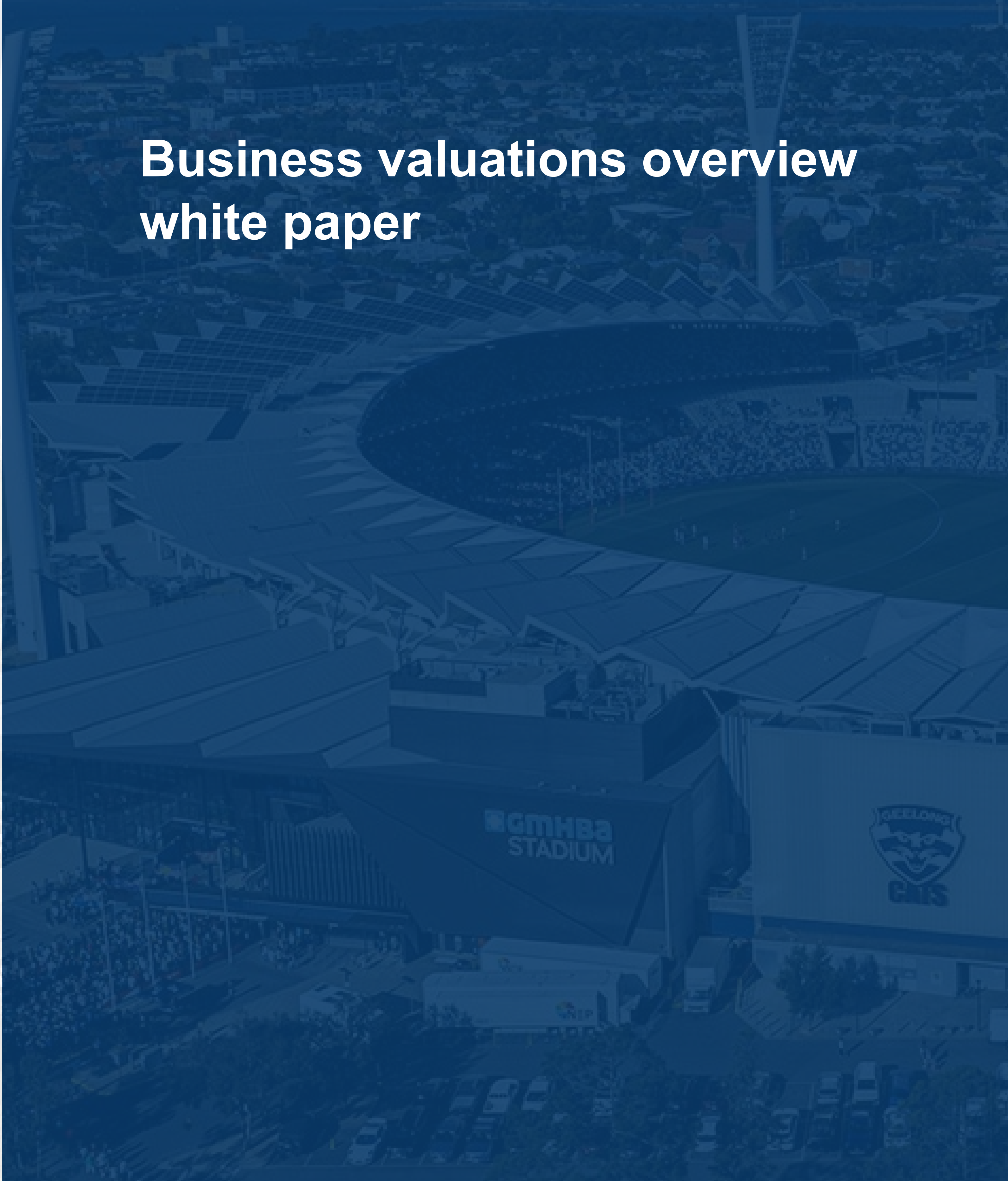
SME Valuations

Business valuations overview white paper



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Contents

Why bother? 3
What is being valued? 6
What are the most common valuation methods? 7
What are normalisation adjustments and multiples? 9
What is the valuation process? 13
What affects value? 14
What are the benefits of a valuation? 16
Who is SME Valuations? 18

This white paper is intended to be a useful guide for business owners and business advisers understand “business value”. You know, that fictional number we are all going to sell our business for in the future.

