The multiple benefits of understanding your company's value

When it comes to business value there are really four categories of owner:

- Many business owners go through life happily ignorant of even the approximate value of their business.

- Others assume that it is worth considerably more than it would be if it were put up for sale.

- And yet others would be pleasantly surprised to know just how much value there actually is.

- A much smaller group have done their homework and have a good understanding of where their value lies.

Where do you fit in?

It's good to know

There are many benefits to knowing what your business is worth or at least having a sense of its value relative to other comparable businesses. These benefits may present themselves at different times and for different reasons. In summary these are:

- It's time to sell to your competitor

- It's time to sell or gift the business to your children

- It's time to sell to your employees

- It's time to go public

- It's time to sell to a private investor who will keep you on as a manager

- It's time to start to plan for retirement

- Your marriage has failed and you need to parcel out your family assets

- You have fallen out with your other shareholders

- It's time to get a grip on where the value in your company lies as part of a wider plan to manage your company more strategically.

Of course there are many variations on these circumstances. Whatever situation you are in however, a full understanding is essential, not only of the approximate value of the business, but, more importantly, how that value is determined.

Key to understanding the value of your business is an understanding of what value really is. Business owners often tell me that their business is worth X times the average of the last 3 years' earnings, because that's what their buddy got for his or her business. This is almost never accurate.

Value is best understood as the inter-relationship between two key factors:

Opportunity and Risk

Value, essentially, is the **inverse relationship between opportunity and risk**: the better the opportunities or prospects, the higher the value. The higher the risks, the lower the value. More of this later but first let's look at what opportunity and risk entail.

Opportunity is the thing that gets most business owners up and working every day. It's the chance to sell more widgets, invent new products, open new markets, lower your costs, increase your margins, improve your cash flows, meet the challenges of the economy, and so forth. It's overwhelmingly exciting and mostly positive. It shows itself in your sales, your profits and your cash flow. It's the lifeblood of the business.

Risk, on the other hand, is what keeps you awake at night. Will my competitors move into my market and undercut me on price with a better product? Will my employees leave or slacken off? Will my products become redundant in the face of technological change? Will new legislation make my business less profitable? Will my projections simply not pan out? Will the economy slow down and lessen the demand for my products and services?

The starting point to understanding the value of your business is a realistic analysis of your opportunities and risks. A SWOT analysis (Strengths, Weaknesses, Opportunities, and Threats) is an excellent way to do this: the opportunities, naturally, point to the Opportunities side of the value equations, the weaknesses and threats will highlight the risks, as mitigated by the strengths.

I suggest you devote a healthy amount of time to this exercise. Many businesses will plan a retreat away from the office for it. Input can come just from senior management or from all levels of staff. If you can, get some feedback from customers and clients. Your commercial bank account manager and / or your external accountant could also help.

There are many things you can and should look at in your SWOT analysis but two things stand out from (and to a large extent capture) everything else: **management** and **product**, (the jockey and the horse).

Management is one of the most important, if not the most important, aspects of your business. With a bit of thought, it is easy to understand why. Companies, on their own, are inert legal vehicles, they cannot make decisions. Only people can. Decisions, large and small, are what move a company forward, or backward. It is therefore **critical that the people in the company can make the right decisions**. Good decisions can help even the most challenged company. Bad decisions can bring down the most successful. Your SWOT analysis should therefore start with the people in the organisation: how do they contribute to the strengths and weaknesses in the business? Do they recognise the opportunities and threats? Are they good decision makers? Would the company miss them if they left?

Your **product**(s) likely meet certain needs within an industry group. You should therefore take a long, hard look at the industry you are in and figure out if the direction your business is taking is in line with the general direction of the industry. **Product obsolescence** spells **doom** unless it is recognized early and responded to in a timely manner before it sets in. Factor in that the competition is not just other businesses producing the same or similar products. It is also other businesses producing alternative products that fulfill the same needs; these alternative products may be very different to yours. **Airlines don't just compete with other airlines**; they also compete with all other ways of getting from A to B. Do not assume that your product, however well it is currently received, will always be in demand.

