Stephen Larsen and Co
TAX AND BUSINESS ACCOUNTANTS

Guide: Valuation of a business

This guide gives an overview of valuation methods and looks at valuation as a step in the planning process for business succession.

Motivations

It is always interesting to explore factors that motivate the buyer and the seller. However, in questions of value, the fair market value standard of value contemplates a transaction between hypothetical and informed parties. Therefore, their individual motivations do not matter.

Valuation Methods

Common methods of assessing business or share valuations are:

- Discounted cash flow
- Capitalisation of future maintainable earnings
- Capitalisation of future dividends
- Net assets value
- Liquidation value

See the table at the end for more detail on valuation methods.

Valuation as a step to succession

Valuing the business is a fundamental element in the succession process.

An early valuation reality tests a business owner's view of the business' value. It is not uncommon for there to be a gap between an owner's expectations around value, and the commercial realities of what the market is prepared and likely to pay.

This valuation expectation gap is best flushed out early in the process and sets a "stake in the ground" for the beginning of a business improvement programme.

Developing a succession plan

Two key questions need to be considered early on in succession planning.

1. What needs to be done to prepare the business for succession?
2. What can be done based on the timetable agreed?

It may well be that the succession plan needs to be fast tracked for whatever reason, be it health of the owner, the owner's procrastination or sudden desire to quit the business, or even an unanticipated approach from a competitor who expresses a keen desire to acquire the business.

Given that we don't always have the luxury of the ideal succession time frame on our side, it's useful to establish the early yardage factors that we should prioritise.

Four key areas

There are four key areas to consider when grooming a business:

1. Structuring
2. Housekeeping
3. Risk management
4. Value enhancement

Time frame

What you can achieve in the preparation stage primarily depends on the time frame chosen. To achieve a sustainable value difference probably requires a minimum of three years in most businesses.

If less than a year is available to complete succession, it is likely that only housekeeping matters can be addressed.

Priorities in a short time frame

1. Complete the diagnostic analysis of financial and non-financial matters
2. Complete an internal due diligence on business risks
3. Take action to remove any obstacles to succession planning success
4. Identify any surface enhancements that can be made to the business to improve its saleability and value

Valuation methods summarised

Method	When Appropriate
Capitalisation of future maintainable earnings	
▪ Based on a future maintainable earnings stream to which a capitalisation multiple is applied.	▪ Suitable when valuing large or controlling interests in a company that is mature with a single growth outlook.
▪ Results of the business for the past five years should be obtained.	▪ Applied when the historical earnings pattern is sufficiently stable and predictable of the earnings that can be expected in future, or where forecasts are reliable enough to allow reasonable estimates of future earnings to be made.
▪ Results should be adjusted for abnormal and extraordinary items which distort earnings or which are not expected to recur.	▪ If a company has a history of losses, declining profits, liquidity problems or in a volatile market this method should not be used.
▪ Forecasts for the next two years should be obtained.	
▪ The capitalisation multiple will be determined by risk and growth expectations.	
Capitalisation of future dividends	
▪ This method requires an assessment of maintainable dividends and a dividend yield appropriate for that business.	▪ Normally applied when valuing small or minority shareholdings.
	▪ Shareholder has no real say in the company and therefore no control over dividend policy.
	▪ This method is not appropriate if the company does not have a history of paying dividends.
Discounted cash flow	
▪ This method uses realistic forecasts of future cash flows	▪ This method is suitable where the future performance is likely to be significantly different from past performance, or where cash flows are expected to fluctuate substantially over time.
▪ This method requires modeled free cash flows after excluding depreciation, amortisation and accounting for expenditure on capital items and working capital investments.	▪ This is the primary valuation method and most other methods are derived from discounted cash flows.
▪ Items influencing the discount rate will include current interest rates and assessments of risk.	
Net assets value	

▪ This method requires all tangible assets to be valued and liabilities deducted to arrive at a net tangible assets value.	▪ This method is appropriate where a sole trader or professional practitioner is selling net assets plus goodwill, or if the assets and liabilities are already marked to market, at fair value. ▪ Other relevant situations include when the entity being valued is a holding company with investments that are recorded at fair value.
Liquidation value	
▪ Net assets are valued and adjusted for liquidation costs, losses, and profits on realisation of stock, debtors and other assets, and tax on undistributed profits.	▪ Appropriate where liquidation is contemplated.
Tangible assets plus goodwill based on super profits	
▪ This method assesses the net value of assets to be sold. Goodwill is added to arrive at the total sale price. ▪ This method values an earnings stream plus net tangible assets. ▪ This method generally lacks external valuation evidence to support the valuation conclusions.	▪ Typically used for sole traders or when the valuations are highly indicative and based on rules of thumb.

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Last reviewed on 5 August 2024