It is yet another white paper about business value and how to value a business.

Enjoy the read.

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Why bother?

Unique business fingerprint

Every business is different.

Every business owner will exit...eventually.

The exit will either be:

Voluntary	Involuntary
Donation (gift to another)	Buried (one foot in)
Internal sale (staff, shareholders, family)	Break up (divorce)
External sale (competitor or other)	Bickering (with staff, partner, shareholder)
Retirement / closure	Bankrupt (liquidation)

Understanding the value of a business is vital for making decisions such as:

- preparing for, or protecting from, the involuntary exit
- monitoring wealth that is trapped in the business
- achieving a successful voluntary exit.

Most business owners only go through an “exit” once, so be prepared and get it right when it happens.

A business exit is ideally planned and voluntary.

Valuations are easy

The most prevalent formula for valuing a privately owned small business is pretty simple and goes something like this:

Business value = Profit x Multiple

For example:

- Profit = average profit over the last three years of $500k
- Multiple = 3 times
- Business value = $1.5 million.

Job done.

What seems simple is not always well understood or calculated properly. For example:

- Which profit do we use? Pre-tax, EBITDA, EBIT, net profit after tax?
- Which financial year do we use? The year just finished? Next year?
- Should I take an average? What about a weighted average?
- Do I adjust profit for one off items, called normalisations?
- Which normalisation adjustments are relevant?
- What do we do with non-cash items like depreciation?

There is never a single answer for a business exit. Equally, there is no single answer in a business valuation. There are different answers depending on the situation and the audience.

What is value?

In the business valuation world, value is often described as:

An estimate of the price that a willing purchaser will pay a willing seller for the business, being fully informed and reflecting existing conditions.

The key ingredients of this statement are:

- estimate of the price:
  - a valuation is an estimate that may not fully reconcile to the actual price achieved
  - the estimate is at a point in time
  - the estimate is based on expected future profits or cash flows from the business
- willing purchaser:
  - there is a possible buyer for the business, even if it is not yet known who
- willing seller:
  - if the price is reasonable, the seller is assumed to sell
- fully informed:
  - the buyer has all the information needed to make a sensible decision
  - the seller is not withholding important information about the business
- existing conditions:
  - having regard to economic activity, industry profile and the extent of competition.

Unfortunately, the concept of value does not stop there. There is lots more jargon attached to the word “value” to make the world more complicated than it needs to be.

This means that the “value” of a business will be different in different situations. For example:

Situation or exit type	Possible “value”	What does that mean?
Sale of business to a competitor (no competitive bidding)	Market value	The same as already described, basically a willing buyer and willing seller and no other funny business
Sale of business to a competitor (competitive bidding)	Investment value	Might be higher than market value because the bidding parties are competing with each other or one “special buyer” might pay over the odds for merged business benefits (synergies)
Tax event (say, internal sale of business from a discretionary trust to a company)	Market value	Same as the first option, excluding any benefit or premium that may be paid by a “special buyer”

Situation or exit type	Possible "value"	What does that mean?
Break up (divorce)	Special value	The value of the business to the divorced party in their hands. Might be higher or lower than market value, depending on how owners are paid and other special rewards of ownership
Bickering (with staff, partner, shareholder)	Fair value	Minority interest (small parcel of shares) to be valued based on 100% and pro-rated. No valuation funny business for being a minority shareholder in a privately owned company
Still bickering…	Market value	The same as the above, except the value might be lower as an adjustment (discount) is applied for lack of control and marketability

Regardless of the base or definition of value, it is important to be aware of the context and the intended audience.

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What is being valued?

Business or equity (ownership interest)

The value of the business most often differs to the value of an ownership interest, say the issued capital of a company.

The business value typically reflects the combination of:

- working capital (such as debtors, stock, creditors)
- fixed assets (such as vehicles and equipment)
- goodwill and intangible assets (such as the business reputation, client relationships, established and skilled workforce).

The value of the business is not impacted by the way the above items are funded. That is, if the business owner has borrowed money (debt)) or raised capital from shareholders (equity). The mix of debt and equity does not typically impact business value.

The value of an ownership interest, say 100% of the issued capital of the company will change depending on the level of any debt and any other non-business assets, such as unpaid dividends and distributions.

