

UNDERSTANDING THE WORTH OF PRIVATE BUSINESS

The financial services market has witnessed substantial growth in terms of depth and sophistry, especially following from the reform programmes being introduced by the various regulatory authorities. This has been the case in the banking and insurance sub-sectors and currently the new recapitalization requirements in the capital market. The attraction and compelling benefits of the capital market as a veritable source of capital, especially equity capital has gained currency amongst companies some of which had concluded that capital market was the exclusive terrain of blue chip conglomerate. The flurry of public offer activities and huge volumes of trades on the stock exchange, clearly there is the need for businesses to understand the dynamics that determine the value of such businesses so as to position the company to receive the highest price or value.

WHY VALUE?

Valuation, in this context, is defined simply as quantity multiplied by unit price. In other words, the value of a business is the number of units of stock (or shares) of the company multiplied by the stock price. Private businesses, however, face a challenge in this regard because they have the trading table to refer to as price reference. This challenge, however, does not mean that private businesses cannot be valued. Private companies, no matter how small, can be valued as long as the business has kept proper business records a statement of worth may be extracted. Incidentally, the major victims of inappropriate assessment of value or worth are SMEs, who sometimes find themselves ill prepared against predatory corporate raiders. Here are some tips to protect such “poor souls”:

FIVE BASIC TIPS:

1. Valuation of business should be done on a regular basis and not when it is required or necessary for an equity or debt investment decision. This needs also to be updated regularly to reflect the company's financial progress over time. The benefit of this approach is that it keeps the realistic value of the company in the knowledge of the owners and helps reduce the play of "sentimental value" at the foot of a transaction. It matches effort with result, result in this case meaning value, such that the owner is not surprised when the result of actual valuation reveals a position which is at variance with his "perception" of worth.
2. Avoid the use of a general rule of "thumb approach". Business owners are sometimes tempted to use a peer comparison mechanism to assess value, ignoring the fact that even on the same industry, businesses differ and as such an industry rule of thumb may be quite misleading and may actually penalize a particularly efficient company, while rewarding or deluding a low performing business.
3. Precedence should not pre-dominate the process. The price at which a similar transaction was struck recently is no accurate indication of the value of a current transaction for the same reason that the micro and macro dynamics of businesses shift from time to time and the timing of a particular transaction or valuation should reflect on the pricing model especially as time plays a critical role in the supply, demand and price equation. The fact that a competitor's business was valued at a particular price three or six months ago bears no reference to what your business is worth today. Today's worth depends on three factors:
 - a) Present Cash Flow - How much cash it generates today.
 - b) Future or Projected Cash Flow – Expected growth in cash in the future and
 - c) The return on investment – ROI. So unless your company's cash flow and profitability are very similar to the competitor's business, the value that business gets is irrelevant to valuing your company. Even if the business fundamentals were exactly the same, a higher interest rate regime today will affect valuation of

- a firm more adversely than a similar business valued in a period of a more favourable interest rate regime.
4. The value of a business is its fair market value (FMV), which is defined as the price a willing buyer will pay a willing seller when each party is fully informed and under no pressure to act. While there may be a FMV range, the wider the assigned valuation range is, the less reliable is the valuation and the more likely it becomes that the valuation will face greater scrutiny from potential buyers or valuers. It is important that the valuation method remains consistent and credible while business owners should resist the temptation to use different methods for different purposes, e.g. low valuation for tax and high for sale.
 5. It is important to note that the fact that a business is losing money does not mean that it is not worth much. Most SMEs and private businesses appear to lose money. This may however be misleading, because of the accounting methodology employed such as the expense and capitalization policy of the firm, which in return may have an impact on cash flow and profitability pictures. Unlike public companies, the distinction between ownership and management is blurred in a private business, thus, giving owners some discretion over how they classify cash flow generated by the business. Quantifying the size of these discretionary expenses appropriately, is often a critical determinant of the firm's value. The owners should keep a tab on what these discretionary expenses may be so that, when they are ready to sell or value the business, they can document these facts to the counterparties. By doing so, the owner increases the counterparty's confidence that the business does legitimately generate the cash the company claims and accordingly increases the buyer's willingness to pay the asking price.

In the final analysis, there are many important reasons that business owners should know the value of their businesses long before they decide to sell albeit a part of it.