VALUING A BUSINESS

[1]Key issues

- Valuing a business is an art not a science and one that is not simple to work out using one set formula. We suggest that you should use a professional such as an accountant or business broker to help in determining the value of a specific business.
- It is impossible to rely on rule of thumb methods for valuation due to the fact that every business is different. The problem is that these formulas don't address all factors that can affect a company's value.
- A fair market value for a business can be defined as a price at which a buyer and seller can agree taking into consideration all information available to both parties.

Determining the value

Factors that need to be considered for a business to obtain a fair market value are:

1. The recent profit history of the business
2. The existing conditions of the business (plant and stock and accuracy of the books and records)
3. Market demand (dependant on industry)
4. The ability to transfer goodwill to the new owner (the intangible value to a new owner)
5. Future potential profit
6. Economic conditions (such as government compliance costs)
7. Value of any intellectual property (design software etc)

There are of course a number of other aspects that have to be looked at to determine the fair market value (FMV) as businesses rarely change hands due solely to these factors.

Method One:

Return on Investment (ROI)
Also known as the Capitalised Earnings Method.

This is one of the most common methods used for valuing businesses. An example follows:

Phil's Photography produced an adjusted net profit of $120,000. The net assets (plant and stock) were $140,000 and Phil paid himself a salary of $50,000. If someone was looking to invest in the business they would probably expect a 30% ROI, as Phil's photos was seen as a low-medium risk investment opportunity.

Note: Most businesses require a return of 20% for low risk up to 50%+ for high-risk businesses.

To work this out …

Net assets	$140,000
Goodwill asked	$75,000
Asking price	$225,000

If you have any questions, please call **0800 CHAMBER (0800 242 623)**.

Return on Investment (ROI)

Desired return (based on risk)	30%
Purchase price	$225,000
Required return	$64,500
Net profit	$120,000
Minus Owners salary	$50,000
Profit	$70,000

In this example Phil's Photography meets the return on investment with $70,000 profit forecasted and $64,500 being the desired rate of return!

Method Two

Asset Based Valuation

In some instances a business may be worth little more than the value of its tangible assets or the buyer of a business may wish to sell the assets immediately after purchase. In this instance the sale of equipment, inventory and other assets will make up the value of the business. The assets value can range from where they are priced as a going concern, ie. assets are valued as a working part of the business, or at salvage value where the assets would only be worth what they can be individually sold for.

Note: These are a couple of basic methods that can be used to assist in gaining a FMV remembering that there are a number of different methods that can be used depending on the different type of business you are looking to value, eg. a service industry business compared with a manufacturing industry business.

General Issues

- One of the main points to remember is that valuing a business is not a quantitative process due to the fact that there are too many variables to consider for each individual business and professionals should be used to help determine these values.
- The process of due diligence should undertaken which means checking that all data and records provided by the seller are in fact proven to be correct.
- Consideration should also be given to the fact that smaller and larger organisations will be looked upon differently due to the fact that the larger business are established and less likely to fail.
- Often professionals will give 'opinions' of valuation and provide clients with ballpark figures rather than a set figure. Full valuations require a high level of investigation and compliance and are therefore detailed and expensive.

This article is based on information kindly provided by Ross Erskine, Staples Rodway Chartered Accountants and Richard O'Brien, NZ bizbuysell , websites www.staplesrodway.com, www.nzbizbuysell.co.