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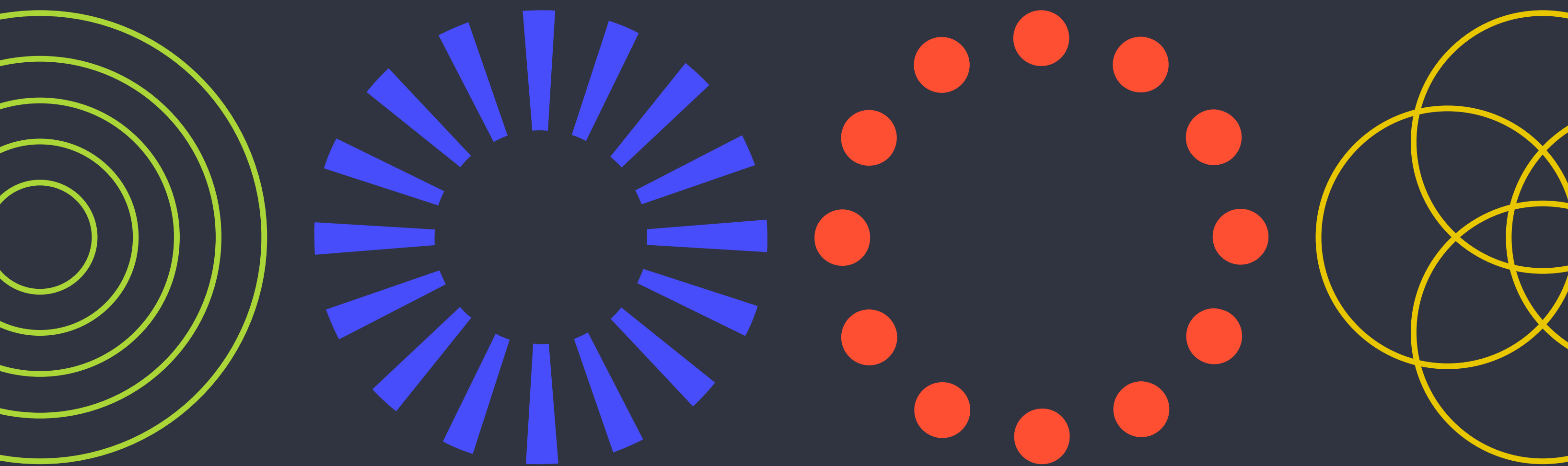
How to Value an SME—Part 3

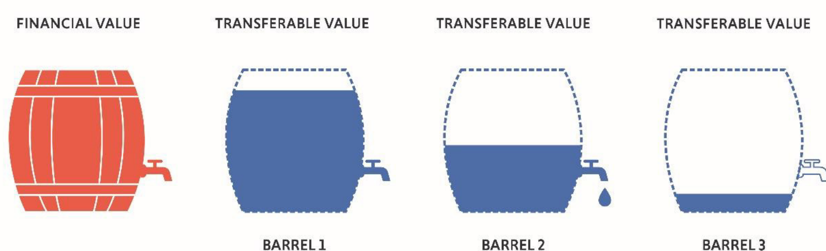


BUSINESS BY DESIGN

How to Value an SME—Part 3

There Are Two Elements to Consider When Valuing an SME:
• Transferable Value
• Financial Value

Financial Valuation Methods



The seven methods I tend to use are:

- Balance Sheet Valuation
- Discounted Cash Flow (DCF)
- Multiple of EBITDA (earnings before interest, tax, depreciation, and amortisation)
- Multiple of Recurring Revenue
- Return on Investment
- Cash Payback
- Cash Flow Valuation

In order to achieve a balanced valuation, I always use and would encourage you to use at least three methods to value a business. This will give you a good all-round picture of the business and creates a balanced view.

The three I use most often are:

- Multiple of EBITDA or Multiple of Recurring Revenue (whichever is more applicable)
- Return on Investment
- Cash Flow Valuation

Why not balance sheet valuation? The value of the balance sheet has little bearing on most SMEs unless the owner wants to liquidate the business or there are some high-ticket items such as property, plant, or machinery. For a lot of SMEs there won't be much in the way of tangible assets.

Why not discounted cash flow (DFC)? DFC is typically used in large corporations because, as with larger businesses, the future is more predictable compared to a general SME. However, if the small- to medium-sized business has a few long-term contracts or has a subscription-based model, this could be used.

Before further discussing multiples of EBITDA or multiple of earnings, return on investment, and cash flow valuation, let me remind you that with the use of any of these for valuing a company, there is always going to be an element of disagreement where the seller only sees the highest valuation number and the buyer only sees the lowest valuation.

Each buyer will view what your business will be worth to them based upon their situation and their requirements. As a seller you'll have no control over which buyer will consider your business or how they will value it. This is all very subjective and you could end up with being offered more for your business than you were expecting and in the same way you could be offered less. What I want to do is give you, the seller, some control over this process and for you to determine the value of your business that no buyer can argue against or disagree with you about it. One of the keys to valuing a business is being able to show a buyer how you got to your valuation and being able to clearly justify to a buyer why you are valuing your business by that amount. All too often sellers tell me how much they want for their business but are not able to show me how they have calculated their valuation, and this tends to lead to the deal collapsing.

