Practical Issues in Valuation of Private and Family-Owned Businesses

Presented by Phillip Rundle
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Agenda

- Why undertake a valuation
- What we need to know prior to performing a valuation
- What is being valued
- Valuation Framework
- Valuation principles and methodologies
- Practical issues in Valuation

Why undertake a valuation

- Restructuring
- CGT/Tax consolidations
- Conflict resolutions / Shareholder disputes
- Key man business insurance
- Buy/Sell Agreements
- Assessing the "price" of buying or selling a business
- Family Law Proceedings
- Intangibles valuations / asset impairment testing
- Financial reporting purposes
- Purchase Price Allocations
- Going public / floating
- Takeover

What we need to know prior to performing a valuation?

Valuation premises

- What is being valued – Business or Shares?

- The purpose of the valuation will impact outcome

- What kind of value

  Fair Market value is commonly defined as:

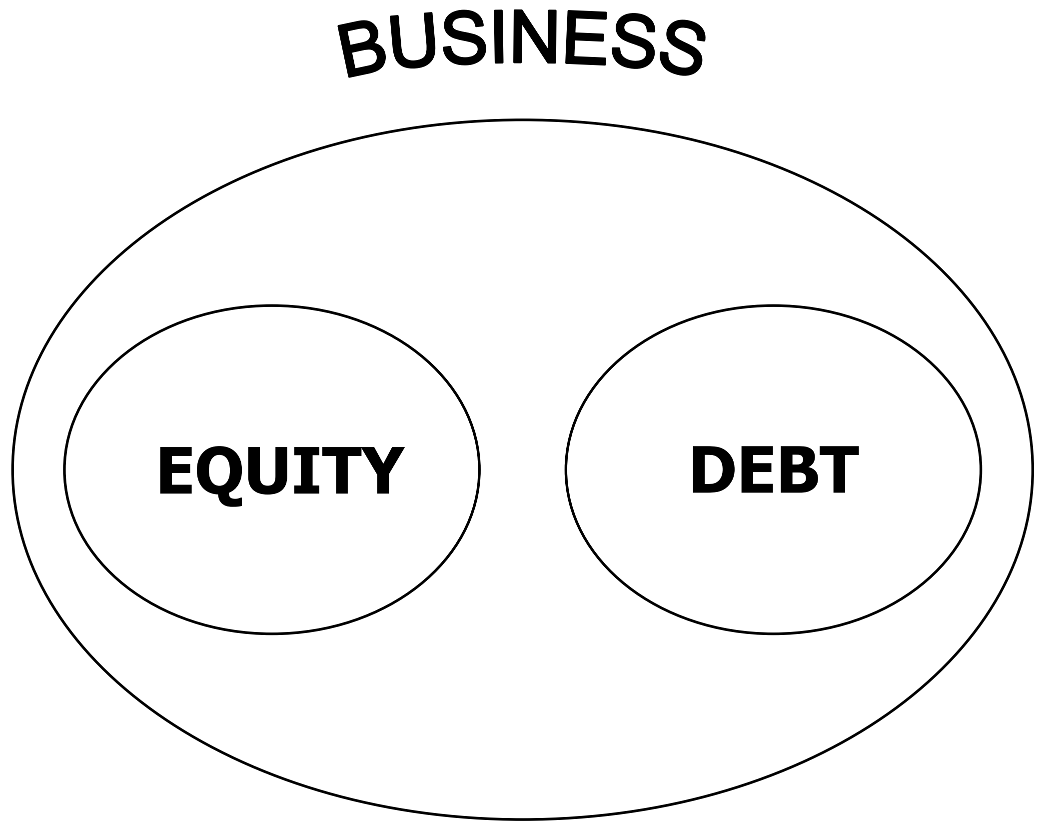
  "the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length."

  Fair market value excludes any special value. Special value is the value that may accrue to a particular purchaser. In a competitive bidding situation, potential purchasers may be prepared to pay part, or all, of the special value that they expect to realise from the acquisition to the seller.

- Valuation date

What is being valued

Business vs Equity

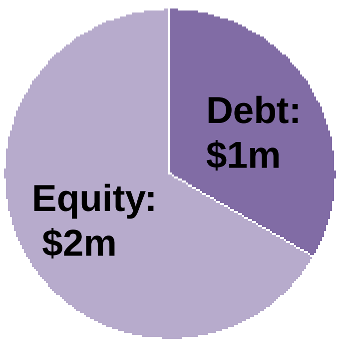


What is being valued (Cont'd)

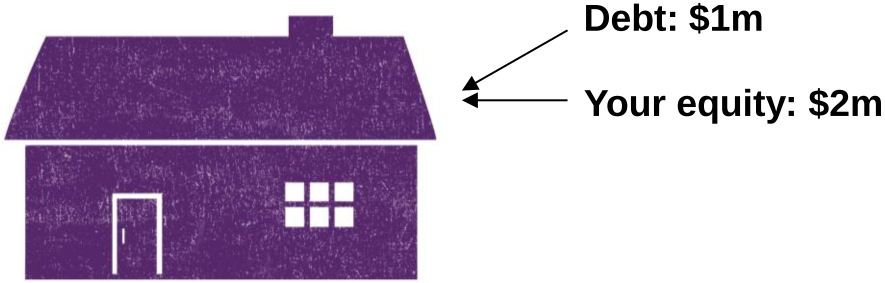
Business vs Equity

- Business or Enterprise value - value of the business "sale price"
- Equity value - the value of the company to the *shareholders* only
- House analogy: market value equals *your equity plus bank debt* "sale price"

