

Cashing-In On Goodwill Value...

Your Hidden Goldmine

by David Mattocks

To maximise its value, every business should be set up and operated so that it can be readily sold. When, or if, you choose to sell is immaterial because sooner or later every business owner will face the reality of this inevitability.

In order to maximise the sale value of your business, it must become an entity in its own right. In other words, you need to think of your entire business as if it were an enormous complex entity, separate from you, the owner. Only then can you systematically go about increasing its value.

What is Value?

The real value of every business is found in its inherent **intellectual capital**, not in the size of its inventory. This is because products don't have value, benefits have value... and benefits are intangible.

For example, you don't go to the DIY megastore to buy a drill bit, you go to buy a solution for making a hole. If someone gave you a better option than a drill bit for making a hole, you'd take it instead, wouldn't you? Because the product itself holds no value to you. It's the solution you're interested in. It's the solution you're willing to pay money for. The same is true for your business.

So how do you increase your intellectual capital?

By capturing and maximising it, in a way that's sustainable. In the majority of businesses, most of this value is stored inside the heads of a few key people. Without them, the business would rapidly slide into trouble. So the challenge is to capture this individually stored knowledge for the ongoing benefit of the business.

Goodwill

To understand the value of your intellectual capital in a measurable way, you need to understand the value of your goodwill - described as the value of your business - over and above its liquidation value.

There are two types of goodwill...

Sellable goodwill, referred to as **business goodwill**, represents the potential profit from the sale of your business. Unfortunately, if you're like the majority of business owners in the UK, much of your goodwill is un-sellable. This is referred to as **personal goodwill**. It has value to you, but has little or no value to a prospective purchaser, because when you leave, it all goes with you.

How To Increase Your Value

Because goodwill typically has minimal liquidity (i.e. can't easily be turned into cash), it represents the greatest risk factor to a potential buyer. One of the chief concerns a buyer has is how long it will take them to earn back the goodwill they purchased using discretionary earnings (£'s available after normal business expenses) from the business.

Consequently, the value of your business is based on two primary variables. The amount of its discretionary earnings and the length of time those earnings are likely to continue once the business has changed hands.

The length of time a business can sustain its earnings directly impacts on what is called its **earnings-multiple**. This is a multiplier applied to the discretionary earnings to arrive at the price a prospective purchaser is willing to pay for the business. Simply put... if the business is able to sustain itself for a longer period of time, then its earnings-multiple will be higher. Of course, the reverse is also true.

As with all investments, a buyer will typically look for a greater "return on investment", that is purchased at a lower price, when the risk is perceived to be higher. Conversely, all other factors being equal, a buyer will typically be willing to pay more for a business when the risk is perceived to be lower. Therefore, an owner can expect to receive a higher earnings-multiple for their business if the perceived risk of failure is reduced.

How Much Growth In Value Is Possible?

The answer is typically influenced by a number of external factors. However, all things being equal, it's possible to systematically **double the value of most privately held businesses within three years**.

Consider the following simplified example.

Let's assume a modest annual growth rate of 10%. Assuming £500,000 in discretionary earnings and a benchmark earnings-multiple of 2.5 times (i.e. 2.5 years worth of earnings), the following chart demonstrates the impact on value of an earnings-multiple increase of 1.5 over a 3 year period. As you can see, the estimated value of the business has more than doubled, from £1,250,000 to £2,662,000.

Year	Discretionary Earnings	Earnings Growth Rate	Earnings Multiple	Estimated Value
Benchmark	£500,000	-	2.5	£1,250,000
Year One	£550,000	10%	3.0	£1,650,000
Year Two	£605,000	10%	3.5	£2,117,500
Year Three	£665,500	10%	4.0	£2,662,000

Even more interesting, is the relationship of growth to its goodwill value.

In the above example, if we assume the tangible assets of the business are £750,000 at the benchmark stage, then the estimated **goodwill value** of the business is **£500,000** (£1,250,000 - £750,000). Assuming the tangible assets grew to £1,000,000 over the next 3 years, with all other things being equal, the goodwill value of the business will have grown from £500,000 to **£1,662,000** (£2,662,000-£1,000,000).

That's an impressive 3 year increase in goodwill value of 332%... an additional £1,162,000 (£1,662,000 - £500,000).

Year	Discretionary Earnings	Tangible Assets	Goodwill Multiple	Estimated Goodwill Value
Benchmark	£500,000	£750,000	1.0 x earnings	£500,000
Year One	£550,000	£800,000	1.5 x earnings	£850,000
Year Two	£605,000	£900,000	2.0 x earnings	£1,217,500
Year Three	£665,500	£1,000,000	2.5 x earnings	£1,662,000

As you can see, while most people focus their efforts on increasing earnings alone, exponential results can be achieved by increasing both your earnings and your earnings-multiple simultaneously. Or to put it another way...

The best way to achieve REAL growth is to focus all your efforts on VALUE.

The financial benefits of a solid infrastructure are undeniable. But there is yet another benefit to building your business properly... TIME.

While every business owner must eventually face the reality of succession, not everyone is on the same timetable. But by systematically developing their business, the owner can gain a tremendous amount of time to lay in structured plans for selling, whilst still functioning effectively as its owner.

Of course, exactly when you sell your business is up to you, but there's beautiful irony in the fact that the more your business is worth, the less you may feel inclined to sell it!

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