WHAT IS THE CORRECT WAY TO GET A BUSINESS VALUATION?

It is a popular fallacy that anyone can plug a few numbers into a computer programme and produce a business valuation. In this article I want to explain some of the thought processes which must go into preparing a business valuation.

Asset Values

I guess a typical extreme example might be a company with £25,000,000 of rental properties which for the last decade has spent every penny of its rental income on costs, maintenance and improvements. So it has no EBITDA, no profits, and no dividends. Whatever earnings, multiple or reverse dividend yield one applies, the calculation produces nil value. But for a purchaser or seller of this business this is clearly the wrong answer. A buyer of the whole business is acquiring £25,000,000 of assets which he could sell for full value and be £25,000,000 better off.

We might consider transaction costs, pregnant capital gains tax and other taxes, but ultimately the value of the whole business will be that of the underlying assets less actual and contingent liabilities. But more complex situations arise. A company might have unvalued assets which have significant value. We have seen examples of fully depreciated but perfectly maintained machinery, undervalued stock, and assets created in house such as product moulds. Intellectual property, such as patents, creates a particular problem, which I deal with later.

Another difficulty is created where a trading business has significant property. One might think of a public house. Generally it is not possible to sell the property and continue the trade so the trick is to look at (i) sale of property with the trade ceased, (ii) sale and leaseback of the property, (iii) trade for 5 years then sale of property, (iv) indefinite continuation of the trade with no sale of the property, and identify which route raises the highest value.

Basically highly valued properties may (like the industrial estate above) set a value eclipsing that of the trade, but more modestly valued properties will almost always tend to increase the value of the trade because they enjoy higher income multiples (lower yields) than trading business itself, as well as a more certain exit value.

It is often important to ascertain the intentions of the buyer, and always crucial to ascertain the purpose of the valuation.

Share Sales

At the other end of the scale from asset valuation are various techniques for valuation of blocks of shares. These techniques usually apply to blocks of shares controlling only a small part of the business.
The first technique is to look at the recent dividend history and see if there is a reasonably consistent and apparently sustainable dividend policy, then to divide by the dividend yield to arrive at a valuation. The most subjective element of this technique is the derivation of the dividend yield. We have seen other valuers put considerable effort into discovering that the dividend yield of comparable quoted companies, then add an adjustment for the fact the company being valued is small and unquoted. The only problem was that the quoted yield was 3.5% and the adjustment was 10%, making 13.5% in total, with no explanation or underpinning of the 10% which is 3 times the value of the quoted yield.
The second technique is to look at recent share transactions. If there have been recent (or very rarely subsequent) arm's length transactions in the shares, these give a strong indication of value of the shares.

A third technique is to try to assess what might happen to the shares in the near future, for example if a sale of the total enterprise is expected then it might be possible to get at a current value of the shares by discounting for transaction risk and for delay, but not for size of shareholding.

If none of these techniques are available then it might be necessary to value the whole enterprise, and then calculate a value for the shareholding. In a few happy circumstances this might be a straight forward pro rata. For example, if the transaction is covered by a co-shareholder agreement which fixes the share price at a pro rata for the whole enterprise. In other circumstances small shareholdings of less than 10% are quite commonly sold for less than 20% of the pro rata value. However the valuer should investigate the split of the rest of the share register, a holder of 45% of the shares each might easily be persuaded to pay a premium over the pro rata value to get control of the enterprise.

Valuing a Trading Business

All valuations of trading businesses must in some way put a value on future cash flows.

The most scientific sounding technique is to project future trading then discount this back to a net present value. A moment of careful consideration will give the lie to this idea. Projections of future events are almost invariably wrong, and small changes in discount rates cause spectacular changes to present value. Nonetheless for many businesses discounted cash flow might be a valid way to produce a valuation.

The classic technique for getting at a valuation for a reasonably stable trading business is to multiply the profit by an appropriate earnings multiple.

As Lord Fleming said in Findlays Trustees v.s IRS (1938)

"It is to be presumed that the hypothetical purchaser having obtained all the relevant information would consider in the first place all the risks which are involved in carrying on the business, and would fix the return which he considered he ought to receive on the purchase price at a rate per cent. The only other factor that he would then require to determine would be the annual profits which he would derive from the carrying on of the business. The determining of these two factors would enable him to fix the capital value of the business".

In fact getting at the annual profit is not so easy. In practice the profits of most trading firms fluctuate, and the accounts of many private companies contain numerous items not directly related to the trade itself. On the other hand some private owners choose not to charge for their own time and expertise, completely flattering the recorded profits, so the accounts figures have to be adjusted. Fluctuations are ironed out by use of weighted average historical profits, but the whole process requires detailed knowledge and good judgement.

Lastly, many industries have their own, shorthand ways of finding value, often some multiple of repeat business income and some businesses have something approaching a "Market Value". Wherever possible a valuer should check their results against this "Market Value".

Contact Us

If you would like to discuss a business valuation required by one of your clients why not contact me, Phil Needham. Telephone **01603 720424** or email **phil@hornbeam-accountancy.co.uk**

If you would like to read our (attributed) commendations or see a sample Hornbeam Valuations report visit **www.hornbeam-accountancy.co.uk/valuations**

Yours faithfully

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