer is and what their plans for the business are, that it is impossible to account for in a desktop valuation exercise.

Terms

One thing that a desktop valuation cannot take into account is the terms of the offers that might be made. The terms, of course, can make a massive difference to the acceptability of a deal and there are many to consider. The headlines, as far as terms go, would be:

- The proportion of money that is paid on completion of the transaction
- Whether the remaining money is based on an earnout – i.e. contingent on performance of the business
- How long the new owner expects the exiting shareholder to be involved and in what capacity

This leads many business owners not to take the highest offer on the table, instead preferring to take a slightly lower offer that gives them more money on day one and a quicker exit from the business.

Future Opportunities

Financial calculations, like the above, work great when dealing with real historic figures. But, as we all know, the real value in a business is what it will do in years to come, not what it did three years ago. The challenge is that the further ahead you project, the more uncertainty is introduced to the figures and uncertainty is not a good variable for calculating value.

This doesn't mean you abandon all attempts to assign value to the future potential of your business, but it has to be done in negotiation with an interested acquirer rather than as part of a desktop calculation exercise.

Step 4: Interpreting The Result

So now that you have a range within which you can comfortably say a valuation of your business should fall. But what does that mean? There are three main uses of this type of valuation, and one thing it should definitely not be used for.

A decision tool...

Selling your business to a trade buyer is only one of several options when it comes to shareholders exiting. To properly assess if it is the right option for you, it is useful to know what your business is worth and how that measures up to your financial expectations and needs.

If you want to have a better understanding of what your ongoing financial needs might be it's worth speaking to a reputable financial advisor and asking them to do an exercise with you on your lifetime cashflow. This will give you a clear idea on whether selling the business for between X and Y will allow you to live the way you want. If you don't already have a relationship with a financial advisor who can do this for you, we would be delighted to make some introductions.

Demonstrate the impact of growth...

Once you have arrived at a suitable range of valuation it is relatively easy to start modelling the impact of growing the business on those values. You will be able to see the impact of increasing revenues and therefore assess whether there is merit in working to achieve that growth before selling the business.

A yardstick

Of course, one of the main uses of your valuation is to provide a yardstick with which to assess whether a potential acquirer has made a reasonable offer or not.

A price tag for your business

The one thing you should **definitely not do** with your valuation! This comes back to our earlier discussion on limitations. If you go to the market advertising the valuation you have placed on the business, you will unwittingly put a ceiling on the value you receive. But you also risk alienating potentially interested acquirers who may not, at first glance, see the rational for the valuation.

Next steps

Quick and dirty desktop valuations are common, principally because doing it properly requires a considerable amount of effort and M&A experience. That's why many business owners turn to a third party to help them assess the value of their business.

The question is whether you can trust what they tell you. There are many trustworthy advisors, but there are also some who will tell you what you want to hear in order to win a mandate from you. The best indication is how willing they are to show their workings.

If you are interested in getting a no obligation valuation on your business, we'd love to hear from you and discuss where you're at and what we can do for you.

Contact Us...

T: 08450 678 678

E: info@entrepreneurshub.co.uk

www.entrepreneurshub.co.uk

Headquarters
The Courtyard,
Brinkletts House,
15 Winchester Street,
Basingstoke,
RG21 8UE

London Hub
107 Cheapside,
London,
WC2V 6DN

Birmingham Hub
Somerset House,
37 Temple Street,
Birmingham,
B2 5DP

Manchester Hub
City View House,
5 Union Street,
Ardwick, Manchester,
M12 4DJ