Understanding value

For many entrepreneurs, their business is one of their most significant assets; often, it's their pension fund. Over reliance on one asset for pension provision is not the subject of this book, but the fact is, many entrepreneurs are heavily, if not exclusively, reliant on their business to provide the funds for retirement. But many don't think about building value until it's too late.

Future value

To understand how businesses are valued you first need to understand how the future value of anything is assessed. Take a simple example of a single amount of money: £1,000. How much would you pay to receive it today?

It's not a trick question – the answer is £1,000. But what if you were to receive it in a year's time? This introduces a 'cost of money' factor: you could borrow some money now, knowing that you could repay it with the £1,000 in a year's time. If the guaranteed interest rate was 4% you could borrow £961.54.

The cost of money

Number of Years	*Interest Rate 4%*	*Interest Rate 10%*	*Interest Rate 15%*
Immediate	**1,000.00**	**1,000.00**	**1,000.00**
1	961.54	909.09	869.57
2	924.56	826.45	756.14
3	889.00	851.31	657.52
4	854.80	683.01	571.75
5	821.93	620.92	497.18
6	790.31	564.47	432.33
7	759.92	513.16	375.94
8	730.69	466.51	326.90
9	702.59	424.10	284.26
10	675.56	385.54	247.18

The table above shows how much you would receive – with 100% certainty assuming interest rates stayed at 4% – if you extended that approach over the next ten years. It's hypothetical but bear with me. I have given amounts for the value in the future with interest rates of 10% and 15%.

The table highlights how the future value of £1,000 can change depending on when you receive it and the interest rate. That is the easy bit, as you can calculate it precisely.

Now imagine the interest rates are risk indicators – in many ways they are a measure of risk. Now consider that our £1,000 represent the profits from a business: how much would you pay for it if it was coming from a low-risk, medium-risk or high-risk business at a future point in time.

Valuing a business follows that rationale; it's a balance of future risk and return.

Determining the value of your business

Ultimately, what a business is worth is what someone else is willing to pay for it. How is that value calculated? An investor will pay an amount that fairly (in their opinion) represents the returns they are likely to obtain in the future, taking into account a risk-adjusting factor.

In simple terms, it boils down to this:

Valuation = *future* adjusted net profits (X) × the risk multiple (Y)

Let's break this down further. X is the future (not the past) adjusted net profits, otherwise known as future maintainable earnings (usually earnings before interest, tax, depreciation and amortisation). It's a bit of a mouthful, but that's the terminology used by many legal professionals to try to confuse entrepreneurs.

Y, 'the risk multiple', is the factor by which your adjusted profits are multiplied to give you the valuation measure. It's an important number, as it *amplifies many times* all the effort you have put into creating a profitable business. Y tends to be overlooked until it's too late, but it should be managed from Day 1. This is how the clever people make serious money.

Factors affecting X

Future maintainable earnings need to be predicted in light of possible changes to the business. Valuers will look at the earnings potential and factor in the following:

1. Systems – This can't be emphasised enough: if a business has strong, comprehensive systems (meaning future income is not dependent on individual personnel) then there will be much less risk in terms of future earnings.

2. Over-reliance on a few customers or suppliers – If the business deals with only a few customers, this will increase the risk to future income. What if one goes bust? Or leaves?

3. Future macroeconomic changes – Macroeconomic factors outside the business' control can lead to problems. If a business is in an area dependent, for example, on low fuel prices, such as distribution, there could be a perception that fuel costs will rise in future and reduce future earnings.

4. Known future events – If changes can be predicted with any certainty, ie due to a written agreement or contract, they will be factored in. It's common for verbal agreements to be put in place but never documented.

This list isn't meant to be exhaustive, but should provide an idea of the typical issues that arise.

Factors affecting the Y multiplier

The table below outlines the various factors that can have an impact on Y.

Factor	Increases Multiplier	Decreases Multiplier
1. Risk	Lower	Higher
2. Systems	Comprehensive	None
3. Designs	Registered	None
4. Trademarks	Registered	None
5. Recurring Income	More	Less
6. Patents	Registered	None
7. Brands	Established	None
8. Documented Assets	More	None
9. Contracts	Comprehensive - Done formally	Few - verbal only
10. Industry Sector	Make Dependent Tech Based	Traditional
11. Growth Potential	High	Low

All of the factors are important, and almost all of them can be improved upon by the entrepreneur. You can even change your industry sector (eg, moving a traditional retail store online).

Several years ago, I took part in a survey of chartered accountants. We were given three businesses to value. The X (future profits) was the same across all three businesses, but the degree of systematisation was fundamentally different. The Y multiplier was increased on average fourfold simply by the recording, documenting and testing of systems already in place.

