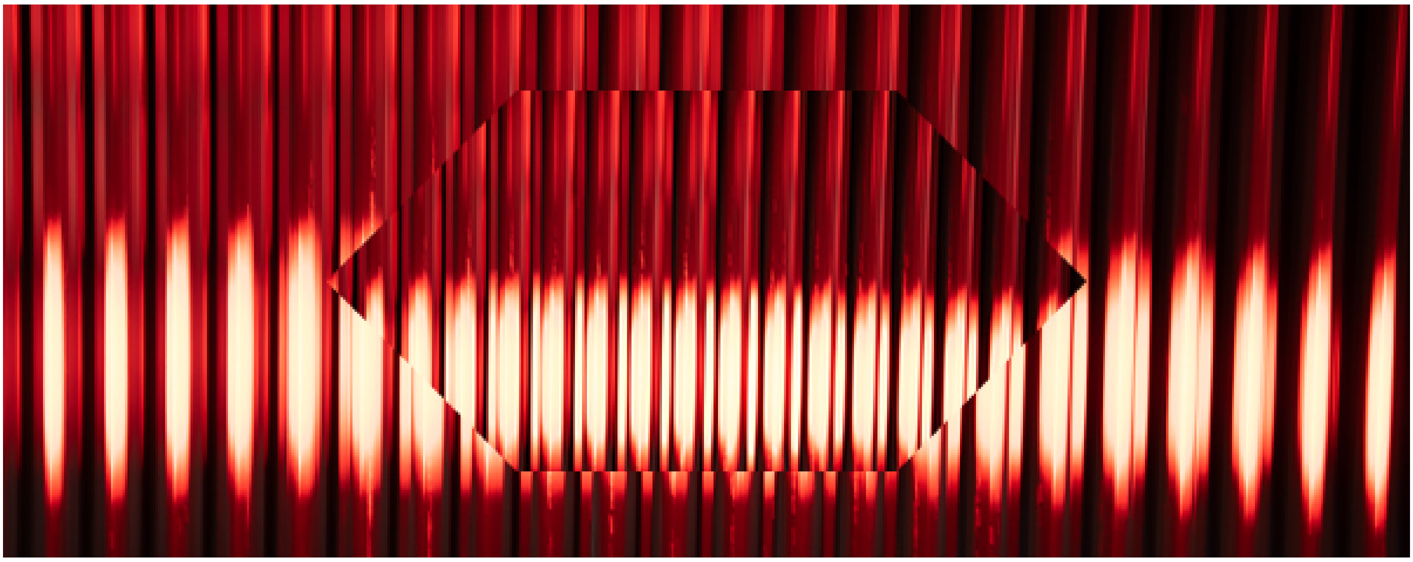
Beyond Business Ownership: How to value your business



A robust valuation is important when it comes to selling, which is why owners often turn to professionals for support. In this article, we explore the fundamentals of business valuations, including the key methodologies typically used, how to tailor your approach and the importance of spotlighting your business strengths.

The fundamentals of business valuation

Valuing a business is a complex exercise and understanding the strengths and weaknesses of a business can set the scene for a more manageable and predictable process.

1. **There are several methodologies used to value a private business, with three being more commonly used in practice.** These are discounted cash flow, asset-based valuation and comparable company analysis.

   "**Discounted cash flow** looks to determine whether an investment is worthwhile based on future cash flows generated by the business," explains Russell Prior, Managing Director and Regional Head of Family Governance, Family Office Advisory & Philanthropy, HSBC Private Banking in EMEA. "**Asset-based valuation**, however, looks at the company asset value after deducting liabilities – but does not consider a company's future earnings potential."

   "**Comparable company analysis**, meanwhile, relies on finding data from businesses similar to yours and works on the assumption that they will have similar valuation multiples applied to EBITDA (earnings before interest, taxes, depreciation and amortisation)" says Andra Ilie, Senior Adviser, Family Governance, Family Office Advisory & Philanthropy, HSBC Private Banking in EMEA.

2. **Diving deeper into 'asset-based valuation' methods, EBITDA[1] is one of the most commonly used approaches for private business valuations** and more specifically, for private equity. This is often due to the method being considered a more reliable indicator of a company's operational efficiency and financial capabilities – enabling investors to focus on baseline profitability. "In order to get your enterprise value, you take your EBITDA figure and multiply that by a number that is relevant to your industry," explains Amar Shanghavi, Investment Director, MML Capital Partners.

3. **In practice, obtaining multiple valuations from different advisors can be beneficial. With several methods widely used across industries, business owners typically seek a number of valuations to form an accurate picture of their business' worth.** Paul Herman, Group CEO, Blue Box Corporate Finance says, "I'd argue that valuation is an art, not a science. It's also important to make sure that the valuations you get are balanced, fair and representative of what you genuinely think you'll achieve when you go into the market."

Why understanding the value of your business matters

Every business owner is looking to maximise the value they receive for the business they have built and grown over a significant number of years, and understanding its financial value is a key (although not the only) part of the process.

