Are you *creating wealth?*

Use these valuation methods to determine whether or not you are increasing the value of your business…

Wealth isn't just about making money. Here's how Robin Sharma defines wealth in his book *The Greatness Guide, Book One* – a great read:

- **Inner wealth**

This means a great attitude and positive mindset and involves high self-respect and loving yourself. Internal peace and connection (however you want to define this) are part of the package.

- **Physical wealth**

Your health is wealth. No point getting to a great place in your career if you get sick doing it.

- **Family and social wealth**

When your family life is happy you will perform better. Family should be your first priority – otherwise do not set out to have a family.

- **Career wealth**

Being world class in your work is so good for your self-respect. Set out to achieve your highest potential.

- **Economic wealth**

Money is important – not the most important – and it does make life easier if you manage it well. Most people don't manage their money well; you need self-discipline.

- **Adventure wealth**

We all need some kind of mystery in our lives. Challenges are necessary for happiness. We need to be creating constantly to feel joy, otherwise we get bored.

- **Impact wealth**

We all crave to be significant, to make a difference. Be self-disciplined, get out there and make that impact.

There are many "rich" people who are unhappy and unsuccessful as human beings – focus on implementing and working on the above seven elements

Valuing your business

So, let's turn our attention to your business. There are two types of businesses, those that create a lifestyle for the owners and those that create money wealth i.e. the value of the business when you sell it. The idea is for these two types to come together in your business. Small business owners should familiarise themselves with the valuation methods below to allow them to evaluate the value/wealth of their business.

- **Retained Income formula**

Let's consider a simple case study. I worked with a business owner who had been operating for three years and had built up an accumulated loss of R1-million. To give you an idea of where to look, this is what the company's Balance Sheet looked like:

Capital Employed
Shareholders' Equity

Share capital	R20 000
Dividend Paid	Nil
Retained Income	(R1-million)

Obviously this is not a very good position to be in; showing a R1-million loss over a three-year period. Plus the business did not have any major assets such as machinery etc. So after three years of trading the business owner is not going to get much money out if he tries to sell.

Twelve years on and the same business has a retained income of R20-million, a R23-million turnaround. So now after 15 years of trading, the business is worth at least R20-million. If you value the business based on the basic formula of retained income shown on the Balance Sheet; this company demonstrated that from year four onwards; sustainable profits were being made. So sustainability was a key issue and the business showed a good track record of profitability over time.

But let's be clear, there is really no one best method for valuing a business. It really depends on the type of business - some businesses, for instance, may have more clients than physical assets and vice versa. So pick one of the methods mentioned here with the help of your auditor or accountant and use this method at each year-end to see how much "wealth" you generated in the last 12 months.

Start today by asking your auditor to give you a valuation. Yes, put him or her on the spot, so at least you have a foundation value that you can use going forward.

I recently visited a client whose business has been going for 10 years; he is 42 years old. I asked him what he thought the value of the business was. His estimate was somewhere in the region of R12-million to R15-million. We then looked at his Balance Sheet together. He had a Retained Income of R1.5-million and had lost R600 000 in the last financial year. The business does not have any big assets i.e. machinery or equipment. I suggested that he take another look at his valuation with his auditor. I believe the value of his business is closer to R3-million, including goodwill, product benefits etc. He was shocked to hear my verdict.

- **PE ratio**

The most common valuation method is the pure earnings method or PE ratio. The PE Ratio will be three, four or five, depending on the type of business. So if your business is generating a monthly profit of R50 000 after tax, this would equal (12 months x R50 000) R600 000. Using a PE ratio of four, the business would be worth R2.4-million plus goodwill etc.

- **Net assets valuation**

Then there is the net assets valuation method. Here we use the value of the assets in the business and don't take into account future earnings/income. So add all the assets in the business and subtract the liabilities at a specific time, e.g. February 28. The difference is the value of the business.

The assets and liabilities are shown in your Balance Sheet as such:

Example

Assets

Machinery/equipment
Fixed Assets........... R2-million
Stock on hand.........R500 000
Debtors..................R500 000
R3-million

Liabilities

Creditors.......................................R300 000
Bank Overdraft............................R150 000
Tax liability..................................R150 000
R600 000

R3-million – R600 000 = R2.4-million (basic value)

Starting up vs. buying a business

Now let's compare the costs associated with starting up a new business vs. buying an existing business.

Let's start by looking at the example of a quick print shop. For our purposes, let's assume the business isn't making a major profit; somewhere in the region of R10 000/month on sales of R250 000/month with a gross profit percentage of approximately 60%. The business has been operating for seven years, mostly has quotes of R1-million to R1.5-million, but only closes about 25% of the deals out with clients.

Remember that when buying a business, the seller is responsible for collecting any outstanding debts and paying the creditors on an agreed-upon date. This will be detailed in the Buy and Sell Agreement.

To start up a print shop you would need to buy expensive equipment, including a PC, big photocopy machine, etc. find customers, build your name/brand, and the market position of your business. Choosing the right method of valuation is tricky here. You can't really use the PE or Retained Income methods; instead your calculations should be based on start-up costs.

I believe that this type of the business would sell for between R1.5-million and R2-million; not that much after years of hard work, long hours, sweat and tears. Interesting though…

Where to start

My advice to business owners is to start using one of the above methods to value their businesses once your auditor has completed your year-end financial accounts.

First off, get a starting valuation; agree on the method with your auditor and factor in capital gains tax to get a feel for the net amount you would receive if you were to sell the business. Depending on your lifestyle, your investment portfolio etc., you will probably need a business to be worth at least R10-million after working in and on it for 10 to 15 years.

Many owners overestimate the value of their businesses based on gut feel. So I hope you will use the guidelines above to get a better idea of the value. YB

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