Don’t be taken to the cleaners on business valuation

So long as a business is profitable, a valuation of that business will derive from the earnings it generates. After all, the motivation for most buyers is to create a return on their investment. Consequently, earnings-based approaches (such as capitalised earnings or discounted cash flow techniques) are commonly applied when assessing the worth of a business, whatever its size.

It is often said that the only truism in business valuation is that a business is worth what a willing buyer is prepared to pay and a willing seller is prepared to accept. There is no denying that. But, beauty is in the eye of the beholder. The key to valuing a business is to look at it from the buyer’s perspective, and to evaluate the particular benefits and advantages he can derive from the acquisition. Those benefits will dictate the return on his investment.

When making this assessment, it is necessary to consider the “real” profits of the business. These are the profits that arise from the normal operation of the business, and it is necessary to eliminate windfall gains or one-off items of expenditure. Furthermore, it is conventional to ensure that all costs are recorded at a “market” rate.

This latter point is particularly relevant to small or family-owned businesses. Often, the benefits paid to the owners or related parties of such businesses do not reflect their labour input or active contribution, and instead are formulated based on, say, whatever the business can afford or for reasons of tax efficiency. Also, they might receive other forms of remuneration, such as extravagant motor expenses and hospitality facilities for personal use – corporate boxes and season tickets at football grounds for instance!

In these circumstances, these costs should be adjusted to reflect the market value of the services provided by the owners. For example, a buyer might identify how many salaried employees it would take to run the business in the place of the owner and his family, and then estimate the total remuneration package that would be required by those employees. This is sometimes referred to as the “notional salary” cost that should be reflected in any assessment of the underlying earnings of a target business.

Let us consider a simple example:

Arthur is a bus driver earning £16,000 per annum. He yearns for a career change, and is looking to become a launderer (not a money launderer, I hasten to add). There are two launderette businesses for sale near him, operated by sole traders. Both report annual profits of £25,000, and each quote an asking price of £100,000. Arthur understands that a valuation multiple of 4 is conventional for launderette businesses, and so at first blush assumes that the asking prices of £100,000 are not unreasonable.

However, the two businesses can be distinguished on closer inspection. The first is owned by Bertrand, who pays himself a salary of £30,000 per annum. The second is owned by Colin, who doesn't take a salary, and instead receives his income from the dividends declared from the retained profits.

Arthur understands that the market salary of a launderette manager is £20,000 per annum. When assessing his investment, it may therefore be most appropriate to substitute the actual remuneration received by Bertrand and Colin with this "arm's length" cost:

- The "true" underlying profits of Bertrand's launderette might be assessed as (£25,000 + £30,000 - £20,000 =) £35,000 per annum. In other words, if Arthur bought the business, he could theoretically employ a manager at an annual cost of £20,000 to replace Bertrand, and still generate a profit of £35,000. Based on a multiple of 4, the business might be worth £140,000. Clearly, the asking price of £100,000 seems favourable.

- In contrast, the underlying profits of Colin's launderette business might be assessed as only (£25,000 - £20,000 =) £5,000 per annum. In this light, the asking price of £100,000 seems extremely steep. In simple terms, if he bought Colin's business at that price, it might take him 20 years to recoup his investment.

Of course, in reality, it is likely that Arthur wouldn't employ a manager to operate the launderette; he would take on that role himself. However, it is still necessary to make the "notional salary" adjustment, on the basis that, if he is prepared to put in the requisite hours, he would be capable of earning £20,000 elsewhere without the need for any capital investment.

[Authors' note: Please don't read too much into the average salaries and multiplier quoted in the above example. I have liberally applied artistic license to keep the numbers simple. Moreover, I have ignored the impact of taxation; which is nice in principle, but unfortunately illegal in practice.]

Such "arm's length" adjustments are not necessarily limited to remuneration costs. It is possible that other expenses might not be paid at a market rate (in the example, above, perhaps Colin's launderette premises are owned by his brother, Derek, and Colin is paying rent to Derek at a discounted rate; if a similar discount is not available to Arthur, then a further adjustment should be made to reflect the market value of the rentals on the shop).

The above example demonstrates how the underlying value of two businesses, which might appear to be very similar based on their reported results, can vary enormously. In our experience, a wide divergence between the "real" and "reported" profits of owner-managed businesses is not uncommon. I must emphasise that this is not indicative of any impropriety by the owners; it simply reflects the flexibility available to the owners of private companies to pay themselves as they please.