The value of a house is no different. If the house is valued at $1 million and the owner has borrowed $200,000 to fund the house, then the situation is:

- house value = $1 million (not impacted by the size of the mortgage)
- equity in the house = $800,000 (after deducting the debt).

This whitepaper focuses only on the valuation of the business.

Level of value

Most of the time business owners think about the value of the whole business (or the equity).

The value of a single share in a privately owned company is the value of the company (100% of the shares) divided by the number of shares on issued.

However, the owner of a single share in a private company typically:

- has no control over decision making with respect to business operations, strategic plans, payment of dividends, and so on
- has a limited market (or none at all) in which to sell the shares held.

These concepts are referred to as a lack of control and marketability, respectively. In some cases, the value of a single share will be less than the pro-rata equivalent. This depends on the context and definition of value applied.

What are the most common valuation methods?

For a business, there are three common valuation methods:

- market based approach
- income based approach
- asset based approach.

The table below provides a brief description of each and when these are commonly adopted.

Method	Description	When is Method Used
Market based approach	• comparison to similar publicly listed companies • based on the earnings multiples or prices from market transactions involving the sale of comparable assets or businesses.	• equity is listed on public market / exchange • transactions for the same or similar assets are available.
Income based approach	Capitalisation of future maintainable earnings ("COE"): • the application of a capitalisation multiple to an estimate of the future earnings ("FME") of the business • FME is adjusted for one-off items and commercial payments to owners • capitalisation multiple will reflect risk, time value of money and future growth prospects. Discounted Cash Flow ("DCF"): • the value of a business based on the future cash flows discounted back to a present value at an appropriate discount rate • discount rate reflects the time value of money and the riskiness of the cash flows.	• reasonably consistent trend in profitability and that trend is expected to continue • the business has an indefinite life • cash flow forecasts are not available. OR • earnings are expected to fluctuate from year to year • cash flows forecasts exist • business in start-up phase or project has a finite life.
Asset based approach	• separation of the business into components that can be readily sold and valuing each component based on the amount that could be obtained if sold • can either reflect: ○ going concern: value of assets on a continued use basis	• the business has been incurring losses for a number of consecutive financial years • the specific assets being considered are surplus to the business operations of the business.

	○ orderly realisation: value of assets after allocation of transaction costs ○ liquidation: value of an assets under forced sale conditions.	

The COE approach is essentially the "Profit x Multiple" formula commonly understood by business owners and advisers. The language used in the table differs from International Valuation Standards and has been simplified on purpose.

What about "rules of thumb"

Rules of thumb (or ROT) are an over-simplified method used in some industries, such as accounting firms and mortgage brokers. An example for an accounting firm might be a ROT of between 90 and 100 cents in the dollar for every client fee generated (or 0.9 x annual fees).

The simplicity of ROTs hides their issues including:

- businesses, industries and economies change, yet many ROTs used are static
- there is no relationship to the profitability of the business. A larger business (defined by higher annual fees) is not necessarily more profitable or more valuable
- no allowance or adjustment is made for the business risk profile, quality of earnings, and growth profile
- there is little (if any) reliable evidence to support ROTs
- where available, they are a condensed version or average of observed market transactions
- they are only useful in highly homogenous businesses or industries where a purchaser is aggregating clients or a market position.

ROTs should be used as a last resort and should not be a substitute for a more comprehensive valuation process.

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What are normalisation adjustments and multiples?

The most common and well understood approach for valuing a privately owned small business is pretty simple and goes something like this:

Business value = Profit x Multiple

In the last section this was referred to as the Capitalisation of Earnings method. The approach is a simplified version of the Discounted Cash Flow method.

The first half of the above formula requires the selection of Profit. More specifically, the objective is to select a Profit for the business that:

- is achievable
- is at least sustainable
- is a best estimate of future performance
- has been adjusted or normalised.

Normalisation adjustments

Many businesses do not have a clean income statement (profit and loss). That is, there are things that happen or are expected to happen that are:

- not related to the business, such as loans and distributions to family members and business owners
- are abnormal in the year, such as large investments in software, profits on the sale of equipment.

Some of the more common adjustments that are made during the valuation process are outlined in the table below.

