10 Value Distinctions

What exactly drives business valuation? A valuation is not about identifying what an enterprise is worth in the current owner's hands, it is about the company's transferable value to a buyer. The purpose of this page is to help you see your company through the eyes of a buyer. This new perspective will ask you to focus on our ten valuation distinctions. Each distinction is a component that either reduces the risks associated with owning the business or enhances the strength that the business will sustainably grow into the future.

The more effective your performance in these areas the greater the selling price of your business. The most desirable outcome is that will sell at a higher multiple normally associated with your industry.

Valuation Distinction No 1: Consistent and Predictable Revenue

Consider revenue and the bottom results of your business as the first introduction to a buyer. This is one of the main attractions for any buyer when looking at a business to purchase. A business with an established track record and pattern of growth will bring a premium price when sold. The value associated with acquiring the available cash flow is directly related to risk. The lower the risk of losing the company's cash flow in a transfer of ownership, the higher the price will be to secure it. If recurring revenues comprise a material portion of a company's overall revenues, the recurring revenue stream can be valued at a higher level than the non-recurring revenues.

Examples of recurring revenues are maintenance contracts, monthly support agreements, annual license agreements, warranties, subscriptions, or other revenue streams that are contractual and repeating in nature. Buyers are willing to pay the highest amount when their perception is that cash flow is predictable and will increase into the future.

Valuation Distinction No 2: Reliable Financial Information

Reliable financial records are not only a critical element of business management but also support the claim that a company is consistently profitable. In the purchase of a business, the buyer will perform some level of financial due diligence. If the buyer is not comfortable when reviewing the company's past financial performance, it will be difficult to do the deal.

If a buyer faces a seller of a business who asserts that the company has been making £1m per year for the past three years and is projected to make at least that much in the future, the seller will be required to prove it. If the seller then produces past financial statements that are incorrect, insupportable, or incomplete, the buyer would most likely leave as a potential buyer. This lack of financial integrity is one of the most common hurdles encountered during the sale process.

Valuation Distinction No 3: Customer Diversity

An expanding customer base in which no single client accounts for more than ten percent of total sales is advisable although sometimes difficult. This helps to insulate a company from the loss of a single significant customer. It reduces the risk of serious revenue issues if one or more customers do not stay after the sale has completed.

Valuation Distinction No 4: Human Capital / Quality of Workforce

Talented people are your business. Buyers look for companies where management and/or key employees have bought in for the long-term for the long term. The quality of the people, including ability, skill, attitude, experience, expertise and depth of knowledge, is also important. An already functioning team that can provide consistency and support the growth of the enterprise under new ownership is an asset that should not be overlooked.

If a company's success is reliant on capable, well-trained stakeholders, not just the owner, the business will not be negatively affected despite new ownership. This reduction of risk may even pay off with an increased offer.

Valuation Distinction No 5: Growth Potential

When an owner can clearly illustrate a realistic plan for growth that specifically identifies the reasons why revenues are increasing the seller may achieve a higher value. A documented plan for growth demonstrates the viability of the company's future and may identify opportunities that a buyer had not considered.

Some areas to consider in developing a growth plan:

- Is your business in a growth industry? Could you move it into a growth industry?
- Are there additional markets that a new owner should pursue?
- What additional products could be delivered to existing customers?
- Where are the best profit margins realised and can they be expanded?
- Can your technology be licensed, or business model improved?
- Will demand for your product or service increase as population grows?
- How will enhanced marketing campaigns and sales efforts affect growth?
- Are there opportunities to grow through acquisition?
- Can growth be achieved by expanding territory or manufacturing capacity?

Valuation Distinction No 6: Operating Systems and Procedures

Do the establishment and documentation of standard business procedures and systems demonstrate that the business can be managed profitably after the sale. Business systems include the computerised and manual procedures used in the business to generate its revenue and control expenses, as well as the methods used to track how customers are identified and how products or services are delivered. The following are examples of business systems that enhance business value;

- Personnel recruitment, training and retention
- Human resource management (an employee manual)
- New customer identification, solicitation, and acquisition
- Product or service development and improvement
- Inventory and fixed asset control
- Product or service quality control
- Customer, vendor and employee communication
- Selection and maintenance of vendor relationships
- Business performance reports for management

Valuation Distinction No 7: Facility and Equipment Condition

The company inventory and equipment should be well maintained to realise maximum value. A buyer will not pay a premium, and may very well discount an offer, for a disorganised facility, office or other building. Seeing a disorganised or poorly maintained company may cause the buyer to perceive that other aspects or the business may be similarly disorganised. (employee records, financial records, compliance records, etc.).

Business owners should ensure that facilities and company equipment are organised and maintained in good condition before beginning the sale process. Buyers will be confidant that their investment will not include major expense repairs and that all equipment and inventory will be in good working order. Finally, are facilities large enough to accommodate a level of modest growth? A buyer does not want to have to look for additional space or immediately invest in new equipment shortly after closing.

Valuation Distinction No 8: Goodwill

This distinction is essentially about stability and consistency. Brand recognition, customer awareness, history and track record, ongoing operations, and reputation are all part of businesses credibility and strength significantly influence value. Even if the company does not have many hard assets, relationships are key. The fact that customers have been with the company for a significant period does matter. Brand recognition, service or product reliability, and high customer satisfaction are distinguishing factors that add value. This driver of goodwill should not be overlooked in a valuation because it is helps mitigate any perceived risk on the part of the buyer.

Valuation Distinction No 9: Barriers to Competitive Entry

Areas that give a company an advantage over its competitors, strengthen its market position, or that can be leveraged for future gain boost value and lessen perceived risk. Buyers will pay a premium for a niche that have high (real or perceived) barriers to competitive entry. One way to describe this is to use Warren Buffet’s term, “Defensible Moat.” Buffet compares a castle’s moat to the protection that a business needs to encroaching competitors. For instance, the wider the moat, the more easily a castle could be defended. A narrow moat did not offer much protection and allowed the castle to be breached. To Buffett, the castle is the business and the moat is the barrier that protects the business’ competitive edge. The following are example barriers that widen the moat and hinder competitors from breaching the company’s castle.

- Brand or Trade Names
- Engineering Drawings
- Customised Software Programs

- Step-by-Step Training Systems
- Customised or Proprietary Databases
- Published Articles or Industry Publications
- Hard-to-get licenses, zoning, permits, or regulatory approvals
- Contracts with difficult-to-penetrate entities (government, for example)
- Copyrights
- Trademarks
- Patents
- Specialised Knowledge
- Trade Secrets
- Developed Processes
- Proprietary Designs
- Proprietary Know-How

Valuation Distinction No 10: Product Diversity

A narrow offering in terms of product or service increases risk and drives down value. Diversity of revenue sources particularly if reoccurring lowers the inherent risk of the enterprise. Therefore, businesses with a healthy product mix, good gross profit diversification, or with products or services sold into multiple industries, receive a higher perceived value from potential buyers.