Market Related Price for Your Business

Aldes Business Brokers have developed a 3-prong approach to valuing a business. They have been successfully using these methods in the market place for the last 25 years. There methods work so well that a number of industry related bodies including the Institute of Estate Agents and a number of business books are now also promoting these formulas for valuing small to medium sized businesses.

The three methods are:

1. Extra Earning Potential – Super Profits
2. Return on Investment – ROI
3. Payback Period – Magic Multiplier

Case Study

Let's demonstrate by way of an example using the methods for a retail business:

Assets

Fixtures & equipment value	R 50,000
Stock value	R 500,000
Net profit/owner's salary/perks	R 60,000 per month (R720,000 p/a)
Manager's salary	R 10,000 per month (R120,000 p/a)
Bank interest on fixed deposit	12%
Business has been established	5 years

Based on the above information, we would then proceed as follows:

Extra Earning Potential (EEP)

This method says that in exchange for the risk of being in one's own business, a buyer should receive an extra amount over and above what he could earn if his money was placed in a bank and he worked for a salary.

	Element of Business	**Total**
Asset Value (a)	R500,000 + R50,000	R550,000
Interest – 12% on asset value	R66,000	
Salary p/a for manager	R120,000	
Total (b)	R186,000	

Net profit p/a of business (c)	R720,000	
EEP (c) – (b)	R534,000	
EEP Factor: 2 years X EEP = Goodwill (d)		R1,068,000
Value (a) + (d)		R1,618,000

Explanation to the above:

- ## Determining Asset Value
  - This includes fixtures, fittings as well as plant and machinery that are unencumbered. It also includes any assets on lease or hire purchase that have a value greater than the outstanding debt. Add the difference between market value of that asset less the outstanding balance to asset value.
  - Stock value should always be taken at cost (the price you paid for the stock from the supplier).
  - You will note that debtors and creditors have been left out of the calculation
- ## Interest Percentage

  Interest is calculated at the rate that an average person could attain from a financial institution, for example the current fixed deposit rate.

- ## Salary
  - This is the amount that an owner would pay a manager to manage the business.
  - NOTE: If the business already has a manager, then use this salary in the calculation if it is a realistic representation of what is being paid in the marketplace for such a person in a similar position. The net profit should then be increased by the amount of the salary to bring it in line with the owner-operated business.
- ## Net Profit per annum

  This amount must reflect the profit after adding back all the perks that the seller takes out of the business.

- ## EEP x [x] years = Goodwill

  It takes an experienced broker to determine a goodwill value on a business, but the following rule of thumb can apply:

  - A non-service orientated business that has been going a number of years and has a high asset value, from 18 to 24 months
  - A service business or a newer established business from 12 to 15 months.
  - A franchise business often recommended by the Franchisor from 18 to 35 months for a top producing franchise
  - NOTE: The period used could vary in different areas but currently they are all the same as reflected in the table below.
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	Areas	Established	New/Service	Franchise
1	Gauteng	18 – 24 months	12 – 15 months	18 – 35 months
2	KwaZulu Natal	18 – 24 months	12 – 15 months	18 – 35 months
3	Cape Province	18 – 24 months	12 – 15 months	18 – 35 months

- ### Value

The asset value (a) and the goodwill (d) must be added together. The interesting part of this method is that it gives a higher value to businesses that have a large asset base, for example plant and machinery in engineering businesses.

Return on Investment (ROI)

This method sets the value based on a return an owner would expect for the risk of being in business after allowing for a salary.

	Element of Business	Total
Annual net profit of the business	R720,000	
Less: annual salary for a manager	R120,000	
Actual net profit	R600,000	
ROI = Actual Net profit		
Expected %	R600,000/0.35	R1,714,286

Explanation to the above:

- ### Annual Net Profit

As in the EEP calculation above, all the perks the seller derives from the business must be added to the profit.

- ### Salary

In this example R10,000 per month = R120,000 p/a. If the business is already manager-run then use the same process as described above when we calculated salary for the EEP method.

- ### Expected %

The expected percentage generally falls somewhere between 30% and 40% (or 0.3, 0.4 etc) of the before tax profits. The higher the risk of the business the greater percentage return the owner expects. Conversely, the lower and more stable the business, the less the return one would expect and consequently the higher the price one must expect to pay.

- R.O.I :

  The ROI value is therefore the actual net profit divided by .30, .35 or .40 etc. This depends on the return on investment that the buyer is looking for as well as the type of business, how long it's been operating and also taking prevailing market conditions into account. Other factors to consider are the requirements of the buyer, i.e. is he buying the business as an investment and then putting in a manager to run the business or is the business going to be the livelihood of the buyer and he is going to be the owner-operator.

Payback Period

This method, sometimes referred to as the Magic Multiplier, bases the valuation on the period one would expect to recover their investment multiply by the net profit. In other words:

Monthly net profit – R 60,000 X 24 Months = R1,440,000

With older, more established businesses with a high asset base, the period could be from 18 to 24 months. Younger businesses and particularly service orientated concerns could be anything from 12 to 15 months. Again as shown above, franchised businesses are generally from 18 to 35 months, depending how successful and/or how well known the franchise group is. This is based on the same time frames as discussed under EEP above.

Average Value

The average value of the business for sale is now calculated on the total of each method (adding them all together) and dividing the result by 3.

Method	**Value**
Extra Earning Potential	R1,618,000
Return on Investment	R1,714,286
Payback Period	R1,440,000
Total divided by 3	R4,772,286/3
Average Value	R1,590,762

Therefore, after taking into account all possible factors which can affect the value of a business, the seller of this retail business would expect to achieve a market value of R1,590,762.

NOTE: Over the years, it has been found that although the three methods might vary substantially in their individual valuation results, an average tends to balance out the variables and is normally close to a realistic market related value.