

PERTH BUSINESS VALUATIONS



BUSINESS VALUATIONS

A GUIDE TO BUSINESS VALUATIONS





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INTRODUCTION

The valuation of a small business (less than 100 employees) is an art form practised by a variety of professions, with differing levels of success. Like the valuation of real estate, there are established procedures and methods for the valuation of business which if followed, will produce a result of sorts.

As a property valuer with over 10 years experience, I understand that the basis of all valuation methods ultimately come back to a direct comparison between the subject property and other properties of varying comparability. You may be comparing improvements, locations, sale prices, leasing rates, zoning etc., but ultimately some sort of a comparison will need to be made, which will largely determine the Market Value of a subject property.

“Informed comparisons can only be made within a framework of adequate and informed knowledge”

Unfortunately, in respect to business sales, it is difficult for most stakeholders to find the scope of information necessary to make informed comparisons between businesses. Information is tightly held by brokers, accountants, and industry specialists, and subsequently most business valuations are made in a semi-vacuum of limited information.

Despite this, it is necessary for businesses to be valued, and valuation professionals make the best use of the limited information at hand to make valuation decisions. This document has been prepared to give an understanding of the process involved with valuing a business, and thus enable all professions to speak a “common language” when referring to business valuing. It aims to make the valuation process more transparent, and will demystify the Business Brokers perspective on how they value businesses.

It is my hope that you find this document useful. Please contact me directly to discuss any aspect of this Guide.

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VALUATION METHODS

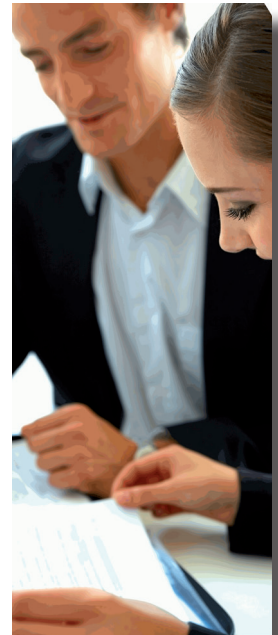
Current valuation theory suggests that there are three basic “levels” of value applicable to a business or business interest. The levels of value are respectively:

- Controlling interest: the value of the enterprise as a whole.
- As if freely tradable minority interest: the value of a minority interest, lacking control, but enjoying the benefit of market liquidity.
- Non-marketable minority interest: the value of a minority interest, lacking both control and market liquidity.

Most business valuations are interested in determining the value of the total business entity, and as such are undertaken on a “controlling Interest” basis.

Determining the fair market value of a company is normally achieved using one or more accepted valuation methods. These methods include but are not limited to:

- i. The net present value of the projected cash flows (Discounted Cash Flow Method);
- ii. The capitalisation of future maintainable earnings (Return on Investment Method);
- iii. Net asset backing based on orderly realisation of the assets;
- iv. Industry market method.



The **Discounted Cash Flow Method** is normally considered a superior technical approach because it allows for fluctuations in future performance to be recognised. It also values the business on the basis of the future free cash flows generated. However, to utilise this methodology requires reliable long term cash flow forecasts. The nature of the business does not lend itself to the development of such forecasts and given the volatility in business performance, it may be an inappropriate method to rely upon. On this basis we have decided not to apply this methodology.

The **Return on Investment Method** is a reliable methodology to employ for mature profitable businesses. This method capitalises pre tax earnings (EBITDA) and establishes a value for the enterprise. This method required the determination of the future maintainable earnings of the business, assessment of an appropriate capitalisation rate and valuation of any assets surplus to the core business. This method is commonly used in the valuation of businesses and is appropriate where there has been sufficient trading history to establish business continuity and where it is reasonable to expect that the value of the business is likely to exceed the underlying value of the net assets.

The **Net Assets Backing Method**, whilst valuable as a comparison tool, is generally considered to be inappropriate for valuing a business under a going concern concept. This method assumes that the value of the business rests in its underlying assets and that the value of those assets as recorded in the financial statements of the company is a reasonable reflection of current value.

