Brief Guide
Valuing your Business

What's your Business Worth?

When you are planning to buy or sell a business how can you work out how much it is worth?

There are many different ways of valuing a business for sale in New Zealand. Many of these methods have been devised for large businesses, especially those listed on share markets. Smaller businesses (i.e. those that have less than 20 employees, - and 96% of all New Zealand businesses are in that size range) need a different approach. Sales contracts for small businesses normally define the value as the sum total of the inventory (stock), plus plant & fittings, plus goodwill. (Debtors and creditors are not normally part of the sale contract.)

When valuing a business for sale the value of the business is largely influenced by profit. A person who buys a business is purchasing a future cash flow. The higher the anticipated cash flow, the higher the value of the business.

Past profits may be a good indication of future cashflow, but there is no guarantee that profits will continue at the same rate. In some cases there will be signs that profit is increasing, in others a downward trend may indicate lower expectations. Other factors such as impending rent increases, new competitors or the loss of a major contract may also raise concerns about the level of profits that can be expected in the future. Each party to a sale must form their own ideas about the future cash flow.

Defining Profits for Valuation:

There are many different measures of profit. (e.g. profit before tax or profit after tax etc.) When valuing small businesses, the most useful measure of profit is known as EBPIDT – Earnings Before Proprietors Income (wages or drawings) Interest and Depreciation. (This is sometimes called the Sellers Discretionary Cashflow.) This determines the basic earning capability of the businesses before any other variables.

Business Valuation Method:

One method used to value a business is to use an Earnings Multiplier. For example, a business which has a profit of $60,000 may sell for $90,000. The Earnings Multiplier in this case is 1.5 ($60,000 X 1.5 = $90,000).

Earnings Multiples:

How do you work out what earnings multiple to use? Avoid "Rules of Thumb." Most of these are likely to be out of date at best, and downright misleading at the worst.

There are several ways of finding an appropriate Earnings Multiplier.

- Ask acquaintances who have recent sold/bought similar businesses to the one you are interested in.
- Ask your accountant. They may have had clients who have been involved in sales of similar businesses.
- Use a commercial data base which lists sales by business brokers throughout NZ such as "BizStats". This will tell you what earnings multiples have been used in recent sales and help you value a business.

Buying or selling a business is a major investment decision. Careful research and professional advice can help you to get the right value.

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