Why Is One Set of Businesses Worth 9 Years of Profit Before Tax or More, Whilst Another Set of Businesses Is Struggling to Be Worth 3 Times Profit?

And how does your business (or your client's business) get into that first category?

Let Me Explain

One very difficult problem for business valuers such as myself is trying to assess what multiples real businesses are actually selling for. Of course, we can look up what similar businesses are for sale on "Businesses for Sale.com" or "Daltons" on the internet, but actual finalised sales prices are much more difficult to ascertain. There is simply no equivalent of the land registry. So, we subscribe to two books which are compendiums of actual sales. A British book "BVB (British Valuation Benchmarks) Insights" published by 2 partners from Grant Thornton that analyses 146 business sales and a US book "The Essential Guide to Pricing Businesses and Franchises" which has more than 600 category headings. In reading and using these guides I am struck by how much the British prices seem to cluster around 9 x profits whilst the American prices seem to cluster around 3 x profits, and I have asked myself the question why should this be so?

Well for a start not because British businesses are more valuable.

A quick trawl through Businesses for Sale.com or Daltons will demonstrate that very few British businesses are up for sale at 9 x Profit-Before-Tax, and how very many are up for sale at multiples of around 3 or below.

And, there are plenty of American businesses buying those British businesses at large multiples, surely not something they would be doing if they could buy something similar in the States for 1/3 the price?

Size Matters

The first thing to note is that the size of the deals in the British book are mainly in the £10 million to £50 million range; many times, the value of the average British business for sale on the internet or in the American "Essential Guide".

Size itself is one half of the valuation equation, the Profit-Before-Tax, how on earth does it seemingly also impact upon the multiple?

In at least 7 ways, I would suggest.

Firstly, the buyers in the British book are almost exclusively large well financed businesses with a low cost of capital (i). When Ali buys an insurance brokerage down the road his bank wants at least 10% of its money back each year for 10 years, interest rates are not likely to be low and if he needs to pay the government loan guarantee scheme charges as well that will pretty much have taken up all of a 20% return on investment, equivalent to a multiple of 5. In contrast a well-financed national or international plc doesn't need to repay its share capital and probably pays a dividend of less than 5%, equivalent to a multiple of 20 or more. If the multinational buys the insurance brokerage at a multiple of 10 times earnings this can still enhance return on investment for the group, whereas it would be impossible or commercial suicide for Ali to pay this amount.

What is more we as brokers tend to find that these large well financed buyers are simply not interested in the very smallest businesses for sale (ii). The *not worth getting out of bed* syndrome.

To summarise let us say both Ali and the multinational want a return of 5% over and above the return needed to finance their capital costs and replacement. Ali cannot afford a multiple above 4 whilst the multinational might accept a multiple of 10. Cost of capital may well be the single most important factor at play.

But size is important in other ways. One of the reasons that we may reduce the multiple we apply to a business is if we think that business is overly dependent upon one key individual (iii), another is if the number of customers (or suppliers) is too concentrated (iv). More sophisticated buyers are interested in the sellers systems (v), and the strength of the team (vi), all things being equal these factors are likely to be stronger in larger business. In short, larger businesses are likely to be more sustainable, more robust, more likely to continue to deliver long term profits to the buyer.

Another thing that buyers tend to value is a track record, and larger business are perhaps more likely to have this (vii).

Future Growth

But it is not size alone that makes the British businesses gain higher multiples. In case study after case study the buyers talk about

- Exceptional growth potential
- Synergies in sales or costs
- Strategic advantages
- Strong brands
- Technological advancement

It seems that the buyers almost always think that they can grow the future profits of the target businesses.

In Conclusion

The multiples at which businesses sell can vary widely, but there is always a logical explanation, at least in the mind of the buyer.

For the business owner there are lessons to be drawn here

- Bigger businesses are likely to attract bigger buyers, with deeper pockets
- A strong team that can continue growing the business is important
- A wide spread of customers will always be more attractive than a few customers
- An established history of growing profits is critical to the multiple
- Business niches, strong brands, the cutting edge of technology, businesses that can be scaled up; these are what the guys with the deep pockets are looking for.

We are available to prepare an action plan for anyone who wants to maximise the eventual value of their business.

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