

# The value of your BUSINESS VALUE

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Many business owners do not understand how critical it is to know the value of their business and to ensure that they have it determined or updated on a regular basis. Let's have a look at reasons why it is important and how to determine the value of your business.

The first aspect to consider is a situation in which one or more partner decides to exit the business. Not only will the value become significant, but also the related arrangements; these should be covered by a shareholders' agreement. The shareholders' agreement should indicate how the business value will be determined and how the exiting parties will be compensated. If the method for determining the value of the business is not agreed in advance, it is highly unlikely that it will be agreed upon at the time when someone exits the business. If these aspects could be determined in advance, the agreement can be structured to ensure that the business remains viable. A forced exit would mean the end of the business due to unbearable cash flow pressure.

The second aspect for which the business value has a significant impact is estate planning purposes. If the business or business interest is held in your personal name, it will form part of your estate and could attract estate duty at 20 per cent and executor's fees at 3.99 per cent. If this is the case, you need to bring the value of your business into consideration in order to determine the possible estate duty. Following from this, you will have to ensure that there is sufficient cash in the estate in order to cover the estate duties.

Obviously related to the previous aspect is the issue of buy-and-sell agreements. This will, for instance, determine that a life insurance policy provides the liquidity to enable your partner/s to acquire your share of the business. If structured correctly, this would typically also be free of estate duties. This is, in most cases, the best way to ensure that your estate receives the appropriate value in exchange for the shares. It is, however, critical that the business value



is determined and updated annually, as well as the related life insurances policies. An out-of-date life insurance policy could mean that your estate would receive substantially less than what your share of the business is worth.

The ideal situation is to have a proper business valuation done and then merely have it updated biannually or at least annually. If the valuation has been done and all the formulas and variables determined, it is easy enough to update certain variables for subsequent valuations and derive the current value. All the parties involved can then sign this valuation every time it is updated and this will alleviate possible disputes relating to determining the business value.

What is your business worth? Firstly, we need to ask, "What is business value?" When you want to purchase a share, what is it that you are actually buying? What you are buying is the future cash flow benefit of holding that share, whether it is the dividend flow or the final capital proceeds on selling it. The same applies to business value. The value of the business is the future cash flow that the business will generate during its lifetime, and the proceeds received when you sell it.

Although there are various methods to value a business for most owner-managed businesses, the most appropriate method is very likely the present value of future cash flow. This means that you cannot use only historic information to value a business, as this is not what someone will be buying.

Historic information is, however, important, as one will use this to determine trends in order to determine sustainable income for the future.

Once the sustainable cash flow has been determined, the present value of this at a fair rate of return would provide you with the business value.

In summary, one would perform the valuation as follows:

1. Take your existing profit and adjust for abnormal items.
2. Determine future earnings by learning from historic trends and adjust with information relating to future events.
3. Determine a fair rate of return given the adjustment for risk.
4. Determine the present value of future cash flows.

Whatever method you use to determine the value, it is critical that:

- it is updated regularly,
- it is signed by all parties involved;
- the relevant buy-and-sell insurance is updated annually, and
- the related shareholders' agreement is signed.

If you are a business owner, this is one aspect you do not want to neglect.



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