1. INTRODUCTION — BUSINESS VALUATION METHODS

The reasons that we need to undertake a business valuation is widespread and includes:

> Looking to Purchase a Business
> Looking to Sell a Business
> Partnership/Shareholder Disputes
> Family Law
> Stamp Duty/Restructures
> Meeting the $6million Small Business Test
> Determine Damages
> Takeovers/Mergers
> Other (Banks, out of interest etc.)

Firstly valuations are not an exact science and so the valuer must assess each situation even though there is a basic methodology that must be followed. However, there will be many times during the valuation process when a valuer will have to make a judgement call.
As is often stated, give ten (10) valuers the same information and the chances are you will get ten (10) different values. It is unlikely you would get two (2) the same. The reason for this is simply the exercising of judgement and how each valuer weighs different aspects of the valuation. For example:

- History and nature of the business.
- Impact of the future economic outlook for the business and the industry overall.
- The business mix.
- Having a business plan can also give the valuer an insight into these matters.

It is widely recognised that the source of reference by the courts is the Valuation of Businesses, Shares and Other Equity — Author W Lonergan.. He sets out the five basic valuation methodologies:

- Discounted cash flow
- Capitalisation of future maintainable earnings
- Notional realisation of assets
- Net tangible assets (on a going concern basis)
- Capitalisation of future maintainable dividends

In most instances I would use both capitalisation of future maintainable earnings and net tangible assets and select the higher valuation of the two methods. Discounted cash flows are usually only used with projects having finite lives, new projects with high growth, existing projects entering high growth/ expansion, or commercial situations with long term leases.

Reliance on unaudited figures can be a problem at times, I use pre-tax figures and I would normally settle for a single value rather than a range to avoid further conflict. Except in the case of projections (looking forward) I use income tax figures i.e. I will not take into account undeclared cash or inventory.

Many small businesses are valued by others based on “rules of thumb”. These artificial markets are quite common with franchising, accounting practices and businesses such as newsagents. Be careful as these methods are prone to serious error. As W. Lonergan states “it is only by the application of sound business principles that a reliable and defensible valuation result can be obtained”.

2. NET TANGIBLE ASSETS (GOING CONCERN BASIS)

In most instances the use of the net tangible asset (NTA's) basis of valuation would only be used as a secondary method of valuation.

To use this method one would assume that the business has little or no goodwill. However, it does highlight the underlying strength of the business. The net tangible assets is required under the capitalisation of future maintainable earnings method to determine the goodwill component (valuation —NTA's = goodwill). When the goodwill exceeds net tangible assets extra caution is required.

What this method highlights is that you can't just accept book values; you must look at the value to the business which you would expect to be higher than say liquidation values.

The process is very simple, namely you start by working your way through all the balance sheet items making adjustments where necessary (i.e. going from cost or depreciated value to a current value). It is also important to take into account unrecorded assets (often assets are expensed rather than capitalised or they may have been made in-house and consequently not recorded). Similarly, any unrecorded liabilities (e.g. annual leave or long service leave) and in some cases contingent liabilities.

The major adjustments you may encounter would be stocktake adjustments, revaluation of fixed assets (up and down), write-off of intangibles and bad and doubtful debts; however, there is an endless list of other potential adjustments.

The business valuation using this method would be on the basis of the following example:

Net assets as per unaudited 2016 Financial Statements		$5,000,000
Add Revaluation of plant and equipment		$100,000
		$5,100,000
Less Write-off goodwill	$300,000	
Bad Debts	$100,000	
		-$400,000
Adjusted Net Tangible Assets as at 30/06/2016		**$4,700,000**

Where it is necessary to revalue fixed assets and the potential impact is material I would always recommend an independent valuer.

3. CAPITALISATION OF FUTURE MAINTAINABLE EARNINGS

Capitalisation of future maintainable earnings is the most frequently used method of valuation. Under this methodology future maintainable pre-tax earnings are multiplied by a price earnings ratio multiplier in order to establish a fair market value for the business. As explained earlier, the goodwill value is the balance after deducting the net tangible assets as calculated in 2, from the total business value. This method is particularly relevant to companies with steady growth, regular capital expenditure requirements and non-finite lives.