NOTE: *This is why it is so important that the Value Assessment Tool looks not only at your business plan but also your personal and financial plan. It is only through combining these three plans, by knowing exactly where you are, what and where your target destination is that you will be able to know what your business needs to be worth to achieve your goals and, more importantly, when those goals have been achieved. That way you will know exactly what you need to sell the business for and can confidently show any buyer how that valuation was calculated.*

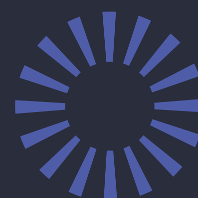
The first step to a financial valuation is to understand how profitable your business is. In some industries, revenue is used to value a business, for others net profit is used, but the proof of any business is whether it can make money—in other words, can it generate positive cash flow?

Multiple of EBITDA or multiple of Recurring Revenue:

Depending on the sector the business operates in, the valuation is based on an EBITDA or a multiple of recurring revenue. These multiples can vary significantly by sector.

To give you an example:

Multiple of EBITDA			Multiple of Recurring Revenue		
EBITDA:		£100,000	Recurring Revenue:		£400,000
Agreed Multiple of:	x	2.5	Agreed Multiple of:	x	1.1
Business Valuation:		**£250,000**	**Business Valuation:**		**£440,000**



NOTE: *Even if you are using a multiple of recurring revenues to calculate the business valuation, it will still be very dependent on how profitable the business is. Remember the two needs that every buyer has: the return on investment and the ability to service any debt. If this business with a valuation of £440,000 is only producing £20,000 in net profit, then that valuation will not make financial sense and is far too high, unless of course there are extenuating circumstances at play, such as intellectual property, trademarks, products, or services that will be valuable to a buyer to command such a valuation.*

Return on Investment:

This method is based upon the annual return a prospective buyer would look to generate from the investment. This will differ between buyers, but the typical ROI will be between 25% and 35%

To give you an example:

EBITDA:		£100,000
Assume ROI of:	x	35%
Business Valuation:		**£285,714**

Cash Flow Valuation

The process that I am going to share with you now is to calculate the value of your business based solely on its performance, which, as the seller, you control. It works in a similar way as how a bank would assess your ability to pay back a loan or a mortgage. This is really a sanity check to ensure the valuation placed on the business is realistic and should hopefully appeal to the widest possible audience of buyers.

This method is called the cash flow valuation method. The reason it is called the "cash flow" valuation method is because we will be using the cash flow generated by the business to calculate its value. The only reason why acquisitions are made is to buy the cash flow generated by that business, which in theory should be as close to the net profit as possible, providing the business has a handle on the six keys that control cash flow.

This method will ask you to input four numbers:

1. The company's EBITDA, or you can use net profit if you do not have the EBITDA to hand
2. Any tangible assets the business may have, i.e., vehicles, plant, machinery, anything a buyer could use to obtain asset finance on
3. If there is any debt in the business, that will need to be included here.
4. Then you need put in an amount, or the market rate, to replace you with an employee/s to carry out all the work you do within the business.

Regarding the fourth input: this could be a rather complex question in itself and requires further clarification. If you have no involvement in the business at all, then the amount will be zero. These zero amounts may apply to you, but it will be for the vast minority of owners. Let me explain why.

As the owner of your business, I suspect you wear a number of different hats and probably do the work of at least two to three people. Take a sober look at everything you do within the business and determine how many people you would need to realistically hire to replace everything that you do. For example: you may need to hire a branch manager and the going salary for that position could be around £40,000 pa. You may need to also hire an administrative person and that salary could be around £15,000 pa. It could be an engineer, an operational manager, any person or people you would need to hire to carry out all the work you currently do within your business. Add them all up and place the total figure in that last box.

The reason for using cash flow valuation method is that it removes all emotion and opinions from the valuation and looks at the harsh reality of how the business is performing. Although this way of calculating the value of your business may seem unfair or inaccurate, it does take into

account the worst-case scenario—if you had to sell the business quickly. However, this method does leave you, as the business owner, in complete control because you and only you are responsible for your company's results. If the value of the business is not where you need it to be, look at your business to see how you can reduce the company's debt, increase its profits, and remove yourself from the day-to-day operation of the business.

The good news is that you are in control. Improving your cash flow and/or the net profit your business generates will improve your businesses financial valuation as well as your ability to sell it. By changing your results, you change your ability to sell your business, and it gives you the most options available for the future, not to mention the best returns on investment in the present up to that future exiting date.

To find out more about how to value a business please visit www.businessbydesign.co.uk.

In the hustle and bustle of running a business it is very easy to take your eye off the ultimate end goal—successfully exiting your business. Keep focused and do not be afraid to ask for help.

Would you like to make sure your business is ready for sale? Learn more about how we can assist you. Please contact Cliff at Business By Design for a free confidential phone call to see how we can assist you.

Written by Cliff Spolander

Founder of:
Business By Design— Value Creation Process
Business Optics

Author of:
The Cash Flow Code: 6 Keys to Unlocking Ultimate Cash Flow
The Smarter Exit: A Strategic Plan to Grow and Exit Your Business

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