



How to determine the real value of your business

What can you expect someone to pay for your business?

If you have ever watched the television show *Shark Tank* you may have wondered with intrigue, and sometimes amazement, at the lack of “science” some of the contestants have in working out the value of their business (and the same can be said for some business owners off-air).

We use the word "science" intentionally because valuations are part art and part science. This means that a valuation is part subjective (art) and part objective (science). The key is to ensure that the objective part can justify the subjective part.

So how do you calculate the value of your business? Or if you are looking to buy a business how can you determine precisely what it is worth?

Mathematically, the *business valuation model* is relatively simple.

Business Value = profit x risk.

Business value is the anticipated future profits to be generated, and a multiple reflecting the perceived risk of investing in that business, and hence the desired rate of return

For example

If a prospective purchaser perceived that they needed a 20% return to compensate them for the risk of investing in a particular business then the multiple is the inverse of this (i.e. five times).

If the required return was 25% then the multiple would be four.

If the future profits were assessed at say \$1m then the business value is arguably \$5m (being 5 x \$1m).

However, as mentioned previously, business valuation is part art, part science.

This means it is largely a personal value judgment. At the end of the day, it doesn't matter what theoretical valuation you come up with, the only one that matters is the price a purchaser will pay and the price a willing vendor is prepared to sell for.

How can you increase your business value?

1) Focus on creating stable and maximum profitability

The first issue in the above equation revolves around how predictable your sales and profit are. The key point to understand here is a purchaser is buying your future profits, not your past profits. Rightly or wrongly, they form their views on your future profits based on your past profits.

Put yourself in the shoes of a potential purchaser. Do your profits fluctuate wildly from year to year or are they relatively stable? What certainty can they obtain that you will make a similar (or higher) profit next year compared to the past year? The more predictable your profits, the greater the comfort a prospective purchaser has that they will be able to make the same amount of profit in the future years.

The importance of sustainable, reliable profits should not be underestimated. For start-ups, there is no certainty regarding future profits.



Sometimes business owners look to make certain adjustments to "normalise" their profits so that, in their minds, they show the "real profit".

However adjustments just make a prospective purchaser nervous. Ultimately, the prospective purchaser or their adviser will make a call on the validity of these "adjustments". You can eliminate this issue by removing "adjustments" in the years well before a business sale.

How can you increase your business value?

2) Reduce the perceived risk

The second issue is the risk a potential purchaser perceives in your business. Risk can revolve around a number of issues but it can generally be put into three broad risk 'baskets': people, product or market and processes and systems.

Reducing a buyer's perception of these risks will not only play a significant psychological role, it will also limit their bargaining power in the negotiation process.

Dependence on the current owner is a key risk in most business sales. If you are the owner, you can lower this risk significantly by removing yourself from the organisation well before the sale of the business or by having your business model not being solely dependent on you. In this way you can demonstrate to a potential buyer that the business can run without you. A happy, committed and competent management team will go a long way to allaying this risk.

Having profitable products or services in a growth industry is also important in reducing perceived risk. So consider your market – does your product or service only have a small market or potentially a global one?



You need to do whatever you can to convince a potential buyer key customers are not going to walk out the door when you sell. Dependence on key customers is also a risk, so do what you can to reduce that.

Perceived risk can also be decreased by having sound processes and systems in place to make sure that anyone can carry out key functions within your business consistently. This includes timely and accurate information to show that you have your finger on the pulse. Also, ensure that valuable assets are protected with trademarks, patents and the like.

For start-ups, the perceived risk will always be high, as often only a very small minority of businesses actually make it.

Why every business should begin with the end in mind

Beginning with the end

If you are not thinking of selling your business any time soon you might be reading this thinking 'that's interesting I'll save this for later when I decide I want to sell my business'.

However you will benefit significantly from starting to thinking now about what the end might look like.

When setting up your business for sale it takes at least two years to get your affairs

in order. However the best outcomes are achieved by those who start with the end in mind and then take up every opportunity along the way to maximise their business value.

It might seem daunting to increase your profits by \$3 million in two years but over 10 years, at \$300,000 a year, this is much more achievable.

How can MGI help?

We regularly help our clients to value a business. Whether it's for clients looking to buy a business and wanting to know what price they should pay or clients getting their business 'sale' ready we can help. We work with you to develop a plan, identify risks within your business/prospective business, establish strategies to overcome these and create opportunities to maximise profits within your business.

[Contact us](#) for a complementary sale or exit consultation today.



Discover how to maximise the value of your business.

Determine the current value of your business and develop a plan to maximise that value. Speak to MGI today about how to get started.

**Book a free mini business
performance review**