An insight into characteristics, considerations and approaches for Valuation of small businesses

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The Perspective

Small business may be defined in various ways e.g. in terms of investment, number of persons employed, volume of output and sales, technique of production etc. Not every small business eventually grows to the size of large corporation. Some businesses are ideally suited to operate on a small scale for years, often serving a local community and generating just enough profit to take care of company owners. Small-scale businesses display a distinct set of identifying characteristics that set them apart from their larger competitors.

Characteristics of small Business Enterprises

A small business is identified with its owners; who themselves act as managers. Often owned and operated by one person.

- Small business is an extension of the personality of the entrepreneur. It is the reflection of the dreams and desires of the entrepreneur(s)
- There is coincidence between corporate ownership and corporate governance, the entrepreneur is the business owner-manager
- A small number of employees usually coming from the local workforce.
- Capital is supplied by an individual or a small group of individuals.
- Accounting information is often insufficiently reliable
- Low sales value, often targeting local markets, except for those developing online channels.
- Low competitive capacity due to limited capital and resources.
- Less structured organizations where business functions may not be clearly divided.
- The firm often places little emphasis on long-term planning
- Not supported by a professional workforce.
- Normally, the firm's stock is not listed with a stock exchange.
- Small business enterprises are mostly labour-intensive
- More flexible in response to changes in the business environment, where owners can easily change business models or even close and pursue other businesses.

Key Areas of focus in Due Diligence

- **financial Health:** Assessing the financial statements, cash flows, and financial performance of the company. This includes identifying any outstanding debts, tax liabilities, or potential financial discrepancies.
- **Operational Efficiency:** Evaluating the operational processes, supply chain, and production capabilities of the company.
- **Legal and Compliance:** Scrutinizing the legal structure, contracts, licenses, and regulatory compliance of the company.
- **Market Position and Competitors:** Analysing the company's market share, customer base, and competitive landscape. This assessment helps in understanding how the company may leverage positioning and opportunities for growth.
- **Intellectual Property:** Reviewing intellectual property rights, patents, trademarks, and copyrights owned by the company.
- **Capital structure :** How the business has been funded

The peculiarities of small businesses are characterized by a mix between the entrepreneur's personal variables and the firm's objective features. Consequently, firm performance depends on either factors (personal variables and objective features). Thus, the valuing process should take account of these two components, since both contribute determining the business value. In fact, the corporate value, that directly depends on the entrepreneurial figure, will probably run out in a short period of time, in the case of changes in the decision-making owner. On the contrary, this value will remain inside the business, in the event of constancy of ownership arrangement.

Valuation of small businesses

There are three common methods to small business valuation: Income-based, Asset-based, and Market-based. Each of these methods takes a different approach to valuation, whether it is based on the cash flows that a business generates, the assets on its balance sheet, or the purchase price of companies in the same business.

The Income valuation method

Also known as the Earnings method, considers a business' ability to generate profits and cash flow in the future. While EBITDA is used in valuation assessments for middle-market business, it is not commonly used for small businesses because it ignores the non-operating expenses that small business owners often run through their businesses. This could include discretionary travel, vehicle expenses, or social club memberships. The valuation approach should

instead focused on the cash flow which can be expected to be known as Seller's Discretionary Earnings, or SDE.

Calculating sDE is a 3 step process.

- Starting with pre-tax earnings, add back interest, depreciation and other non-cash expenses.
- Normalize earnings by adding back one-time or non-recurring expenses and subtracting one-time revenues.
- Add back owner benefits. This includes the owner's salary, health insurance, and any other non-business expenses like a personal car or travel expenses.

The advantage of this method is that it reflects the profitability and potential of your business. The disadvantage is that it relies on assumptions and forecasts that may not be accurate or realistic.

Asset-based method

Another way to value small business is to calculate the total value of its assets minus its liabilities. This method involves adding up the fair market value of all the tangible and intangible assets of your business, such as equipment, inventory, goodwill, trademarks, and patents, and subtracting the total amount of debt and obligations. To conduct this type of business valuation, start with all assets stated in your accounts to discover your net book value. Afterward, refine this figure by accounting for items such as inflation, depreciation, and appreciation. Asset estimation is best used if there is a stable company with lots of assets. It doesn't consider any future earnings, but can form part of a more extensive method for determining value. The advantage of this method is that it is simple and objective. The disadvantage is that it may not capture the earning potential and competitive advantage of your business.

Market-based method

One way to value small business is to compare it with similar businesses that have been sold or are for sale in the market. This method involves finding out the sales price, revenue, profit, or other metrics of comparable businesses and applying a multiple or ratio to your own business. Some of the relevant considerations while comparing a business with other businesses in the same industry could be as under:

- Does the business target the same customer base or employ the same revenue model?
- Is your business larger or more profitable than the business in the sample?
- How many employees (full-time, part-time or contract) does your business have compared to the sample?

The advantage of this method is that it reflects the current demand and supply in the market. The disadvantage is that it may not account for the unique aspects and potential of your business.