I would like to share with you some quotes from others:

a) "Valuations require a logical and methodical approach and the careful application of basic valuation principles and common sense" — Wayne Lonergan — The valuation of Businesses, Shares and Other Equity - 4th Edition.

b) "Perceptions of value have to be backed up by reality, which implies that the price we pay for any asset should reflect the cash flows it is expected to generate" — Damodaran on Valuation — 2nd Edition.

c) "Investors buy tomorrow's cash flow, not yesterday's or even today's" — James R Hitchner — Financial Valuation Applications and Models — 31d Edition.

The value of the business using the capitalisation of future maintainable earnings is calculated as follows:

Value of the business = future maintainable earnings x earnings multiple

Following on, the goodwill component is calculated as follows:

Goodwill = value of the business — net tangible assets

3.1. FUTURE MAINTAINABLE EARNINGS

Here the expert valuer is required to exercise considerable professional judgement and experience which is why, as stated earlier, valuations are an art rather than a science. For example, should we use a three (3) year earnings average or just the current year's earnings or for that matter projections for the year ahead. How do we handle losses in the mix, declining profits, irregular earnings, or say, significant changes in competition, government legislation changes, tax rates, interest rates etc.

Examples of adjustments to future maintainable earnings is endless, however, I will highlight the main ones. These include:

- Market wages for business owners
- Market rent on business premises
- Statutory superannuation
- Non-arm's length transactions such as family members or payroll and associated telephone, cars etc. when they are not actually working in the business

In many businesses work in progress is not brought to account: if applicable we would also adjust for non-commercial management fees, abnormal items and such things as adjustments for declining margins where there is increased competition.

Future maintainable earnings must be before interest, depreciation, amortisaton and tax (EBITDA).

An example of the calculation of future maintainable earnings would look like this:

Net profit before Income Tax 2016 Unaudited Financial Statements		$3,000,000
Less Market Rental - Premises	$300,000	
Market Salaries & Superannuation for Directors	$200,000	
Interest received — surplus cash	$40,000	
Depreciation	$20,000	
		$560,000
		$2,440,000
Add Donations (not business expense)	$1,000	
Director's wife's salary (not working business)	$60,000	
Superannuation Director (excess contributions over Super Guarantee)	$20,000	
Debtor Write — off (prior year debt)	$80,000	
		$161,000
Future Maintainable Earnings		**$2,601,000**

What we have done above is to take out non-core transactions, non-arms length dealings and prior year adjustments to ensure that maintainable earnings is on an "arms-length" basis and as best as can be anticipated what is expected for the future.

3.2. EARNINGS MULTIPLE (CAPITALISATION RATE)

Without doubt determining earnings multiple is the most difficult factor in valuing a business. Simplistically, to arrive at an earnings multiple we would use the following formula:

$$\textbf{Earnings Multiple} = \frac{100}{\textbf{Required Rate Return}}$$

For example if you require say a 25% return the earnings multiple would be four (4), calculated as follows:

Earnings Multiple = 100/25 = 4

In most instances, earnings multiples have to reflect what the market dictates for similar businesses at a point in time.

Rules of Thumb:

- Higher risk, lower earnings multiples
- Small/medium enterprises earnings multiples are usually between 1-5. (almost 50% of smaller entities - say those with annual turnovers less than $2 million - would sell for multiples of between 1-2)
- Usually earnings multiples would only be around 20-40% of comparative multiples in public companies.
- My view is that it is difficult to get earnings multiples over three (3) unless turnover is around $15 - $20 million plus with solid management structure and excellent systems and procedures and expectations of future growth.

Examples of issues effecting earnings multiples include turnover/profitability, quality of the management team, exposure to currency movement, impact technological change, interest rates and competition.

Normally earnings multiples can be obtained from third parties (with an element of judgement) and also after having regard to third party research on the industry generally.

3.3. CALCULATION OF CAPITALISATION OF FUTURE MAINTAINABLE EARNINGS

The calculation of the capitalisation of future maintainable earnings with an earnings multiple of say 3, would be calculated as follows (based on information in 3.1 above):

Value of the business = future maintainable earnings x earnings multiple
= $ 2,601,000 x 3
= $ 7,803,000

3.4. VALUATION

In point 2 I calculated the net tangible assets to be $4,700,000 and then in 3.3 above the capitalisation of future maintainable earnings to be $7,803,000.

Consequently I would take the higher value being $7,803,000, the goodwill component being $3,103,000. ($7,803,000 - $4,700,000 = $3,103,000 (39.8%)); the fact that the goodwill is less than 50% also gives a certain amount of comfort.