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By Amanda Visser

Valuating an enterprise is part science and part art

Understanding the business and relevant valuation methodology remain crucial when selling your business.

The economic swamp in which many companies find themselves has highlighted the need for a credible valuation that reflects the true worth of a business.

Up-to-date valuations are crucial when the owner or management want to sell the business, but equally important for regulatory compliance, good governance, applying for loans or renewing insurance policies.

Johann de Lange, valuation expert and co-founder of Worth.Business, says it is rather risky to attempt an "in-house" valuation if there is not sufficient knowledge of the methodology and underlying assumptions which are needed to get a credible valuation.

Nicholas Mothilal, director of The Business Counter, recommends that especially small and medium-sized business owners do a high-level (desktop) valuation on an annual basis.

"Desktop valuations are relatively inexpensive and should be incorporated into the signing off of the annual financial statements at year-end," he says.

Valuations are far from an exact science. It requires a fair share of "number crunching" but is also based on several assumptions.

THE METHODS

Although there are various valuation models available, there are essentially three methods that are most widely used, notes Mothilal.

Market approach (earnings multiple)

This method calculates the value of the business by applying a particular multiple to the earnings or profit of the business. The multiple used could be calculated based on similar listed entities or certain industry norms. This multiple is then applied to the entity's earnings before interest, tax and depreciation (ebitda), earnings before interest (ebit) or any other profit metric.

Net asset value method

With this method the value of the business is determined by revaluing the entity's assets to market value and then deducting from this all its liabilities and the resultant tax on the revaluation. This is often viewed as the lowest value that a business could be sold for.

Income approach (discounted cash flow)

This method calculates the value of the business by discounting the future cash flows from the business over its lifespan by an appropriate risk-adjusted discount rate. This method is viewed by most valuators as the most empirically correct method as it considers items such as the future working capital requirements of the business, as well as planned capital expenditure, which are not ordinarily addressed in the other valuation methods. This method also considers the future income and expenditure of the business, which becomes important in instances where future income and expenditure is expected to change.

Mothilal adds that the risk profile of the business is also captured in the calculation of the discount rate, which may not be addressed in the other methods.

"The valuation methodology chosen would depend on the nature of the business being valued. However, in practice it is recommended that a combination of valuation methods are used in order to assess the reasonableness of the value calculated."

Ferdi van Greunen, owner of Aldes Business Brokers, says one would follow a different approach conducting a valuation on a business for the purpose of a loan or a funding application compared with a method to follow when conducting a valuation for purposes of calculating capital gains tax.

"One will also be more cautious with the valuation of a business where the public is invited to invest compared to a valuation for own purposes."

Key financial information

Certainly, the most important financial information is the actual profits achieved, and the value of the asset base (if any). Other important information to consider is monthly revenue or sales and the gross profit margins.

The three biggest expenses effecting the bottom line are normally the payroll (staff), monthly rental and utilities. Van Greunen advises that these expenses should always be compared with industry or sector averages.

De Lange says there needs to be a firm and realistic understanding of the company's outlook for the future in terms of growth margins and working capital. "The valuer needs to understand the market risks, what the market-related returns are and how to adjust for these risks."

The people

A business valuation is strictly a financial function; however, people do impact the valuation, says De Lange. They affect future cash flows, margins and forecasts and the sustainability of the business.

One needs to consider what will be required to keep key and specialist employees on board. Long-term growth assumptions and the risk-based discount rate must be considered where the business relies on one person for big contracts and what the risk for the company is when it loses that person.

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SOME CRITICAL VALUE INFLUENCERS

Type of business
A franchised business is perceived to be a safer bet than a similar non-franchised operation. This is due to its success formula, franchise manuals and the franchisor's continuing support and advice. Commercial banks look favourably at funding these types of businesses and hence a bigger pool of buyers is created, driving the perceived value upwards.

Asset base
A business with a low asset base (service-oriented businesses) does not achieve similar value as a business with a sizeable asset register (such a manufacturing), even if they deliver the same profits. The main reason being that commercial banks will finance assets, but not goodwill.

Manager
Businesses managed and run by competent managers tend to dictate a stronger selling price in the market. This is because it opens the buying market for potential investors who prefer not to involve themselves in running the daily operations of the business. It also ensures the smooth transfer and continuation of the business.

Stock
The amount of stock required in a business is a debatable issue. However, the generally accepted thinking is that stock is part and parcel of the total amount a potential buyer must pay. Just because a business has a large inventory does not necessarily mean that it is worth more.

Creditors and suppliers
Favourable credit terms from suppliers do a lot for a business. Not only does it free up cash flow, but it also creates perceived value where suppliers are willing to extend similar terms to a potential buyer of the business.

Government
The single biggest, and sometimes harshest, influence on the value of a business, however, often stems from government decisions. One simply must ask any restaurateur, bottle store owner or entrepreneur operating in the hospitality and tourism industry about their experiences in 2020 and the government's management and handling of the Covid-19 pandemic.

SOURCE: Ferdi van Greunen, Aldes Business Brokers

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> Mothilal says they often come across private expenditure of the shareholders and directors being expensed through the business.

"It is a combination of subjective adjustments and quantitative measures to stress-test your valuation. A valuation is part art and part science," says De Lange.

Typical mistakes
A typical mistake, says Van Greunen, is to compare a business with another similar business and to derive a value from such a comparison. No two businesses are ever alike and there are always unique features that will increase or decrease the value of the business.

"The idea that value relates to asking price is absurd and one should resist from referring to asking price if such is totally out of line with the market value," warns Van Greunen.

A business needs profits before assets represent any value. Without profits – or potential profits – a business is worthless and so are its assets.

Mothilal says they often come across private expenditure of the shareholders and directors being expensed through the business. This is particularly the case in smaller owner-managed businesses.

"This has the effect of inflating expenditure, lowering profits and decreasing the value of the business if not identified during the valuation process."

The worth of a good valuation
A well-founded, defendable valuation enables the business to make informed decisions. It eliminates the regulatory risk of non-compliance and enhances corporate governance.

It enables the company to understand which of its underlying investments are reducing value and what is the strategic route to manage that risk, says De Lange.

Although value may be a perception, the application of common sense and good judgment has never failed the prudent investor, notes Van Greunen. ■

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