Other small business Valuation Methods

Price-To-Earnings Ratio (P/E): Small businesses are commonly valued by their price-to-earnings ratio (P/E), or multiples of profit. The P/E ratio is best suited to companies with an established track record of annual earnings. In most cases, working out the proper price-to-earnings ratio to use is determined by profits. If a company has high forecast return growth, it might suggest a higher price-to-earnings ratio. If a business has an outstanding record of repeat earnings, it may have an even higher P/E ratio. How you arrive at the correct number for your price-to-earnings ratio can differ significantly from business to business. Tech startups and B2B companies often have high ratios because they're generally high-growth companies. On the other hand, companies such as jewellery stores or real estate agencies often have a lower price-to-earnings ratio. Since these differ so much in terms of nature of business.

Entry Cost Valuation : The entry cost appraisal is advantageous if a business is to be started from scratch, as it gives an impression of what it would cost. It can also act as a figure for valuing existing small business. To determine this type of business valuation, you need to factor in everything that put your business in its current position. This includes all startup costs (such as fees for legal expenses or obtaining specific licenses), all tangible assets that are purchased to operate, the cost of advertising and marketing budgets to develop brand, recruiting and training employees, product or service development fees, and more. Once you have a record of these initial costs, think about where you can save. For instance, you may rent in a cheaper area, or source from cheaper suppliers. Once you have this number, deduct it from the primary startup figure for your entry cost.

sOTP Valuation- This type of valuation is used for a company that has business units in different industries. It is the process of valuing a company by determining what its aggregate divisions would be worth if they were spun off or acquired by another company.

Equity Valuation- is the value of a company available to owners or shareholders. It is the enterprise value plus all cash and cash equivalents, short and long-term investments, and less all short-term debt, long-term debt, and minority interests.

Valuation of businesses with poor earnings

A business can be described as achieving poor earnings if its return on equity has been lower than the discount rate over a period of time. A long period of poor earnings can lead to an inability to pay creditors and over-indebtedness, factors leading to insolvency. When valuing businesses which are recording poor levels of earnings the accountant must evaluate not only the ability of the business to continue as a going concern but also the breakup concepts, to the extent break-up concepts represent a reasonable alternative in the specific case. If the present value of business profits arising from the liquidation of an entity is higher than the present value of business profits from continuation of the business as a going-concern, the liquidation value is the base value to use in valuing the business

Valuation of rapidly-growing businesses

Businesses which are growing rapidly are often distinguished by product and output innovation, high

expenditures on human and physical capital, considerable up-front investments in development, production and sales, growing capital requirements and the use of risk capital, rapid changes in its organisation and related rapidly increasing revenues. For these entities, past results often do not provide an appropriate basis for the projection of future developments and carrying out plausibility analyses. The projection of business profits, and particularly the achievement of stability or a steady state, are subject to considerable uncertainties and fluctuations connected with a high sensitivity of the forecast parameters. In determining the value of the business an analysis is to be made of the market and competitive abilities of the business's product and output programmes, availability of resources, changes to the internal organisation due to rapid growth and financing of the business's growth. Finally the risk premium and growth deduction must adequately reflect the specific features of fast-growing entities.

Specific valuation of non-operating assets

In addition to assets used in the business an entity often also has assets which are not used in the business. Such non-operating assets can be freely disposed of without affecting the normal activities of the business. When valuing the entire business using an earnings-based method those assets not required in the business, including any related liabilities, are subject to separate valuation based on their optimum disposal. To the extent the break-up value of these assets exceeds the present value of profits which they would be expected to earn if they were to remain in the business, it should not be assumed (as would otherwise be the case) that they will continue in their existing state, but a break-up scenario should be adopted. For the purpose of determining the overall value of the business the break-up value of non-operating assets is to be added to the present value of business profits generated by those assets used in the business.

When valuing non-operating assets at their break-up value the costs of the liquidation are to be deducted as well as any tax effects at entity and shareholder level. To the extent an immediate liquidation cannot be expected a liquidation plan must be drawn up which can be implemented within a reasonable period of time and the liquidation receipts must be discounted to the valuation date. To the extent there are liabilities directly associated with the non-operating assets the amounts required to repay them must be deducted from net liquidation receipts, together with any expenses relating to their settlement. If assets which serve as collateral for loans are identified as non-operating assets it should be noted that their disposal could lead to a change in the financing situation of the business.

Measures planned but not yet undertaken

In determining an appropriate worth of the business the valuation should reflect not only measures not yet introduced but also plans to make structural changes which are not (yet) part of the business's current strategy. For example, these can include expenditures relating to expansion of the business planned by the acquirer, dis-investments, rationalisation of the product range or changes to strategic business segments, whose effects on future business profits can influence the maximum price an acquirer is prepared to pay. The present value of business profits from the optimum use of operations based on probable specific intentions of the acquirer usually determines the subjective value of the business. From the point of view of a potential seller, the subjective value should reflect perceived and achievable opportunities, even if the measures to take advantage of them have not yet been taken.

