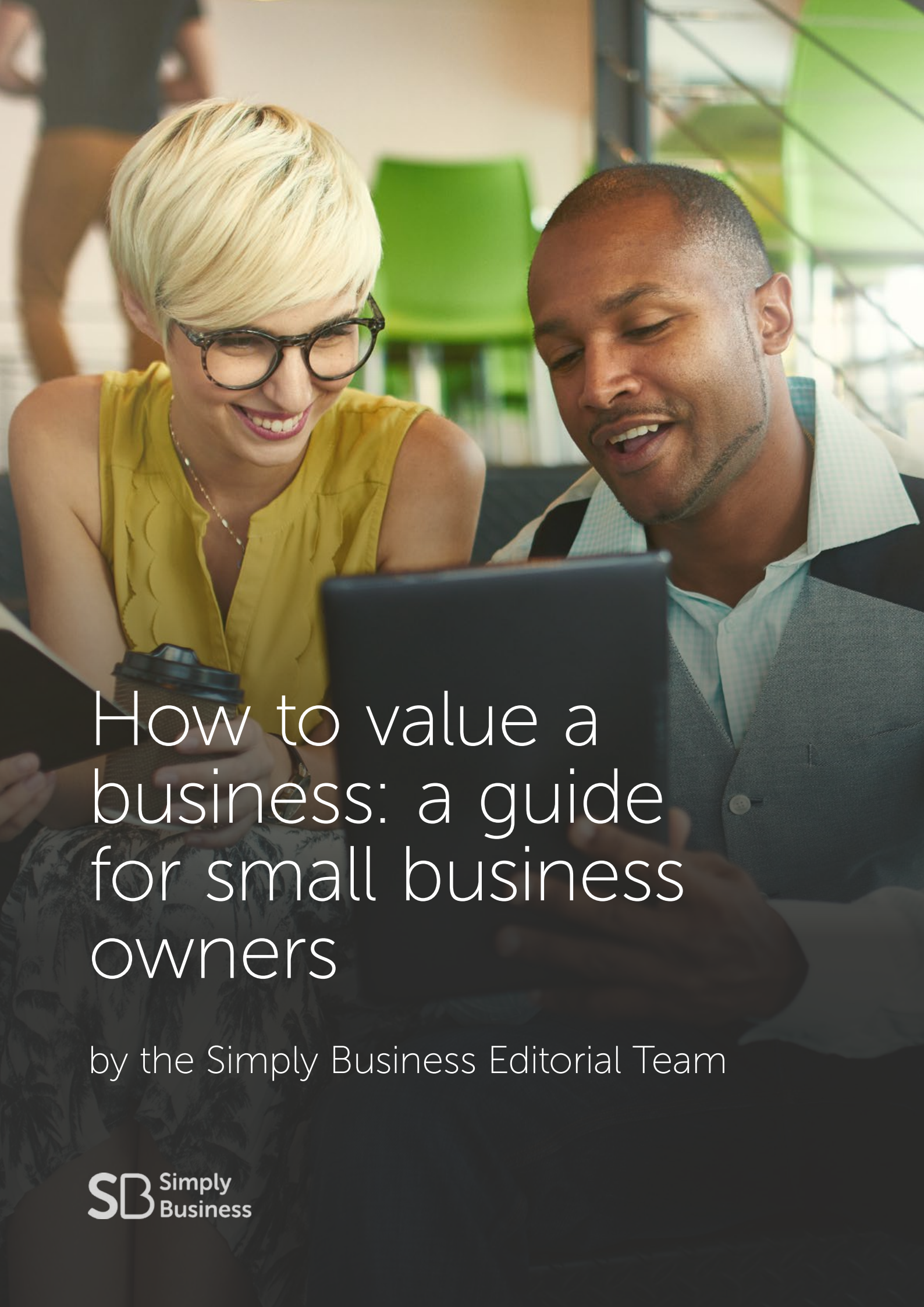

How to value a business: a guide for small business owners

by the Simply Business Editorial Team

Simply Business

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Valuing a business

It's often said that a business is only worth what someone is willing to pay for it, but there are several methods you can use to reach a sensible figure.

Contents

What is a business valuation?

A business valuation helps you determine the market value of your business. By using a range of measures, you can understand the economic worth of a business. This is useful for entrepreneurs and small business owners looking to buy or sell a company.

A company valuation can also help when:

- **securing investment** – think of Dragons' Den, where investors want to see a realistic figure and value in the deal you give them
- **setting a fair price for employees** – if your employees want to buy and sell shares in the company
- **growing or expanding your business** – an annual valuation helps to secure funding and focus your energy on areas for improvement
- filing your taxes – you might need to provide valuation figures as part of your company tax return
- **establishing a** business partnership – or buying out an existing business partner

Ultimately, you want to reach a valuation that doesn't sell the business short. It also shouldn't overstate what the business is actually worth.

It's tricky to find a balance – if you're finding the valuation easy, you might need to revisit your method. It's a good idea to combine a couple of valuation

What affects business valuation?

While there are some parts of a business you can value easily, there are always going to be intangible assets.

Beyond stock and fixed assets (like land and machinery), which are tangible and have clear value, you should also look at:

- the business's reputation
- the value of the business's customers
- the business's trademarks
- the circumstances surrounding the valuation (like a forced sale rather than a voluntary one)
- the age of the business (consider startups making a loss that have lots of future potential, versus established profit-making companies)
- the strength of the team behind the business
- what kind of product you have

These intangible assets make it fairly difficult to reach an accurate valuation, but there are a number of techniques you can use to make it easier.