The **Industry Market Method** may be used in industry sectors where there is a relatively large number of participants, sale of these businesses occur on a frequent basis and where the sale price is known to the broader public. In these sectors current market prices can be established for similar businesses and which allow for comparison with any features unique to the business under consideration. This can provide a basis for forming a reasonable market opinion. A market of this type does not exist for this business.

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OVERVIEW OF RETURN ON INVESTMENT METHOD

There are a number of valuation methods and 'rules-of-thumb' which have developed over time for the valuation of businesses, and particular business industries may even have their own specific methods of valuation. This can be very confusing, particularly if you are comparing businesses from different industries.

To cut through this confusion, a **single consistent valuation method** has been developed allowing all businesses to be valued on the same consistent basis. This method of valuing is known as the **Return On Investment (R.O.I.) Method of Valuation**.

The **R.O.I. Method of Valuation** analyses the income stream of a business, and then assesses the **Risk** of this income stream continuing on into the future. This risk is expressed as a percentage (%) and is known as the R.O.I%. The higher the percentage, the higher the perceived risk of the ongoing income stream (See Page 8).



A prudent buyer will ask "Is the current income from the business sustainable and on-going?" The R.O.I% used in calculating the value of the business is a reflection of this risk. It is important to note that the R.O.I% is determined by supply and demand. If a business is in a sought after industry then a purchaser may be prepared to pay more for a business, thus lowering the R.O.I%. The R.O.I% changes over time as business cycles ebb and flow. It is, therefore, important not to rely on "rules of thumb" when valuing businesses.

The advantages of using one single method to value businesses is that it allows for different businesses across various industries to be compared to each other on the same basis. A wholesale business can be compared with a manufacturing business, even though the industries are completely different.

HOW IS THE BUSINESS VALUE CALCULATED?

Let's consider an example. Jenny has a successful wholesale/retail business which has an Adjusted Net Profit of \$200,000 per annum. An R.O.I% of 40% is deemed to be appropriate in this instance. With these two pieces of information the potential sale price of the business can be calculated using the formula shown below:

| | | | |
|----------------|-------------------|---|---|
| EXAMPLE | SALE PRICE | = | $\frac{\text{Adjusted Net Profit}}{\text{Return on Investment (R.O.I.)\%}}$ |
| | SALE PRICE | = | $\frac{\$200,000}{40\%}$ |
| | SALE PRICE | = | \$500,000 |

Note: a full explanation of "Adjusted Net Profit" and "Return on Investment (R.O.I.)%" appears on the following pages.



HOW IS THE R.O.I % CALCULATED?

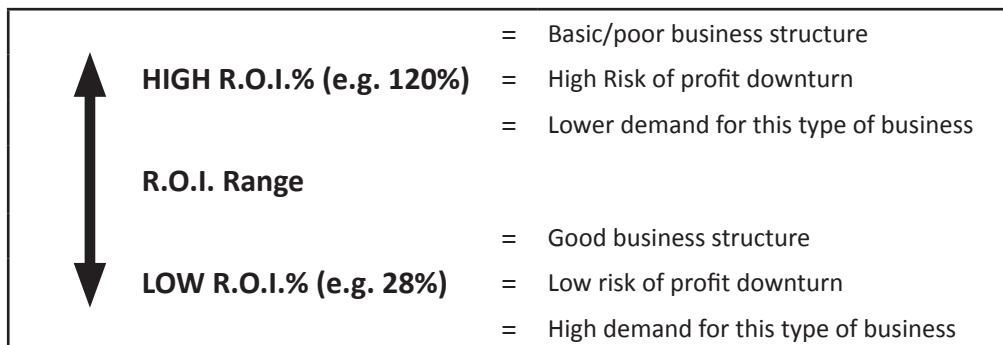
The R.O.I% is derived by dividing the Sale Price of a business by the Adjusted Net Profit of the business (Please see formula below). For example, if Jenny sells her business for \$500,000 to Robert, and at the time of sale the business was producing an Adjusted Net Profit of \$200,000 per annum, then the R.O.I% for that business will be calculated as:

EXAMPLE Return on Investment (R.O.I)% = $\frac{\text{Adjusted Net Profit}}{\text{Sale Price}} \times 100$

Return on Investment (R.O.I)% = $\frac{\$200,000}{\$500,000} \times 100$

Return on Investment (R.O.I)% = 40%

Note that this is a reversal of the formula show on page 5.



An example has been provided below on three different businesses, all with the same Adjusted Net Profit of \$100,000. The hypothetical businesses are compared with each other, and note the effect on the overall value that the R.O.I.% has:

| | Wholesale/Distribution | Metal Fabrication | Personal Training |
|----------------------------|--|--|--|
| BUSINESS OVERVIEW | <ul style="list-style-type: none"> • Long established; • High quality brands; • Low staff requirements; • No shop front required; • Written exclusive contracts; • 5 days per week; • Run under semi-management; • No prior experience necessary; • Low competition | <ul style="list-style-type: none"> • Prior experience required; • High plant and equipment levels; • Specialist staff required; • Difficult to relocate; • High over heads; • Low gross profits; • Established business relationships; among • Low-mid levels of competition | <ul style="list-style-type: none"> • No long-term contracts; • Low barriers to entry; • High competition; • Highly motivated charismatic owner; • Limited business history; • 6 days per week; • Business is based on owners personal relationships |
| ADJUSTED NET PROFIT | \$100,000 | \$100,000 | \$100,000 |
| R.O.I. % | 27% - 30% | 45% - 50% | 80% - 90% |
| VALUE RANGE | \$330,000 to \$370,000 | \$200,000 to \$225,000 | \$110,000 to \$125,000 |

As you can see, the lower the R.O.I%, the higher the value of the business. Remember that the R.O.I.% is derived from the Business Sales Market, to calculate up-to-date R.O.I.%s on businesses which have recently sold.

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WHAT IS ADJUSTED NET PROFIT?

In our business valuation calculations (pg7) we use the business Adjusted Net Profit to determine value.

$$\text{SALE PRICE} = \frac{\text{Adjusted Net Profit}}{\text{Return on Investment (R.O.I.)\%}}$$

So just what is Adjusted Net Profit?

In its most simple form, Adjusted Net Profit is the true underlying profit of a business after allowances have been made for the owners' personal structure and any abnormal income or expense events. In accounting terms it is known as E.B.I.T.D.A (Earnings Before Interest, Tax, Depreciation, and Abnormals).

People buy or start businesses in order to have access to an income stream from the services or products that the business produces. The R.O.I. Method of Valuation calculates the value of a business based on the income it produces.



The income stream of a business is shown in the Profit and Loss statements prepared by the business accountant. Financial statements of privately held businesses are usually prepared to report income taxes. These financial statements serve the purpose for which they were intended, however they rarely show the economic reality of the business's earnings or assets.

To determine the appropriate Adjusted Net Profit to value a business, it is usual practice to work on the figures from the current financial year, as this is usually the most up-to-date picture of how the business is performing.

When valuing a business, I use the business financial statements to determine the ongoing income stream that would be available on an "Under Management" basis from the business, and then multiply this income stream by an R.O.I. Percentage to determine the sale price of the business.

Adjusted Net Profit is "adjusted" to remove accounting changes and the owners personal structure from the business profits.

Adjusted Net Profit = Business Operating Profit before Tax, Depreciation, Interest & "Add-Backs"

We discuss "Add-Backs" in greater depth on the next page.



WHAT ARE ADD-BACKS?

