

## How are businesses valued?

There are many different ways of valuing your business. All the methods try to estimate the business's ability to make money in the future. The more money your business is likely to make, the more it is worth. All valuation methods are driven by the return on investment or return on investment potential, and the associated risk. We've listed a number of components that are considered when valuing a business.

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### Goodwill

Often the final value of the business is more than the accounts say it is worth – in other words, the value is more than a sum of all the assets less liabilities. This additional value is called goodwill. Exactly what goodwill is can be argued at length. One assessment is that goodwill is the potential of the business to make above-average profits in the future.

This will depend on a range of things such as:

- A sound marketing strategy.
- Secure contracts.
- Limited competition.
- Good management.
- Entrepreneurial vision.
- A top product or service.
- A leading brand.
- A compelling competitive advantage.

If all these factors are exceptional, then you could argue that the goodwill value is substantial. If they are poor, then the goodwill of your business might be close to zero. So when you come to value your business goodwill, make sure you fully document what you mean by this goodwill and justify why you're asking money for it.

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### Establishing a value

There is no set scientific method for valuing a business; it is really a subjective art and often can be the first point of real tension between the investor and investee company.

The key for any entrepreneur seeking investment is to remember that there are two sides to the debate. You may have spent your life's energy on the development of the business and taken all the risks to date, but the investor should be able to add more value than just the money, through experience and hopefully, networks. Find out what other value the investor can add to your business, besides hard cash, before getting too bogged down in the dollars and cents debate.

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### Considering the opportunity cost

Another method of valuing your business is to assess what return the purchaser expects to receive, and then divide this by the opportunity cost of what the investor requires as a return. For example, if the investor wants a 25 percent, or greater, annual return on their capital, and the

business is currently making a clear net profit of \$500,000, then they will value the company at \$2,000,000 (\$500,000 divided by 25 percent). In this example, the valuation is from the investor's point of view, which is quite often the value you will receive because it is they who are offering the money.

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## Factoring in variables

The main problem is that there are so many variables. As people who have sold part of their business to investors frequently note, your business value is based on demand and supply. If you have a company that has \$1 million in assets, yet no one wants to buy it, then technically it is worth nothing. Some people have businesses with very few fixed assets, with the main value instead residing in the intellectual property (such as software). Such businesses could be worth millions.

There are other variables (which may be outside your control), including:

- The general economic outlook for your industry.
- The market price being paid at the moment for similar companies.
- The experience and profile of your team.
- Legal agreements that are due to expire.
- Legislation that could be passed that might affect your business.

The main problem for investors valuing businesses is that the business might only have a few years of operating history. Many high-growth businesses have only been around for a few years. This means that:

- The business will only have a few years of information available.
- The business might have run at a loss while being built and developed.
- It's almost impossible to forecast what sales might be, because of this lack of information.
- Sometimes the main asset is intellectual property. The physical cost has been legal fees, which might only be in the thousands, but the market value may be hundreds of thousands.
- If the industry is really new, then there are no other companies to compare with – you're breaking new ground.

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## Other factors that can influence the value of a business

Every investment has an element of risk. The value of a business will be a trade-off between risk and expected return. The more risk associated with an investment, the lower the value. The more certain the profits are, the higher the value.

### Control adds value

A controlling shareholding (more than 50 percent) has greater value than a minority stake because it means they have:

- Control over the appointment of directors and the board.
- Ability to direct strategic initiatives and management actions.
- Ability to determine the level of timing of shareholder benefits, such as the payment dividends.
- Control over future ownership decisions regarding equity.

A shareholder holding more than 75 percent has even more value.

### Liquidity adds value

The ability to sell or quit an investment quickly adds value because:

- The sale of a shareholding in a small or medium-sized company in New Zealand may take a long time.
- Investors may not want their capital tied up for so long (possibly years).
- This wait means there is an opportunity cost because the investor is unable to invest in other projects while the money is tied up in the business.
- Investors will pay less if they think they might get stuck in an investment and can't get their money back quickly.

### Growth adds value

Be aware of growth opportunities and how to exploit these as future growth adds value because:

- Valuations are based upon future income. If this is growing, so will your business value.
- As you demonstrate your ability to grow, you increase the potential rewards available to an investor.

## **Size adds value**

Larger companies and businesses are usually worth more because:

- Larger companies are usually more established and have greater resources to exploit opportunities and withstand threats – the perceived risk is lower.
- Larger companies are more attractive to other large companies.
- There's usually less reliance on key people or key products, which means the business is less vulnerable if key staff leave, or demand for a major product suddenly drops.

## **Intangible assets add value**

Intangible assets such as brand names, special processes, trademarks, and patents can add significant value because:

- They may provide the business with a key strategic advantage.
- They allow the business to earn significant returns and profits.

It is often difficult to quantify the value of intangible assets. The process requires significant judgment. Be prepared to back up your valuation with supporting information.

## **Reliance on key people reduces value**

Reliance on a key person or product normally reduces the value of a business because:

- If key people leave, it may affect profits or the viability of the business.
- There is a greater risk to the investor; therefore, they are likely to pay a lower price.

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- This information is provided by New Zealand Trade and Enterprise