Description	Examples
One off / abnormal items	• COVID-19 government funding received • Investment in new software system to support the business • Profit / loss on sale of fixed assets • Insurance losses or recoveries • Product research and investment • Litigation costs • Abnormal staff recruitment fees • Accelerated depreciation of fixed assets purchased due to tax concessions available.
Unadjusted personal items of the business owners	• payments for personal vehicles, mobile phones, house renovations • interest paid / received on loans provided to / from the business
Non-commercial amounts	• rent paid above / below market rate for business premises owned, typically by the business owners or say a Self-Managed Superannuation Fund • remuneration (or lack of) paid to working owners and family members.

The idea of cleansing the income statement is to identify the earning potential of the business that may be available to a purchaser. Such adjustments are also used to convert the income statement from being historical to one that is forward looking.

Which profit is used?

The second consideration in the formula is which profit do we use, including:

- EBIT (earnings before interest and tax)
- EBITDA (earnings before interest, tax, depreciation and amortisation)
- NPBT (net profit before tax)
- NPAT (net profit after tax)
- NOPAT (net operating profit after tax).

Any one of the above profit types can be used provided the multiple selected matches the profit type.

The more common selection of profit is based on EBITDA or EBIT, primarily because these profit types:

- exclude the impact of debt finance (the interest bit). As previously stated, the business value is not impacted by debt funding
- exclude the impact of tax, which is often specific to the ownership structure the business operates in. It is far easier to compare and contrast businesses for valuation purposes by ignoring whether they are operated in a discretionary trust, company or a partnership
- may exclude depreciation on the basis that the expense in the profit and loss statement is often not reflective of how the fixed assets are used, but more reflective of any accelerated tax concessions that may be available.

For businesses that are not capital intensive (not much equipment or other fixed assets), then it really does not matter. An example might be an accounting practice.

For capital intensive businesses, like a manufacturer, then depreciation is critical as this represents the investment in fixed assets that are fundamental to running the business. Even though the equipment might have been purchased several years ago, the benefit of the equipment goes on for a number of years. Also, eventually the equipment will need to be replaced.

Lots of corporate organisations focus on EBITDA in their annual reports and market presentations. Referencing EBITDA promotes comparability across businesses, but has its limitations when used in the private business world.

Should we apply an average profit?

When selecting the profit for the simple business valuation formula, the objective is to estimate a level of future maintainable profitability. Reference is often made to historical normalised performance.

Is it appropriate to select future maintainable profit based on some sort of historical average?

Consider the different business profiles in the table on the next page.

Business	Year -2 profit	Prior year profit	Recent year profit	Average
Growth	1,000,000	1,200,000	1,350,000	1,183,000
Decline	1,350,000	1,200,000	1,000,000	1,183,000
Lumpy	1,250,000	1,450,000	850,000	1,183,000

Using historical averages is only appropriate for the lumpy business, provided there is a pattern to the lumpiness of profitability and this is expected to continue. Many engineering and construction businesses that operate large projects / contracts across financial years can fall into this category.

The growth business should not be penalised in the business valuation for a lower performance that occurred three years ago. Likewise, the decline business should not be rewarded for performance several years ago if the future follows a declining trend.

What are multiples and where do they come from?

The second half of the simple business valuation formula requires the selection of a Multiple.

The multiple represents a benchmark or comparison to another business that is similar. The multiple is really just a factor that is applied to profit, say 2 or 3 times. The idea of a multiple is the same for when valuing a house. In a perfect world, the house value is benchmarked to similar property sales in the same street or suburb, then adjusted for the quality, land size, location, number of bathrooms, pool, off street parking and general appearance of the house compared to the other property sales.

For a business, the multiple is ideally estimated based on recent evidence of business sales - in the same industry, similar location, similar size, and so on. Adjustments are made for relative size, location, profitability, market position, competition, key person risk, and risk profile.

The trick is finding a comparable business that has recently been acquired which can be used as a benchmark, as well as digging up the sale price, profitability and other information the buyer/vendor is unlikely to share.

This is the science part of business valuations. The art is in the adjustments.
Put it another way, think of a multiple as reflective two things:

1. Growth - has the business grown historically or is there opportunity for growth?

2. Risk – including customer concentration, key person risk, profit variability, and so on.

Put simply, the higher the growth profile, the higher the multiple will be. The higher the risk profile, the lower the multiple will be.

In summary, where do (or where should) multiples come from:

- transactions (business sales) of comparable businesses
- industry specific information
- business brokers and mergers and acquisition advisers
- client insights (sometimes)
- a decent bit of judgement.

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What is the valuation process?