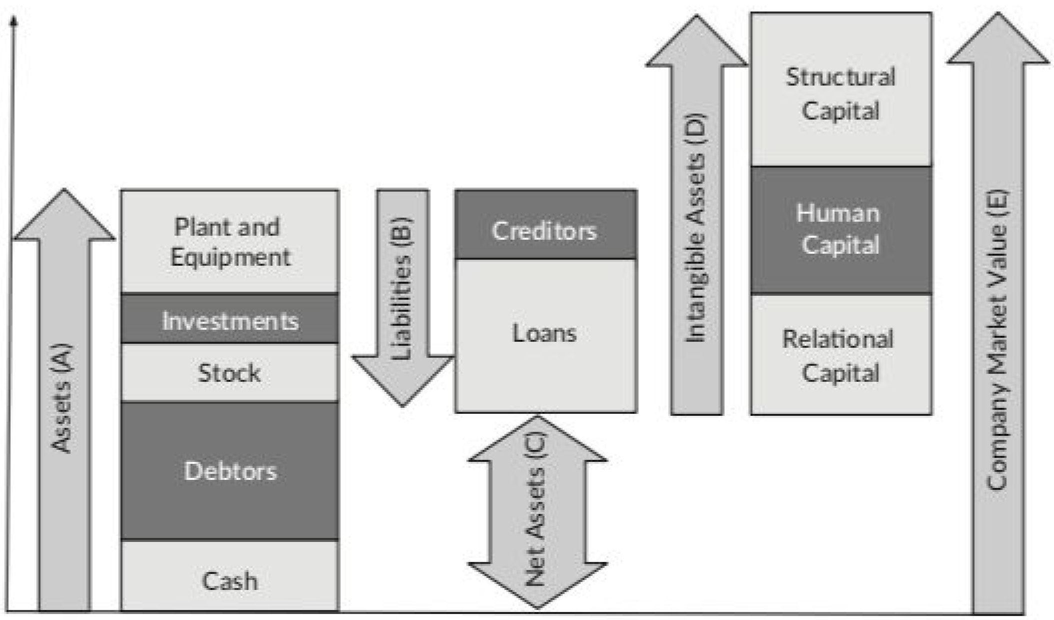
What's the point of a balance sheet, then?

Company law defines what a balance sheet is and how it should be put together. The balance sheet governs how much a company can pay out to shareholders in dividends. This is a far cry from telling you how much the business is worth.

The balance sheet commonly doesn't include the full value of 'intangibles'. Why not? Accountants are trained to measure the tangible assets, ie things that have been purchased that last for more than a few years, such as cars, machinery and furniture. They don't measure the intangible assets unless they have been acquired as part of a business purchase.

The Intangibles

Many academic studies attempt to explain scientifically what the intangibles are, but the business valu- ation components diagram below provides an easier way to think of the concept.



On the left are the 'traditional' assets (A), which, in order of liquidity, are cash, debtors (customer balances owed to the business), stocks, investments, and plant/equipment – all things that have been bought and can be measured with certainty. Then you have the business' liabilities (B), which are the amounts owed at any given time – overdrafts, loans, amounts due to suppliers, amounts due to the tax authorities, etc.

The sum of (A) and (B) is the business' net assets (C). This number is usually positive. (C) is the figure at the bottom of a balance sheet. But this is where the balance sheet stops. Balance sheets don't take into account intangible assets (D). Often there is more hidden value in (D) than in (A).

The intangibles fall into three main categories.

1. Human capital – This comprises your people and the subcontractors that work for you or with you. You could look at it as the capital that leaves the business each night when the doors close. What's critical to understand is that human capital cannot be owned. Ultimately, your people can give you notice and leave. The value of human capital is dependent on the abilities and qualities of people that make them productive. This includes knowledge, motivation, ability to change, punctuality and health.

2. Structural capital – This is all the intangible assets that remain in the business once the human capital has left each night. It includes systems, processes, procedures, software, technology, trademarks, intellectual property, brands, and all of the explicit knowledge tools you use to produce value for customers.

3. Relational capital – This is made up of the business' relationships, including those with customers, suppliers, network partners, referrers and joint venture arrangements. Reputation also falls under relational capital.

It's important to understand why these elements are valuable and important. It all comes down to their effect on future value creation. The more defined the intangible assets become, the higher their valuation (because they will have greater income-creation effectiveness). Essentially, the more defined assets you have, the greater the income- and value-generating ability you have. It's crucial that these assets are not lost when the entrepreneur sells and leaves the business.

In today's knowledge economy, emphasis has shifted away from traditional assets and toward intangibles. Tangibles can be easily bought and sold. Intangibles are much more likely to be unique to your business and can therefore be leveraged to create a premium.

All successful entrepreneurial companies are likely have an abundance of intellectual capital – a subdivision of structural capital, but – and it's a significant but – many are probably not recording and defining it. If it's in your head, it isn't an asset. It must be defined, documented and transferable.

Next Steps

If you want to increase your value, start documenting what the business does, the systems and processes – how it creates value.

Want read more on how to **Build Value** for your business?
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