How do you value a business?

There are a few approaches you can take when it comes to how to value a company. We explain more on each of these below.

1. Price to earnings ratio (P/E)

Businesses are often valued by their price to earnings ratio (P/E), or multiples of profit. The P/E ratio is suited to businesses that have an established track record of profits.

Working out an appropriate P/E ratio to use can be driven by profits – if a business has high forecast profit growth, it might suggest a higher P/E ratio. And if a business has a good record of repeat earnings, it may have a higher P/E ratio, too.

> As an illustration, using a P/E ratio of **four** for a business that makes **£500,000** post-tax profits means it would be valued at **£2,000,000.**

How you arrive at the right number for your P/E ratio can vary dramatically depending on the business. Tech startups often have high P/E ratios, because they're usually high-growth companies. A more common high-street company, like an estate agency, will have a lower P/E ratio and is likely to be a mature business. You can see quoted companies' historic P/E ratios in the financial section of the papers.

And as the shares of quoted companies are easier to buy and sell, they're more attractive to investors. Smaller, unquoted companies usually have around a 50 per cent lower P/E ratio than their quoted counterparts.

Because P/E ratios differ wildly, there isn't necessarily a 'standard' ratio that can be used to value all businesses. Having said that, a business adviser might suggest a valuation of four to 10 as a P/E ratio.

2. Entry cost

This is a simple one – how much would it cost to set up a similar business to the one being valued?

You need to factor in everything that got the business to where it is today. Make a note of all the startup costs, then its tangible assets. How much would it cost to develop any products, build up a customer base, and recruit and train staff?

After that, think about savings you could make when setting up. If you can save money by locating the business somewhere else or by using cheaper materials, subtract that from the figure.

When you've taken everything into account, you've got your entry cost – and a valuation.

3. Valuing the assets of a business

Stable, established businesses with a lot of tangible assets are often suited to being valued on these assets. Good examples of businesses like this are those in property and manufacturing.

To do an asset valuation, you need to start with working out the Net Book Value (NBV) of the business. These are the assets recorded in the company's accounts.

Then, you should think about the economic reality surrounding the assets. Essentially, this means adjusting the figures according to what the assets are actually worth.

For instance, old stock depreciates in value. If there are debts that aren't likely to be paid, knock those off. And property could have changed in value, so refine those figures, too.

4. Discounted cash flow

This is a complex way of valuing a business, relying on assumptions about its future. The technique is suited to mature businesses with stable, predictable cash flows – think of utilities companies.

Discounted cash flow works by estimating what future cash flow would be worth today. You can reach a valuation by adding the dividends forecast for the next 15 or so years, plus a residual value at the end of the period.

You calculate today's value of each future cash flow using a discount rate, which accounts for the risk and time value of the money. The time value of money is based on the idea that £1 today is worth more than £1 tomorrow, because of its earning potential.

Normally, the discount interest rate can be anything from 15 to 25 per cent.

5. Industry rules of thumb

Buying and selling businesses can be more common in particular industries, so those industries might have certain rules of thumb that you can use as a guide. They'll be based on things other than profit.

Let's look at retail. Rules of thumb here mean that businesses are valued on factors like business turnover, how many customers it has, and its number of outlets.

It's a good way for a buyer to value the business based on how they expect to shake things up and get operations to industry-standard.

6. A valuation based on what can't be measured

This brings us round to what we said at the beginning – a business is worth what someone is willing to pay for it. Intangible assets mentioned earlier could be considered here, with negotiation skill playing a part, too.

If the business has desirable relationships with customers or suppliers, it might be more valuable to a buyer.

If the buyer doesn't have a stable team behind them to take the business forward, a strong management team (that won't jump ship) could also add value.

And each prospective buyer might see different risks, variably lowering the value. The key as a business owner is to pre-empt any risks and minimise them.

How do you value a business based on turnover?

Business turnover is when you work out your business income over a set period of time (for example the tax year). This is the number of sales you've made – also known as the 'net sales' figure. However, this mustn't be confused with profit, which is your earnings after deducting expenses.

Calculating turnover is a useful step to understanding the health of your business fairly quickly, but will need to be compared to gross profit and net profit to give a full picture. Read our guide on how to calculate business turnover to find out more.

How much is my business worth?

As we mentioned earlier, valuing a business can help you focus on areas for improvement. There are lots of things you can do to help secure a good valuation, including:

- **planning ahead**: have a solid business plan, with a focus on how you're going to achieve both short-term and long-term results
- **reducing risk**: for instance, if you rely on a particular group of customers, consider diversifying
- **putting great processes in place**: think about how you store information, whether it's financial records or simply how the business works. Often, the more you can show, the higher the confidence in the business

What works for one business won't always work for another. By giving an overview of several popular business valuation methods, though, we hope you're closer to understanding how much your business is worth.

General finance and accounting guides

For more tips and resources on accounting and finance for small businesses, check out the links below:

- get a snapshot of the health of your business with our guide to doing a balance sheet – it shows your business's assets and liabilities
- keep track of your business income and expenses with our free budget calculator template and guide
- understand how to increase profit of your business

Business finance is a complex topic. Please treat this article as a guide only and get professional advice if you're not sure about anything.

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