Every business is different. Regardless of the nuances of the business, the valuation process typically looks like this:

Stage	Description and questions
Preliminary stage	• Why is a valuation required? • Is a valuation required? • Will a valuation be helpful? • What type of valuation is required?
Engagement stage	• Valuer proposes scope of work, information needs, process and fees • Agree on valuer and timeframe for completion • Information request provided
Valuation stage	• Collate information available based on the request • Initial research with respect to the business and industry it operates in • Review of information provided • Interview with management to explore the business, financial performance, risk profile and outlook • Analysis of qualitative and quantitative information • Valuation calculations
Reporting stage	• Preparation of draft report including calculations, assumptions and research • Provide draft report and discuss • Finalise valuation report.

The valuation process can take between two weeks and two months depending on the complexity of the situation, the ease of access to information, the availability of management, and of course the valuers' pipeline of projects.

[You know the drill]

What affects value?

Many private business owners consider that value can be created by increasing profits. Consider again the basic valuation formula for a business:

Business value = Profit x Multiple

Value tends to increase with profit, but there is a compound effect if the risk profile is reduced over time.

The multiple broadly represents growth and risk.

The higher the risk, the lower the multiple.

What are the risk factors and how do they impact the selection of the multiple?

Business risk has been categorised into eight areas with low risk business descriptions provided.

Risk factors	Description of low(er) risk business
Reliance on owner	• Documented succession plans • Investment in external management • Owner seeks business mentoring • Spend no / little time on the tools • Focus on strategic and investment decisions only • Owner takes regular time off.
Defined business systems and procedures	• Documented and well organised • Outsider (buyer or staff) has confidence that they can run the business • Copies of leases, contracts, software licences and so on • Accessible and shared with staff • Useful CRM in place • Clear ownership structure (avoidance of messy trust and overly complex family structures).
Staff and management team	• Low staff turnover • Managers able to make operating, financial and investment decisions • Regular training and mentoring • Accountable for the good and the bad • External help is often sought • Clear reporting structure • OH&S is well managed • Incentivised to share in growth • Employment agreements in place.

Risk factors	Description of low(er) risk business
Diverse and repetitive	• Customers are repeat, recurring, diverse and contracted • Suppliers are abundant and not price makers • Products are diverse and / or unique • No single customer / supplier represents more than 10% of annual revenue / cost of sales.
Asset quality	• Current register of assets • Suitable maintenance records • Regular replacement of core assets • Legal protection for trademarks, products, patents • Excess equipment is sold – if not needed, get rid of it • Mix of ownership and leasing of assets • Environmental audit undertaken • Understanding of intangible value in business.
Financial discipline	• Up to date records that are reliable • Audited financials • Integrated system with low human involvement • Qualified finance team • Regular review of performance • Budgeting at least annually • Decrease working capital investment • Maintain employment provisions and keep in balance • Staff take leave • Adequate insurance in place.
Clearly defined plans	• Strategic plan exists and is used • Business plan supports strategic plan • Plans reviewed regularly • Plans are realistic, not nonsense big hairy goals • Plans shared with others in the business.
Optimise capital structure	• Right balance of debt (cheap) and equity (expensive) • Tax deductible debt used to fund growth • Investment risk spread across owners and lenders • Debt is consolidated • Low reliance on short term funding like overdrafts • Cash is returned to owners when not re-invested.

A business owner can achieve a significantly higher business value when controllable risk has been identified and a plan of attack is underway to manage these risks. Reducing controllable risk can be easier over time than doubling your sales or your profits.

What are the benefits of a valuation?

Australia has a wonderful enthusiasm for business ownership. Many of us want the thrill of controlling our own business, watching it grow and reaping the rewards just before retirement (the exit).

The reality could not be further from the truth.

Owning and operating a business is bloody hard work. You have to deal with demanding staff, pesky clients and a minefield of business rules.

What about the exit? Remember, every business owner will exit….eventually.

For the majority, when it comes to reaping the rewards from business ownership, there is no magic elf that sprinkles gold-dust and makes a business purchaser appear from the trees.

The reality is that achieving a business exit (a sale) is also hard work.

With that in mind, what are the benefits of a valuation:

- preparing for, or protecting from, the involuntary exit
- identifying and monitoring wealth that is trapped in the business
- achieving a successful voluntary exit.

