

WEEKEND

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SKILLS Knowledge on valuation of SMEs will help you avoid being taken advantage of by investors and lenders



Knowing the different methods of valuing your business will give you the armour you need in meetings with investors or possible buyers. FILE

How to get the fair value of your business from investors



BUSINESS TALK

SCOTT BELLOWS

Linge dreaded the idea of understanding finance. All her life she remained determined to just hire an accountant whenever finance matters cropped up in her company.

Linge's business operated a network of midwives in rural yet affluent areas of the Rift Valley and Eastern and Central Kenya. She started the business ten years before, being passionate about maternal health. Much to her surprise, the business grew and flourished due to a resurgence in preference for traditional home births.

Finally in 2012, Linge took her first finance class during her MBA. She decided to pursue post-graduate education in order to learn new marketing and operations techniques for her midwives network.

She unhappily accepted the rule that USIU required a finance course in order to complete the MBA degree. She pushed off the class until her final semester.

During the course, she did learn something new: while the terms accounting and finance often get interchanged in the workplace, in reality, the two represent drastically different concepts.

Accounting entails record keeping for historical events whereas finance encompasses forecasting future events.

Pleased that she knew the difference between the two, Linge struggled with apathy throughout the rest of the semester. During her graduation, she commented to a classmate that at least she would never touch a finance book again.

Linge's business continued to grow and the home births trend increased among her niche target group. By April 2014, a leading Kenyan hospital approached her and inquired about buying out her business. The hospital system asked to see her financial statements. Linge happily instructed her accountant to send over the statements.

After a few days, the hospital called her and told her that a proper valuation for her company came in at Sh50 million. For that amount, the hospital system would take over 100 per cent of the equity in Linge's firm.

Linge went home that night pleased that her business empire could garnish such a large buyout figure.

However, throughout the night, Linge struggled to sleep. She pondered whether Sh50 million represented the accurate figure for her business. Perhaps she should receive more? Her annual sales alone came to Sh40 million, but her annual net profit represented only Sh6 million.

In the morning, she telephoned her accountant. Much to her shock, the accountant told Linge that he only kept the books and had no idea about valuation amounts. Linge then remembered that she had learned the difference between accounting and finance. Desperate to decide before her 2pm meeting with the hospital, she called some of her former classmates as well as her finance professor.

Throughout that morning, she started to realise that finance indeed did represent a skill set that every business owner should have.

From her network, she discovered that three main forms of valuations exist for SME businesses. Each type of valuation technique depends on the particular type of industry.

1. Revenue multiple valuation

More straight forward industries that deal in commoditised markets — like petrol stations — often deal with a "multiple".

A multiple involves the notion that your business should sell for a certain amount based on a figure in your financial statements. A common multiple includes a business to sell for 1.5 times the annual gross revenue figure. So, in Linge's business, if her annual sales total Sh40 million, then her revenue multiple for her valuation should be Sh60 million.

2. Net profit multiple valuation

You can also derive a valuation using net profit as a multiple. Industries that rely heavily on efficient cost structures to survive, such as the airline business, often use multiples of net profit.

A common net profit multiple entails a business to sell for 10 times its annual net profit. So, specifically for Linge's firm, since her net profit equaled Sh6 million, then the business would yield a Sh60 million valuation.

3. Net present value

Finally, a completely different form of

valuation exists as the third option. Every worthwhile introductory finance class begins with an explanation of the time value of money. Think of it like this: would you rather receive Sh1,000 today or tomorrow? The answer is obvious: you prefer to receive money sooner rather than later. A shilling today is worth more than a shilling tomorrow.

If someone owed you Sh1,000 payable in one year, but you wanted to get the money today, how much money would you demand to receive now?

You desire the present value of that money. You can compute, using the Treasury bill rate that currently stands at around nine per cent, then work backwards by "discounting" the Sh1,000

to its value today. Divide the 1,000 by 1.09 and you arrive at Sh917.

So if you invested that Sh917 today in a Treasury bill, you should receive Sh1,000 back at the end of one year.

Investors, like the hospital system, often use such a method to determine the valuation of a business.

So, if Linge's company expects to earn cashflow of Sh11 million next year, then expects this to increase by Sh1 million each of the next four years, then the hospital system would look at a cash flow of Sh15 million in five year's for Linge's business. If you enter the figures into Microsoft Excel and use the Treasury bill rate of nine per cent, you easily arrive at a net present value (NPV) of Sh50 million.

Since Linge's business involves a complicated service-based sector, the hospital decided to use the NPV method for determining her value.

Microsoft Excel can turn even the most clueless business owner into a powerful negotiator with investors and banks.

Armed with her new knowledge, Linge went ahead to her 2pm meeting with the hospital system and signed the sale papers knowing that the deal did not cheat her but gave her a fair value for her business.

What system of valuation seems appropriate for your own business? Have investors ever tried to take advantage of you? Share your opinion and debate ideas at #KenyaEconomics on Twitter.

Prof Bellows serves as the director of the New Economy Venture Accelerator at USIU's Chandaria School of Business and Colorado State University. He can be reached on www.ScottProfessor.com, info@scottprofessor.com or @ScottProfessor