Your own business will dictate exactly what **other attributes**, and there will be many, you should consider in your SWOT analysis and what importance you should attach to each. Access to financing, for example, could be a big issue; reliance on a major customer could be another. You will be the best judge if you are honest and take your time. But remember, the greater the risks, the lower will be the value of your business. List all the risks and, as a follow up exercise to the SWOT analysis, consider how you could mitigate all the weaknesses and threats you found. This is the **key to growing the value of the business**: everyone faces risk and uncertainty; it is only those who tackle those issues successfully who will see the value in their businesses grow.

Finally, **look at your own role in the business**. Most owner managed businesses are hugely reliant on their owners but this is very much a **two-edged sword**. While the owner can be a great benefit to the business, when it comes time to sell it is unlikely that this benefit will pass on to a new owner. I have a few more comments on this at the end of this article.

Value is not an exact science

It is not critical for you to know exactly what your business is worth. Even two trained experts, such as Chartered Business Valuators, may disagree as to the exact value. However it is important for you, as an owner, to have a sense of the **relative worth** of your business. There's not a lot you can do about the general economy but you can get a measure of your worth by assessing yourself on the things that you can control. Comparative analysis within your industry will help. Among your peers are you in the top quartile or the bottom quartile? How do you know? Make a list of your top 5 competitors. To the extent that you can, compare yourself to them on the basis of (you can make your own suitable list but here are some to start with):

- Market share
- Management capabilities
- Dependence on the owner manager
- Dependence on key customers
- Employee "bench strength"
- Other assets employed in the business
- Other dependencies
- Product strength

Consider this one question: would you, as an independent outside investor, prefer to invest in your business or in one of your competitors? Your answer will likely indicate where you fall on the relative value spectrum.

Value attributable to the current owner

Two of the most vexing questions in all matters related to the value of owner managed businesses are (a) how much of the value is attributable to the current owner and (b) how much of such value is transferable. This challenge is particularly important when planning to sell the business. It is a fairly common phenomenon that **owner managers place a higher value on their businesses than an outside**

expertor third party buyer would and this can lead to a major mismatch between the asking price and the price offered by a buyer. The reason why is easily understood if we go back to the basic valuation formula involving opportunity and risk, especially if we remember that **risk has an inverse effect on value**. Most owner managers have a very sound understanding of the weaknesses and threats in their businesses and how they have managed these in the past. They know the business and are comfortable within it. In other words, **the owner's perception of the risk in the business is lower than the perception of an outside observer**. The value, therefore, is higher in the eyes of the owner than in the eyes of the outsider notwithstanding that they may agree on the opportunities for the business.

It could be said that the value attributable to the owner (the "**personal goodwill**") is the difference between (a) the value that he/she places on the business and (b) the value put on the business by an outsider; however this would be too simplistic. There is no assurance that either party is correct; **expert advice should be sought ahead of declaring either an asking price or an offer**. A Chartered Business Valuator should be well placed to provide such advice.

In calculating the value of a business a qualified valuator should be able to identify how much of the value in the business is personal goodwill. The key however is to distinguish between personal goodwill that is impossible to transfer (such as a surgeon's skills) and how much could transfer with just a bit of extra effort (such as a business owner's personal connections in the industry). I contend that with **cooperation between buyer and seller**, and the inclusion in the sale agreement of certain specified duties of a seller to the buyer, the seller will be able to provide greater assurance to the buyer that **elements of goodwill that have value prior to the sale will continue to generate value** after the sale process is complete. With such an assurance that intangible assets can be fully transferred the risk to the buyer is reduced and **the price should therefore be higher**. The specific duties that I refer to would include ways that the personal knowledge of the seller is transferred to the buyer within a specific time. For example, the seller should agree to introduce the buyer to certain, specified key suppliers and customers, to educate the buyer fully on the intricate details of the products, and/or to train any new staff brought in by the buyer on the systems in place that give the company an advantage.

Forewarned is fore armed

There is no necessity for a business owner to become an expert valuator. There are more important things for an owner to do. However a basic understanding of the key inputs to value will mean that you can have **a more informed and meaningful discussion** with the expert you hire, the prospective buyer, or anyone else who may challenge you on what you consider to be the value of your business. As in other aspects of life, forewarned is fore armed.

Paul Maarschalk CPA, CA, CBV August 2015