More practically, SME valuations are essential and necessary for:

- tax restructuring and planning purposes. If a business is sold, what amount of money is actually received by the owner(s) after taxes have been considered?
- determining the price to offer equity to staff (say under an Employee Share Ownership Plan)
- determining the price to offer specific owners in the event of a buy-out, retirement or other exit
- establishing a base line price to purchase a business or sell / divest
- negotiating with prospective purchasers or vendors / sellers
- identifying current value and the value gap that needs to be addressed before an exit is achieved to satisfy owner goals (say in retirement)
- identifying areas that will be used by purchasers to negotiate a lower price
- identifying opportunities to attract buyers that will be a higher price
- independence. Most business owners (and their advisers) are inherently biased
- ensuring the owner is prepared for the reality that the value (and potential exit) is lower than the in-house view
- understanding whether the business value is sufficient (after tax) to support the needs of an exiting owner, say the lifestyle of the owner and their family at retirement
- understanding and monitoring value over time. Similar to the share price of a company on the stock exchange, value fluctuates over time to reflect market, industry and business conditions
- treating the business like an investment, not a bank account. If business owners do not understand the value of their business, which may represent one of their largest personal assets, then how do they know whether the investment is performing

- understanding whether the business is more valuable to the owner(s) than an outsider. That is, in-house or value to the owner may exceed market value due to the special benefits available to the owner group (such as a family)
- all the nasty involuntary stuff such as disputes and divorces.

How much does a valuation cost?

Every business is different.

The need for a valuation also differs for each client / business owner.

Valuation costs can range from zero to $25,000 for a fairly straightforward business, depending on who performs the valuation and the complexity of the situation.

Fundamentally, valuations are not costly. If a business has value of $1 million, a fee of say $7,500 represents 0.75% of business value.

Consider an investment (share) portfolio that is externally managed by a financial planner or wealth manager. Many of us would not hesitate to spend up to 1% of portfolio value per year on protecting the portfolio and maximising returns.

What questions should business owners consider?

With respect to business owners that have wealth trapped in their business, consider these questions to start the valuation process:

- What is your business worth?
- What are your other assets worth?
- How much of your wealth is tied up in your business?
- What is your rate of return on your business in last year / 3 years?
- How does the rate of return compare to other assets you own or other asset classes?
- Is your wealth suitable diversified?
- Are there ways to create liquidity from your business before the exit?
- Is your business ready for an exit?
- What do you think you are existing (selling)?
- Do you need to / want to stay in the business after the exit?

Regardless of whether you have a large or small business, all good owners should obtain regular business valuations.

[Just one more page]

SME Valuations

Who is SME Valuations?

Established in 2017 (including predecessor firm), we are an independent and dedicated business valuations service for private businesses in Australia.

We have been undertaken private business valuations for more than twenty years across a range of industries and locations around Australia.

We run our own business so we understand the ups and downs and are well equipped to show you the importance of understanding your business value.

Importantly, we are not tax agents, accountants, financial planners or anything else for that matter. We are expert and experienced business valuers with proven knowledge when it comes to business valuations. We would rather share that knowledge than keep it to ourselves, and there is always more to learn.

We know our limits and are not afraid to decline work if we consider a valuation is not appropriate, not necessary or outside our area of expertise.

Please call us to discuss your own, or your clients', business valuation needs.

About Lachie

Lachie McColl has more than 20 years' full-time business valuations experience. He personally and passionately believes that all private businesses, particularly those with a value of between $1 million and $50 million should obtain regular valuations.

Lachie has worked with a range of businesses and industry sectors – micro, small, medium, large and ASX listed, and valued more than $1 billion in privately owned business between 2017 and 2022.

He was one of the first accredited business valuation specialists in Australia, and is also a lecturer and tutor for Kaplan business valuations subjects.

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Business Valuation Services

SME Valuations (and predecessor business) has been performing private business valuations since 2017, with the teams’ experience of more than 20 years in the industry.

We perform valuations for:

- Tax and compliance
- Family law and other disputes
- Commercial transactions
- Financial reporting and impairment testing
- Value benchmarking
- Succession planning
- Ownership changes and employee shares
- Internal decision making.

Our industry experience spans retail, commercial, real estate, manufacturing, professional services, logistics, health, and IT.

We regularly work with accountants, lawyers and business owners in identifying and understanding value.

We are an independent business valuations firm.

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