

## Dr Philip E Dunn explores the various methods of valuing a business.

### Business Valuation

A business is valued when it is to be sold and, in the case of a limited company, several methods are used by accountants to determine the value of shares in a business. The use of the various methods, some of which are illustrated below in a case study, will result in a value being reached though this may not be the final sale price as there are many other factors that influence the negotiations.

These additional factors are linked to business strategy and include: the ongoing use of the resources – the employment of assets, the market position, diversification and innovation, and the enhancement of quality of product or service.

The case study which follows focuses on three methods of business valuation relevant to a private company. However there are other techniques which are more relevant to listed companies.

### Case Study

The directors of Sandsend Chemical Ltd a small company manufacturing agricultural fertilisers and chemicals have decided that it is likely they will have to sell the company in the near future. In preparing for this they wish you to assess the value of the business using methods which a prospective buyer might apply.

In this case study we will focus on:

- Asset Basis (Net Asset Valuation)
- Super profits valuation (including Goodwill)
- Present value of future cash flows.

The most recent accounts for the company showed:

Sendsend Chemical Ltd

Balance Sheet at 31 March 2009

		£m
<b><u>Tangible Assets</u></b>		
Fixed assets		
Land and Buildings		2.5
Plant and machinery		1.0
		<b><u>3.5</u></b>
<b><u>Current Assets</u></b>		
Stocks	1.2	
Debtors	0.5	
Bank	0.3	
	<b><u>2.0</u></b>	
<b><u>Less Current Liabilities</u></b>		
Creditors	0.9	

<b>Net Current Assets</b>		1.1
		<b>£4.6</b>
Capital and Reserves		

The following additional information is available:

- Land and Buildings are currently valued at £3.5m.
- Included in the debtors figure is an amount of £0.05m which may prove irrecoverable.
- Businesses of a similar type, according to inter-firm comparison information for the sector provide a return of 20% on net assets employed.
- The profits over the past five years were: Years ended 31 March:

2005	2006	2007	2008	2009
£1.03m	£1.08m	£1.14m	£1.21m	£1.27m

It is anticipated that over the next four years profits will increase at 5% per annum and future cash flows will be:

2009	2010	2011	2012	2013
£1.42m	£1.48m	£1.55m	£1.62m	£1.69m

#### Business Valuation

##### (1) Assets Basis (Net Asset Valuation)

Net assets per Balance Sheet	£4.6m
Revaluation of Land and Buildings	£1.0m
Provision for bad and doubtful debts	£0.05m
Value of business	£5.55m

This assumes that the assets would realise their Net Book Values. Property has been revalued and doubtful debts are provided for and that the other assets including stock would realise the book values.

The business is only worth its market value of its constituent parts. There is no valuation of Goodwill.

##### (2) Super Profits Valuation

Profit projection: 1.27 10 1.33 11 1.40 12 1.47 13 1.54 7.01/5

Year	£m
2009 (actual)	1.27
2010	1.33
2011	1.40
2012	1.47

2013	1.54
	<b>7.01/5</b>
<b>Average Profit</b>	<b><u>£1.40m</u></b>
	<b>£m</b>
Average Profit	1.40
Expected Return on Net Assets	
£5.55m x 20%	1.11
Super Profits	<b><u>£0.29m</u></b>
Capitalise at rate of expected return:	
Goodwill £0.29m x 100/20 = <b><u>£1.45m</u></b>	
	<b>£m</b>
Valuation:	
Net Assets	5.5
Goodwill	1.45
	<b><u>£6.95m</u></b>

This assumes that the future projections can be achieved and that it is acceptable to value goodwill at the capitalisation rate which represents 5 times super profits; and is it fair to assume all companies in the sector can achieve a return of 20%.

(3) Present value of future cash flows:

		<b>NPV Factor</b>	
	<b>£m</b>	<b>20%</b>	<b>NPV</b>
Year 1	1.42	.833	1.18
2	1.48	0.694	1.03
3	1.55	0.578	0.90
4	1.62	0.482	0.78
5	1.69	0.401	0.68
		Value of Company	<b><u>£4.57m</u></b>

This method is based on the assumption that future investors will be willing to take risk on the assumption that there will be a future stream of dividends paid out of future cash flows