Scott Legal
LAWYERS & ADVISORS
ABN: 46 600 469 172

P: (03) 9111 0078
F: (03) 8692 1032

E: info@scottlegal.com.au

277 Heaths Road
Hoppers Crossing VIC 3029

PO Box 6062, Point Cook, VIC 3030

Valuing a business

What is a fair price for a business is a difficult question and one that frequently causes doubt and uncertainty.

1. It is worth what you can buy and sell it for

As simple as it sounds, a business is worth what you can sell it for, or what you can buy it for. The market will normally dictate the price for the business.

Perhaps the best indication of how the market values the business is what other like businesses are sold or purchased for. Do some research and try to find out the values of recent sales of similar businesses or those currently on the market.

2. Formal valuations

A professional valuer may value the business. Provide the full details of your business and they will give you a valuation or a range of values. If you are finding it difficult to value your business, or if the business is complex or a large business, consider engaging a valuer. Less formal assistance can be obtained from your accountant or lawyer.

3. Valuation approaches

There are a range of a valuation approaches. These include earnings of profit multiples, net asset and future earnings.

Earnings or profit multiples

Value = Earnings/before interest and tax and depreciation x [multiple]
Value – Net profit or (After Tax) (NPAT) x [multiple]

This method values the business by multiplying the earnings or profit of a business by a variable. It takes into account the goodwill of the business and this together with its wide acceptance and ease of use are its strongest features. Basically, it calculates the value according to the earnings before interest and tax and multiply it by a multiple. The multiple varies according to the relevant industry. Typically, a multiple is anywhere between 3 to 5 for a normal trading business, although it can be as low as 1 and as high as 10. Where the business is stable, has recurring income, and is not dependent on the owner or limited customers, then the multiple should be higher. Regard should also be given to the consistency and trend of profits and the stage of life of the business (emerging, established or declining). The multiple used for profit will typically be higher as interest and tax are excluded.

Net asset value

Net asset value = Value of assets minus value of liabilities

 Liability limited by a scheme approved under Professional Standards Legislation

This is a simple method which relies on adding up the value of the assets and subtracting the liabilities. The problem with this method is it does not include any valuation for goodwill that is central to any business acquisition. Therefore it is generally only for valuing businesses where the holding assets are fundamental or where the business' profits are such that there isn't any goodwill.

Future earnings – return on investment

ROI = net profit divided by cost base

This method works on valuing the potential earnings of the business looking at the rate of return on the investment by dividing the net profit or average net profit of the business by the cost base. The difficulty is in determining the appropriate return on investment required. Basically, the more risky the investment the higher the rate; the lower the risk, the lower the rate. Returns on investment can vary from 10% for low risk businesses to 20-25% for business with a greater risk profile. This approach is often used in reverse to determine whether the return on investment is reasonable (when considering buying into a business).

There are numerous other methods to value an investment in a business that may be helpful. These include: Net Present Value (NPV) which essentially values the present value of cash flow from the investment; and Discounted Cash Flow (DCF) which is similar and considers future cash flow projections and discounts them by capital cost. These are measures more often used for profit or investment valuation and are more complex methods.

4. Look at all the factors and discuss it with your advisors

For a small, medium or emerging business it is difficult, if not impossible to say any one approach is appropriate. We generally consider that the profit or earnings valuation approach is useful. However, this will depend on the nature of the business and comes with the inherent difficulty of agreeing to a fair multiple.

When looking at the multiple, think about the net value of the assets, the growth potential, the client base, and security over key parts of the business such as leases, supply and sales contracts. Multiples also depend on growth opportunities, the nature of the business, whether significant capital is required, the net worth and net asset backing.

We suggest that you look at the all the relevant factors and discuss the price with your financial, accounting or legal advisors.

5. It's different for small business

With smaller businesses, the valuation methods may need to be modified.

It may be appropriate to adjust profits to take into account owner benefits, interest and loans; this amount is effectively the earnings of the business for the owner. Then apply the multiple which you can adjust taking into account relevant factors.

The multiple tends to be a bit lower for small businesses (between 2 to 4). Where the business is heavily dependent on the owner, such as an owner operator service provider, or strong customer relationships, the multiple is lower. Where the business is more stable has recurring income and is not dependent on the owner or limited customers, then the multiple should be higher. Regard should also be given to the consistency and trend of profits and the stage of life of the business.

Beware if a seller tries to suggest that the accounts do not show the true earnings because of cash payments. Unless it can be substantiated, our advice is that you should not take cash payments into account. How do you know the seller is telling the truth? Who is the seller cheating on – you or the ATO?

This information is intended as a guide only. For further information, feel free to contact Leanne Scott of Scott Legal on 03 9111 0078.

© Scott Legal 2020