The financial statements of privately owned businesses rarely portray the true assets and earnings they generate. Pro-forma adjustments, often referred to as “Add-Backs”, are used to adjust an historically reported financial statement for a truer picture of the underlying cash-flow of the business.

Add-backs help portray the true underlying cash-flow of a business

Adjusted Net Profit = Business Operating Profit before Tax, PLUS Depreciation, Interest & “Add-Backs”

The type of Add-Backs that are relevant depend on the circumstances unique to each individual business. The underlying goal is to adjust the historically reported profit to the economic reality of the business by adding or subtracting amounts to individual financial statement components.

Typical Addbacks can include:

- Donations
- Bad Debts
- Rent Adjustments
- Adjustment for Owner’s Wages & Superannuation
- Hire Purchase and Leasing charges
- Loss on sale of Fixed Assets
- Interest (Both expense and income)
- Depreciation

Add-backs are an important tool for adjusting financial statements to show the economic reality of the business, but they are not tools that can alter history. Add-backs are not appropriate to depict how a business could have performed had the owner taken a different strategic direction or captured an opportunity that was missed. Add-backs are used to properly depict the earnings and assets of the business as it was actually operated and not how the owner should have or could have operated the business.

The importance of properly identifying Add-Backs shouldn’t be overlooked as they directly impact the Business Value when using the R.O.I Method of valuation.



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ADD-BACKS EXPLAINED

WHY DO WE ADJUST FOR MANAGEMENT WAGES?

In most small businesses (less than 100 employees) the business director(s) work actively in the business in an operational capacity. Depending on the business structure and taxation structure recommended by the business owner's financial adviser, the directors salaries may be above or below fair market remuneration.

The Wage Adjustment is made to ensure that a full charge is made for the costs of operating the business under full management, and hence full charges made for owners' wages for time engaged in the working in the business.

WHY DO WE ADJUST FOR RENT?

Another income statement adjustment often involves occupancy cost or building rent. Some businesses own the premises they operate out of, thereby not needing to pay Fair Market Rent.

An adjustment to the historical rent expense for the business may need to be made to reflect the earnings of the business as if it had been paying Fair Market Rent all along, since an incoming buyer of the business will have to incur this expense themselves in the course of their normal business activity.

WHY DO WE ADJUST FOR DEPRECIATION?

The Return on Investment Method of Valuation relies on E.B.I.T.D.A (Earnings **B**efore Interest, **T**ax, **D**epreciation, and **A**bnormals). The income of the business is valued before depreciation has been taken into consideration.

In the accounts, the depreciation is determined by taxation laws. This may or may not have any relevance to the actual market value of the plant and equipment. For example say a machine is bought for \$990 on the 30 June. One day later, on the 1 July, this item will have no book value as it has been completely written off for tax purposes. To say that this item has no real value to the business owner the next day is illogical. If that person was selling the business, he would want to get more than \$0 for this new piece of equipment. Many items of plant and equipment can be written off completely on the books, but are still used by the business for many years thereafter. Experience has shown that in the vast majority of times, the asking value of the plant and equipment exceeds the written down value and in many cases by large amounts.

EXCEPTIONS

Depreciation should not be added back for video stores and companies that hire out plant and equipment. Video tapes have a 100% depreciation rate. Thus the purchase of these should be treated as an expense. Hired out plant and equipment is the "stock" of the business and should be considered as an expense.





HOW IS GOODWILL CALCULATED?

WHAT IS GOODWILL (Intangible Asset)?

Goodwill is the value of a business to a purchaser over and above its net asset value. It reflects the value of intangible assets such as strength of the on-going income stream, reputation, brand name, contracts, good customer relations, high employee morale and other factors that improve the company's business.

The correct method of deriving Goodwill is very simple and accurate.

Goodwill = Total Business Value less Net Asset Value (See example below)

The first step to calculating Goodwill Value is to determine the Total Business Value, using the R.O.I Method of Valuation outlined in the preceding pages. Once the Total Business Value has been determined it is a simple matter of deducting the Net Asset Value (plant, equipment, stock, vehicles etc.) of the business from the Total Business Value, to arrive at the Goodwill Value, or intangible asset value.

