How To Fund Your Goodwill

Do you have plans to:

- buy a new business
- take over a competitor
- grow your business, or
- buy out your business partner...

and wonder what the value of the business is?

Assessing the value of a business for sale, purchase or expansion can be tricky. What you think a business is worth and what the other party may think can often be two quite different figures - and a potential lender could also have another view.

When considering the value of a business, it is important to carry out thorough due diligence and consider the impact of identified findings within your valuation.

Assessing the business history, sales and business expenses, assets and liabilities, market conditions, staff, supplier arrangements and customer information are all necessary. ***But the real challenge is settling on a valuation to determine the purchase price!***

The valuation is usually calculated as a multiple of profit or revenue. The multiple will be determined having regard to several considerations including the historical growth of the business (or lack thereof), industry profile, stability in earnings and the associated risks of the business. While the profit or revenue should be simpler to assess, there are many alternatives that may be used – an average of the last three years' profit, the last year's profit, the projected sustainable profit or other method determined by the purchaser or seller.

Having determined a value it will be necessary to allocate it to the various components/assets of the business. It will first be allocated to various assets within the business that have a pre-determined value including motor vehicles, machinery, patents etc. The remaining proportion of the purchase price is allocated to goodwill.

Goodwill is an intangible, saleable asset, arising from the reputation of a business and its customer base as distinct from many assets taking on the physical form[1].

Businesses that generally deliver services are likely to have a greater proportion of their purchase price allocated to goodwill than those that manufacture physical products requiring extensive machinery. Therefore, businesses that are service orientated (ie a graphic design business) are generally going to have a higher proportion of goodwill than those heavily dependent on manufacturing.

Having agreed a purchase price, you also need to consider how this is going to be funded.

The purchase can be part funded with either a lender's secured or unsecured loan or a combination of both. Secured loans by their nature are secured against property and assets and are generally more cost effective than unsecured loans.

Why? Lenders like tangible assets as they are generally separately identifiable and able to be sold independently of the business. These assets can be sold quickly making it easier to recover outstanding moneys.

Goodwill however only holds its value when all the business is sold (in its entirety). Without all the assets and components being included in the sale it is highly unlikely that the goodwill will be able to be

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sold at all. If a lender has taken possession of the business to recover outstanding moneys, it is also most likely that the business is no longer trading at historical levels and therefore the goodwill is also likely to have depleted in value.

While it may be easy to value and finance the physical assets of a business, ***how do you fund the purchase or expansion of a business that has a high proportion of goodwill?***

In most cases, many business owners look to utilise assets held outside of the business as loan security to reduce the costs of the borrowings. This could include personal real estate or commercial assets outside of the business.

The type of asset you put forward as security and how much it is worth can impact your loan term and the amount you are able to borrow.

Don't want to put your home on the line? ***Read our article on How To Secure Business Finance Without Using Your Home Equity.***

In many instances unsecured business loans may also be able to be accessed, however these are likely to be at a higher cost and a reduced LVR. The quantum of funds, interest rate, loan term and conditions of the loan will be determined by cash flow and the industry your business operates in.

As you can see, there are many determinants when choosing how to finance a business purchase or expansion. It can feel overwhelming sifting through eligibility requirements and the many options available.

As your finance broker, we seek to understand your business, have access to many finance products and can provide options to best suit your situation. We can help you through the loan process to put your best application forward.

Sources

1. Goodwill and business assets (taxinstitute.com.au)

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