# The financial drivers of business valuation

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A "bigger" business in terms of revenue or people does not equate to a more valuable business. So what factors are considered in calculating business valuation? Business value is based on future cashflows to the owners and the certainty of earning those future cashflows.

There are many factors that impact the future performance of the business and we briefly explore the financial drivers of valuation.

**Rate of growth**

If you can increase your growth rate e.g. from 5% to 10%, and if the increase in growth rate is sustainable for a period of time, your business valuation can be increased significantly. Protecting your growth rate from new entrants or other competitors can be very valuable.

**Increase length of competitive advantage**

Competitive advantage allows you to generate more cashflows for period of time vs your competitors. It allows you to thrive rather than just survive. Extending customer contracts, strengthening your brand, or becoming the lowest cost producer are a few examples of how this might be achieved.

**Reduce incremental investment spend**

Reducing your investment spend while maintaining your current rate of growth is often possible but not easy in most businesses. Be careful of cutting too much investment and impacting your future growth rate.

**Increase operating margins**

Higher profit levels translate into higher cash flows. Examples of increasing profits might include increasing pricing, reducing costs, increase volumes sold, improve the utilisation of assets & so on.

**Reduce incremental working capital**

Investment in Stock, Debtors and Creditors ties up a lot of cash in most companies. It is also an area that not enough companies focus on or understand in enough depth. Reducing the investment requirement (as a % of sales) supports the ability to grow and creates additional cashflow to owners.

**Reduce the cost of capital for the business**

The cost of capital is effectively the return an investor requires to invest in the company. For example, debt investment has less risk than investing in shares as debtors get paid first and as a result, demands lower returns. By changing the proportions of debt & shares, you are able to reduce the average cost of funding, and effectively leave more cashflow for shareholders to be reinvested or distributed as dividends. Beware: increasing debt increases the financial risk profile of your business.

**Reduce the cash tax rate**

Tax is paid out before cashflows are available to shareholders. Reducing your cash tax rate increases cashflows to shareholders. Drive your operational performance and address tax as a secondary measure.