ALDES 21
BUSINESS BROKERS

BUSINESS VALUATION METHOD

Aldes Business Brokers has developed a 3 pronged approach to valuing small to medium sized businesses. We have been using this method successfully in the marketplace for the last 25 years. It works so well that a number of industry-related bodies including the Institute of Estate Agents have adopted it. It is also promoted in a number of business books.

The three methods are as follows:

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

EXAMPLE:

Data Used:

Retail Business (Shops, Restaurants Etc.)

Assets: Fixtures, equipment etc valued at	R50,000	
Stock (at cost)	R200,000	
Net Profit/owner salary/perks	R15,000 pm =	R180,000 per annum
Would pay a manager	R 5,000 pm =	R 60,000 per annum
Bank interest on fixed deposit	6%	
Business has been established	5 years	

Based on the above information, proceed as follows:

1. EXTRA EARNING POTENTIAL

This method states 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.

Assets + Stock

Asset Value (a)	(50,000 + 200,000)	R250,000
Interest @ 6% on asset value	R15,000	
Salary per annum for manager	R60,000	
Total (b)	R75,000	
Net Profit pa of business (c)	R180,000	
[E.E.P.] (c) - (b)	R105,000	
E.E.P. x (24) months =	Goodwill (d)	R210,000
Value = (a + d)		**R460,000**

Asset Value:

Fixtures and fittings, plant and machinery, motor vehicles etc. that are unencumbered and any assets on lease or HP 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 is at cost.

NB. Debtors and creditors are left out of the calculation.

Interest Percentage:

Calculated at the rate which an average person could attain from a financial institution, ie fixed deposit rate.

Salary:

The amount an owner would pay a **manager** to run the business.

NB. If the business already has a manager, use his salary if realistic. The net profit should then be increased by the amount of the salary to bring it into line with the owner-operated business.

Net Profit per annum:

The profit, after adding back all amounts that the seller takes out of the business. These include members remuneration and personal items, which do not relate to business activities, such as medical aid, motor expenses, private cellphone etc.

Also added back are “non cash” items such as depreciation; and bank interest payable, which is merely a function of the amount of cash the owner chooses to put into the business, as opposed to operating on an overdraft.

EEP x [ ] months = Goodwill :

It takes an experienced broker to determine the goodwill value of 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 20 months.
- Franchise business (often recommended by the Franchisor) and usually from 24 to 36 months and possibly more for “top” franchise. Also applies to stand-alone businesses with a strong brand.

Value:

The asset value (a) and the goodwill (d) are added together.

The interesting part of this method is that it gives a higher value to businesses that have a large asset base, ie plant and machinery in engineering businesses.

2. RETURN ON INVESTMENT [ROI]

This method sets the value based on the return an owner would expect, as an investor, for the risk of being in business after allowing for a manager’s salary.

Annual Net Profit of the business	R180,000	
Less Annual Salary for a manager	R60,000	
Net Profit	R120,000	
R.O.I. = Net Profit / Expected %	**R120,000 / .35**	**R342,857**

Annual Net Profit:

As in EEP above, all the perks the seller derives from the business plus the profit.

Salary :

In this example: R5,000 pm = R60,000 pa for a manager.

Note: If already manager run, use the same process as EEP salary (above).

Expected % :

Somewhere between 30% and 40% before tax. The higher the risk of the business the greater percentage return the owner expects.

The lower the risk and more stable the business, the less the return one would expect and consequently the higher the price one must expect to pay.

ROI :

The ROI value is therefore the actual net profit (less salary) divided by between .30 and .40.

3. PAYBACK METHOD

This method, sometimes referred to as the Magic Multiplier, bases the valuation on the period of months over which a buyer would expect to recoup his investment multiplied by the net profit.

MONTHLY NET PROFIT R 15,000 x 24 months = R360,000

With older, more established businesses with a high asset base, the period could generally be from 18 to 24 months. Younger businesses and particularly service orientated concerns, anything from 12 to 20 months. Franchised businesses from 24 - 36 months (and sometimes more), depending how successful / well known the franchise group is. Mugg & Bean's for example generally sell at more than 36 months profit.

NOTE: This multiplier is the same as that used in 1. above.

4. RESULTING VALUE

This is the total of the above three methods divided by three. 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 closest to a realistic market related value.

AVERAGE VALUE of above valuations

Method	Value
E.E.P.	R460,000
R.O.I.	R342,857
Payback	R360,000
Average Value	**R387,619 say R390,000**

Therefore, after taking into account all the factors affecting value, a seller should expect to be able to market his business at this price.