Using our example of a Wholesale / Distribution business from the Page 8 (see below), the Total Business Value is calculated at \$370,000, as determined using the R.O.I method of valuation.

| Example Wholesale / Distribution Business | |
|---|--|
| BUSINESS OVERVIEW | <ul style="list-style-type: none"> • Long established; • High quality brands; • Low staff requirements; • No shop front required; • Low competition • Written exclusive contracts; • 5 days per week; • Run under semi-management; • No prior experience necessary; <p>The business needs the Plant & Equipment and Stock shown below to successfully run at its current levels:</p> <p>PLANT & EQUIPMENT VALUE: \$50,000 STOCK VALUE: \$150,000</p> |
| ADJUSTED NET PROFIT | \$100,000 |
| R.O.I. % | 27% |
| TOTAL BUSINESS VALUE | \$370,000 (calculated by dividing the Adjusted Net Profit by the R.O.I %) |
| LESS PLANT/EQUIPMENT | -\$50,000 |
| LESS STOCK | -\$150,000 |
| GOODWILL VALUE | \$170,000 |

The value of the Goodwill is directly determined by the overall value of the business, which in-turn is derived by the R.O.I. Method of valuation as outlined earlier in the report.



ABOUT THE AUTHOR



Blair Macdonald

My entry into the world of Business Valuing arose out of my passion for business.

Prior to commencing my business valuing career in 2006, I operated as a licensed commercial and residential property valuer throughout Australia. I find this valuation expertise invaluable when valuing businesses.

I specialise in the value of businesses ranging from \$100,000 to \$10,000,000 in value, and I am familiar with all business industry types.

***Contact me for an professional,
accurate, and confidential
valuation on your business***

How Can You Benefit From My Services?

I aim to add value for my clients through the following services:

- **Business Broking** - I enjoy helping people successfully transition into, and out of, quality businesses. I am dedicated to providing the highest quality service, documentation, and marketing for all my clients in regards to business transactions.
- **Business Valuation / Business Health Checks** - As a licensed valuer I am well-qualified to undertake business valuations, and have a solid history in providing business valuations for a range of circumstances.
- **Buyers Representative & Negotiator** - I successfully approach companies, not currently for sale, on behalf of buyers who are keen to acquire that particular business. Alternatively we can canvass specific industry sectors on behalf of buyers who are looking to acquire a business within a certain industry.
- **Sales Transaction Documents** - I prepare legally binding and enforceable sales transaction documents for buyers and sellers who may have already agreed on a sale price.

Blair Macdonald

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Definitions

"Document" means Business Valuations - A Guide to Business Valuations;

"You" means the user of the Document (and "Your" has the corresponding meaning).

BUSINESS VALUATION CHECKLIST

You will need to prepare:



The Date of Valuation; usually the date of the most recently prepared accountant's financial statements.



Up-to-date financial statements, preferably from your Accountant;



A complete copy of the lease and any lease assignment documents;



Details of any contracts, agencies, exclusive agreements, trademarks, patents etc. held by the business;



An up-to-date list of the plant, equipment and vehicles that are required for the ongoing operations of the business, as well as the current Market Value of these items, and their general condition;



An accurate stock-take as at the date of valuation, at the cost price of the stock;



Details of the employees, including employment contracts, length of tenure, pay rates, outstanding entitlements and long service leave;



A list of your top 10 customers, and the overall percentage of the sales they comprise in your business;



A list of your top 10 suppliers, and the overall percentage of the purchases they comprise in your business;



A copy of your franchise agreement (if applicable). Note that you may need the franchisor's permission before releasing this document.



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OTHER BUSINESS GUIDES:

- **BUSINESS BUYERS GUIDE**
- **GUIDE TO BUSINESS SALES**