Starting a Business: Buying a Business - Valuation of a Business

Valuation of a business is essential before you decide to buy it.

What is the value of a business?

When a business is on the market, the selling price is usually set by the owner who arrives at the sale price in a number of ways. It might be based on the previous purchase price, the original investment or by comparison with other businesses on the market. Other methods include the value based on future earnings, or on a comparison with the cost of setting up a similar business from scratch.

However, the selling price does not always accurately reflect the value of a business and prospective buyers should always conduct an independent valuation.

How value is determined ?

Like any asset, a small business is only worth what someone is prepared to pay. But an objective assessment of total worth will include a valuation of:

- Goodwill
- Plant and equipment (machinery, vehicles, tools, furniture and computers
- Fixtures and fittings
- Stock
- Work in progress (existing contracts)
- Intellectual property
- The liabilities of the vendor

The buyer and vendor will arrive at their own estimations of these values, but usually the amount that should be paid for a business is based on:

- General condition of the business, including the condition of the facilities, the completeness or accuracy of the company records and staff morale
- Market demand for the particular type of products or services
- The profitability of the business. If highly profitable, the business can demand a higher purchase price
- Economic conditions. What is the current cost and availability of capital? Are there specific economic factors that directly affect the business?
- Cash flow. How much of a loan will the cash flow support?
- The goodwill attached to the business and the ability of that goodwill to pass to the new owner
- The strategic value of the business such as a long term lease or time saved in existing licences

Goodwill

Goodwill is an intangible asset that reflects the reputation, viability and potential of a business. It is the part of the purchase price left over after deducting all of the other assessable parts of the business, including fixtures, assets and outstanding debts. Goodwill is made up of:

- Personal goodwill (largely how the customer values the business)
- Corporate goodwill (for instance, how the supply chain views the business)
- The location of the business (a motel located in the middle of a swamp has less location goodwill than one built near a highway)

It may be that the vendor has over valued the goodwill, basing their assessment on a market comparison. But for the purchaser, goodwill should be assessed as part of the overall investment in a business that needs to be sufficiently profitable to at least:

- Cover the capital repayments after tax
- Provide a fair income for the new proprietor

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Intellectual Property

The term 'intellectual property' refers to ideas and their commercialisation rather than to physical objects. Intellectual property, sometimes called 'IP', is a collective name for rights in information and ideas that are usually protected by copyright, patent, design, or trademark registration.

Intellectual property covers business or company name registration, copyright and confidentiality agreements and can also include customer lists, industrial processes and business tactics.

Unlike plant and equipment, intellectual property is particularly difficult to value, as it does not 'depreciate' in the way that a physical asset does. Detailed assessment is vital when looking at a business where the IP is more than just a list of customers.

Some accountants and other consultants are experienced in assessing the value of IP.

Liabilities of the Vendor

The liabilities of the vendor are not normally calculated in a sale price. A purchaser of a business would not normally take over:

- debtors
- creditors
- liability for future orders

A purchaser may, however, have to take on responsibility for employee entitlements such as holiday and long-service leave. These entitlements would have to be assessed and deducted from the purchase price.

Business Profits

In buying a business, you need to be aware of factors related to ongoing profitability, namely:

- the commercial life of the business
- opportunity costs
- assets and liabilities
- Commercial Life of the Business

As an investment, a business needs to give you a higher return than if you simply put the cash into an interest bearing account. Note that the value fluctuates throughout the commercial life of the business. For instance, changes in the economy, the need to replace failing equipment and cancelled contracts will all impact on the viability of the business and its ability to remain profitable.

The value of a business not only depends on its current position but also on its future. A common misconception by purchasers is that a business can always be resold at a later date and the capital investment recovered.

Often capital recovering isn't possible and purchasers lose some or all of the investment in the business. This needs to be factored into your estimation of profits and the amount you need to pay for the business.

Opportunity Costs

Opportunity costs refer to the cost of passing up the next best choice when making a decision to invest. This accounts for the purchaser missing the opportunity to obtain income from other possible investments. Therefore, purchasers should expect the business to provide a return on the investment higher than what could be obtained from the next best choice such as putting the money into a term deposit. Investing in a small business is risky, and the purchase price should reflect a percentage return higher than that which could be otherwise obtained in a more secure investment. The key issue in buying a business is that profits must be sufficient to meet all the usual outgoings such as:

- Business expenses
- Taxation
- Reinvestment to maintain the business
- Interest and principal payments on loans
- Return on the proprietor's own investment

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In addition, the profits must progressively recover the invested capital over the commercial life of the business. If the estimated profits are insufficient for this, then the price of the business is too high and the purchaser should not buy the business

Assets

There are several ways that a business can be valued, for instance, a value based on future earnings, or on the cost of establishing a similar business. If the business is strong in tangible assets, such as machinery and buildings, then these assets can be used as the basis for valuation.

The assets are listed in the accounts of the business as 'tangible assets' (buildings, land, equipment, fixtures and fittings), and usually with an estimation of how they have depreciated, or an estimation of their resale value. If the business for sale is a consultancy, or part of a service industry, the bulk of the assets are more likely to be 'intangible assets' (including intellectual property and goodwill in the form, say, of a strong client list).

Valuation of a business will take into account the two kinds of assets, as well as the other methods of valuation to arrive at an agreed figure. Valuation of assets involves understanding depreciation, the difference between current and non-current assets and the impact of leased equipment as opposed to equipment that is owned.

Due Diligence

Prospective purchasers should only buy a business after due diligence, which means basically acquiring and analysing all the information you need to make a wise decision. Failing to take time to find out about all aspects of the business may result in a costly mistake. The information you should obtain and analyse relates to all facets of the business, both financial and non-financial as outlined above. Due diligence reduces the risk of buying a business.

Professional Assistance

One of the main causes of business failure is paying too much for a business. Get detailed professional valuations of all assets and liabilities of the business you want to buy to reduce the risk of making a bad purchase and give your potential business the best chance of success.

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