1. **You need a clear view of the value you expect to obtain before going to market to help set and manage your expectations.** "You need to be able to benchmark the valuations you get," says Shanghavi. "What's more, your business will be worth different amounts to different people. Knowing what could drive valuations is important because you could maximise those features during the sale process."

2. **If you receive an unexpected bid, it may be an opportunistic or a strategic one – and knowing how to differentiate between the two is important.** "The way to distinguish this is to carefully read everything in the offer letter that's not the number," says Shanghavi. "How thoughtful have they been? Can they talk knowledgeably about your business?"

3. **Be aware that buyers might use certain tactics to try to lower the sale price – and it is within your abilities to manage and respond to it constructively.** Herman stresses the need for competitive tension here: "Make certain that the buyer gently knows that they're not the only person in the ring," he says. "Secondly, ensure that you're not coming to the market at a point in time where you desperately need to sell – buyers will be able to sense this."

Tailoring your valuation approach: Real Estate

Each industry has a different set of characteristics and understanding what those are and how they impact valuation is critical. When it comes to real estate, having a mostly illiquid, asset heavy balance sheet will bring its own complexities.

1. **Firstly, establishing the buyer universe is crucial.** Andrew McDonald, Head of Real Estate Finance, HSBC UK says, "This includes establishing who the buyer of the property is, what their interest is in acquiring the underlying property and what they're looking to achieve in being the owner."

2. **Valuation methodologies between commercial and residential properties can be vastly different.** "It's not about whether or not they are commercial or residential properties," McDonald continues, "but whether they are investment properties or owner-occupied properties."

3. **Finally, business owners need to unpick the constituent parts of their balance sheet to understand the types of buyers that would suit them best.** "If you're selling a business on a 10 times multiple, but you have investment properties valued on a 5% yield – i.e. a 20 times multiple – it's important to ensure that you're able to maximise value and target specific buyer sets for each of the parts of your business," says McDonald.

1 EBITDA = earnings before interest, taxes, depreciation and amortisation

Tailoring your valuation approach: Tech

For innovative, fast-moving businesses within the technology space, the lack of tangible assets and unpredictability of future profits will be core considerations in the valuation exercise.

1. **First of all, it is important to understand the main categories of technology businesses for valuation purposes.** Roland Emmans, Head of Technology at HSBC UK, discusses two broad categories. "These are software, which includes software as a service, and then there's 'everything else'. And in the 'everything else' category there is hardware, data centres, cloud, consulting businesses and managed services."

2. **Valuing tech firms is not straightforward and unpicking what they do and where their strengths lie is critical.** "Before you get anywhere near valuing a firm, you've got to understand what it does," says Emmans. "Technology is rife with jargon and cutting through that jargon is really hard."

3. **Finally, the question of whether a business owner can explain their business in three sentences needs to be addressed.** Emmans explains that entrepreneurs live and breathe their companies, but "sometimes they struggle to simply explain what their business does." He suggests that owners need to be clear about why people buy their products or services, why they value it and who the end buyer is. Having answers to these questions will help a potential buyer better understand where the value sits.

Tailoring your valuation approach: Franchise

Valuing a franchise business has its own intricacies, not least driven by the significant premium linked with the intangibility of the intellectual property, branding and often, streams of royalties.

1. **What makes valuing a franchise business different from another industry?** "Most mature franchise brands have an established secondary resale market," says Gillian Morris, the Head of Franchising at HSBC UK. "And often a franchisor will have a target list of potential acquirers already lined up. That said, unlike a standalone business, the franchisee cannot sell their business without the approval of the franchise owner."

2. **Another aspect that makes franchise businesses different is the fact that having a single unit or a franchise outlet can cap potential growth.** "This means that growing organically or acquiring neighbouring territories can really accelerate a franchise's potential – enabling the franchise to leverage the economies of scale and the span of control," continues Morris.

3. **What other factors can affect the valuation of franchise owners' business?** Morris believes that a franchisee's main focus is their operational excellence. "This includes operational standards, customer satisfaction and brand performance indicators," she explains.

How to spotlight your business strengths

Knowing how to show your business in the best possible light before a sale can make all the difference when it comes to the valuation achieved, and there are actions that business owners can take prior to a sale.

1. **Having a strong management team is of critical importance.** "Strong leaders will ensure that the deliverability of the transaction is enhanced," says Paul Herman. "They also give you a much broader range of purchasers to approach, because some people will want to rely on a team that's already in situ and able to carry the business forward."

2. **Increasing your bargaining power matters.** For Herman, the key is making sure that the potential buyer is aware that there are other suitors out there and they are also interested in the same asset – once again, creating competitive tension can help.

3. **Start early on your exit.** Herman believes that three to five years can be an appropriate timeline for planning an exit. "My top tip would be to develop an opportunity map that shows a purchaser how the business is going to grow in terms of new products, services, channels, territories and initiatives." It is important to remember that buyers are interested in the perceived potential and future value of the business and not the present one.

To conclude, business valuation is both an art and a science, with multiple methodologies and industry specifics to consider. That said, certain steps, such as building a narrative for your business, preparing in advance, building competitive tension and highlighting the strength of your management team can give business owners a head start in the process.