Income taxes of the owners personal income

Income taxes of the business's owners which are related to the ownership of the business must be reflected in the valuation. Consideration of income taxes of the business's owners can only be omitted in those (exceptional) cases where profits from an alternative investment arising at the same point in time are subject to the same income tax charge as the expected profits from the business.

Private businesses which are dominated by the owners

In order to define the business being valued, for private businesses which are dominated by the owners particular care should be paid to the separation of business and private assets and liabilities, income and expenses. Special tax balance sheets could be used for determining the assets used in the business but not included in the balance sheet and corresponding future business profits to be included. Significant elements of the business's non-current assets (in particular patents and real estate) are often included in private assets. As a result, for the purpose of the valuation of a business, care should be taken to ensure that these are either brought into the assets being valued or are reflected in another manner (e.g. through determination of a rental, leasing or royalty payment). In this connection it should also be determined whether all expenses and income are part of the business activities and are completely included in the accounting records.

Valuation of the business unit

Businesses are specific combinations of tangible and intangible items which, together, are intended to work jointly to produce business profits. The value of a business is thus not determined as the sum of individual items of assets and liabilities, but rather by the combination of all items involved in the business. When determining the business being valued, all the areas of a business which work together, such as procurement and sales relationships and markets, research and development, organisation, treasury and management are to be combined, as all parts of the business work together to contribute to future business profits (overall valuation). The item being valued must not necessarily be identical to the legal form of an entity, but consists rather of the economic criteria which make up the business being valued (e.g. group, branch, strategic business unit).

Determination of earnings from operating assets

While determining earnings from operating assets it is necessary to carry out adjustment of past performance it is recommended that prior years' income statements be

adjusted for the following significant matters:

- Elimination of expenses and income from assets not used in the business (e.g. income from investments not required for business activities),
- Adjustment to arrive at a proper periodisation of income (e.g. proper allocation of profits on work-in-progress to the correct periods, allocation of significant prior period expenses and income to the periods to which they relate and adjustments resulting from the setting up and release of provisions and accruals),
- Adjustment due to exercising options in applying accounting policies (e.g. correction of effects on income of changes in accounting policies),
- Adjustment of personal-related and other specific success factors (e.g. inclusion of imputed remuneration for the owner/manager of a partnership, adjustment for the effects on income of specific purchase and sales relationships within a group of companies),
- Changes resulting from adjustments made (in particular adjustments relating to previous years or subsequent years and recalculation of expenses, such as taxes and bonuses, which are dependent on income levels).

When analysing past results it should be noted that the financial statements of small and medium-sized entities are often specifically tax-related. It should also be considered that capital expenditures are often only made at greater intervals of time. It is thus possible that the income statements for recent periods inadequately reflect average results and must be adjusted accordingly

The selection of the Valuation Approach

Generally accepted business valuation standards (including the IVS), classify the valuation methods into three wide categories: market approach; income approach; and cost approach. The selection of the approach to be adopted can lead to different bases for the derived value.

Practitioners should consider which of the approaches can provide the most reliable value in relation to the characteristics of the entity and the information that has been collected. Each approach might present issues related to its application to SMEs.

The **Market approach** determines the entity value by examining observable transactions of comparable entities (comparable transactions method) or by applying relevant "multiples" of value of comparable entities (guideline publicly-traded comparable method). In many circumstances, SMEs are "unique" and the appropriate comparison cannot be found. The guideline publicly-traded comparable method also starts with the analysis of relevant multiples produced by public companies, which - while considering enterprises that operate in similar markets – can operate differently. This can require some "usual" adjustments, such as the Discount for Lack of Marketability (DLOM).

The **Income approach,** whose most popular and frequently applied method is the Discounted Cash Flow (DCF) method, is based on prospective financial information (PFI). SMEs may not produce a complete set of PFI. In this case, the practitioner should carefully assess whether it is feasible to apply a method requiring this kind of information. In general terms, the absence of reliable PFI precludes the adoption of DCF and other income approach methods. In case appropriate PFI exists, the practitioner should consider the composition of the elements determining the discount rate to understand whether they should change any value to better reflect the related systematic and unsystematic risks, even if most of the corrections, such as the total beta, do not find a unanimous approval by the literature

The **Cost approach** is usually adopted by practitioners in specific circumstances or in connection with some measures representing the capacity to realize extra-income in the future. These latter mixed methods "share" the considerations mentioned above for the determination of prospective values and the appropriate PFI.

Conclusion

A small business isn't just about offering a snapshot of the profit and loss of your business, it can give a detailed overview of your company's chances of sustainability over a prolonged period of time. There is no one-size-fits-all method to value your small business. The best method depends on the type, size, stage, and industry of your business, as well as the purpose and context of the valuation. There is no one true value of a small business. All three valuation methods should be used to create a **valuation range** that would be acceptable.

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