Company Enterprise value: $3m



House Enterprise value (Sale price): $3m



What is being valued (Cont'd)

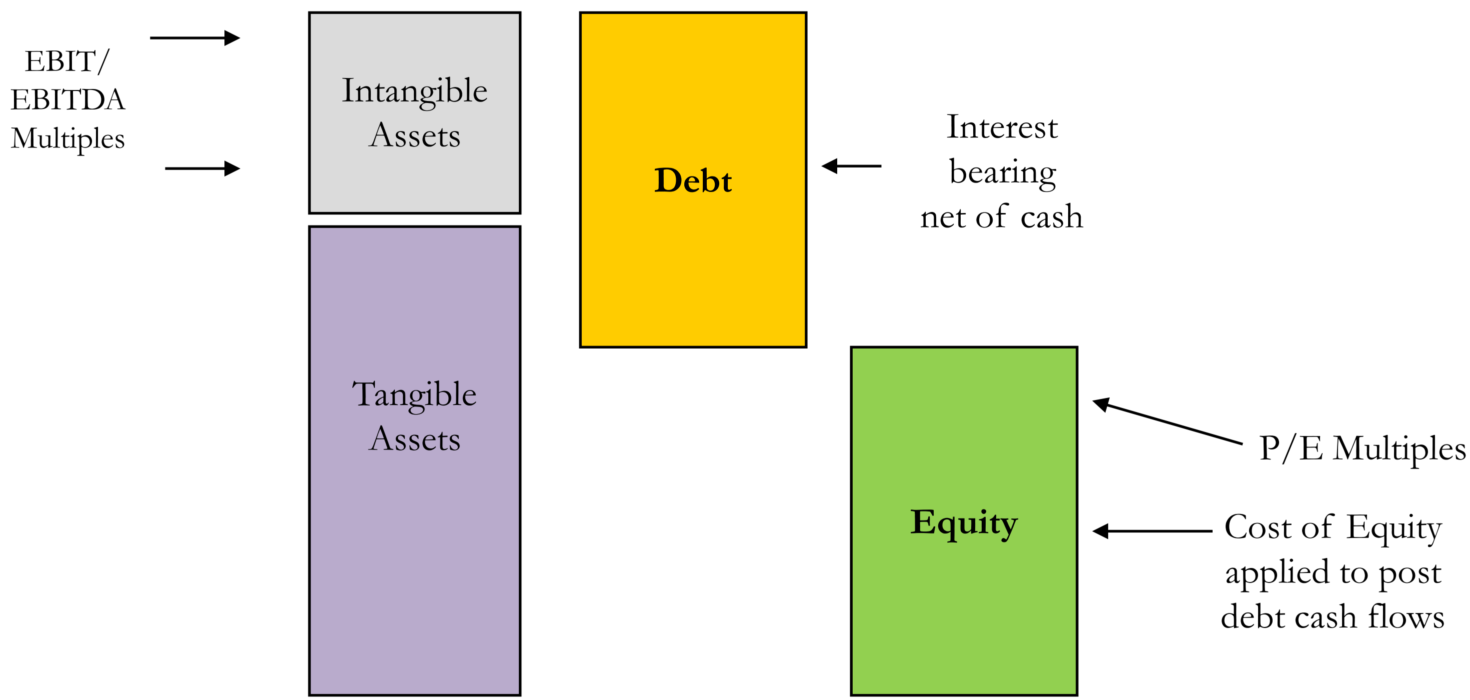
Intangible assets

- Goodwill / Intangible Asset – Both identifiable and goodwill.
- One of the most important reasons for small to medium businesses to undertake a valuation will be to understand the value for the intangible assets.

What is being valued (Cont'd)

Business (Enterprise) Value v Equity Value

Total Business Values



Valuation principles and methodologies

Market Based Approach

- A valuation technique in which the market value of the shares is estimated by comparing the subject company to companies which have been sold (recent genuine offers) or whose ownership interests are publicly traded (when there is a liquid and active market.

Income Based Approach

- Determines the value of the shares based on the expected returns from the subject company and the required rate of return thereon.

Asset Based Approach

- Determines the value of the shares having regard to the market value of the assets and liabilities thereof.

Rules of Thumb

- Generally industry based.

Valuation principles and methodologies (Cont'd)

Income Based Approach

Discounted Cash Flows

- We consider this methodology to be the most appropriate method in the calculation of the value where there is adequate information about likely future cash flows, usually over a finite term.

Capitalisation of Maintainable Earnings

- Under this method, the fair market value of a business is derived by capitalising the estimated future maintainable earnings using an appropriate multiple.

Most appropriate	Less appropriate
Subject is a going concern	Subject is a holding company
Subject is a reasonable size to make comparison meaningful	History not indicative of future
Stable future earnings	Subject company not large enough
Not practical to try and predict future cash flow	Company not sufficiently profitable
	Start up companies

Valuation principles and methodologies (Cont'd)

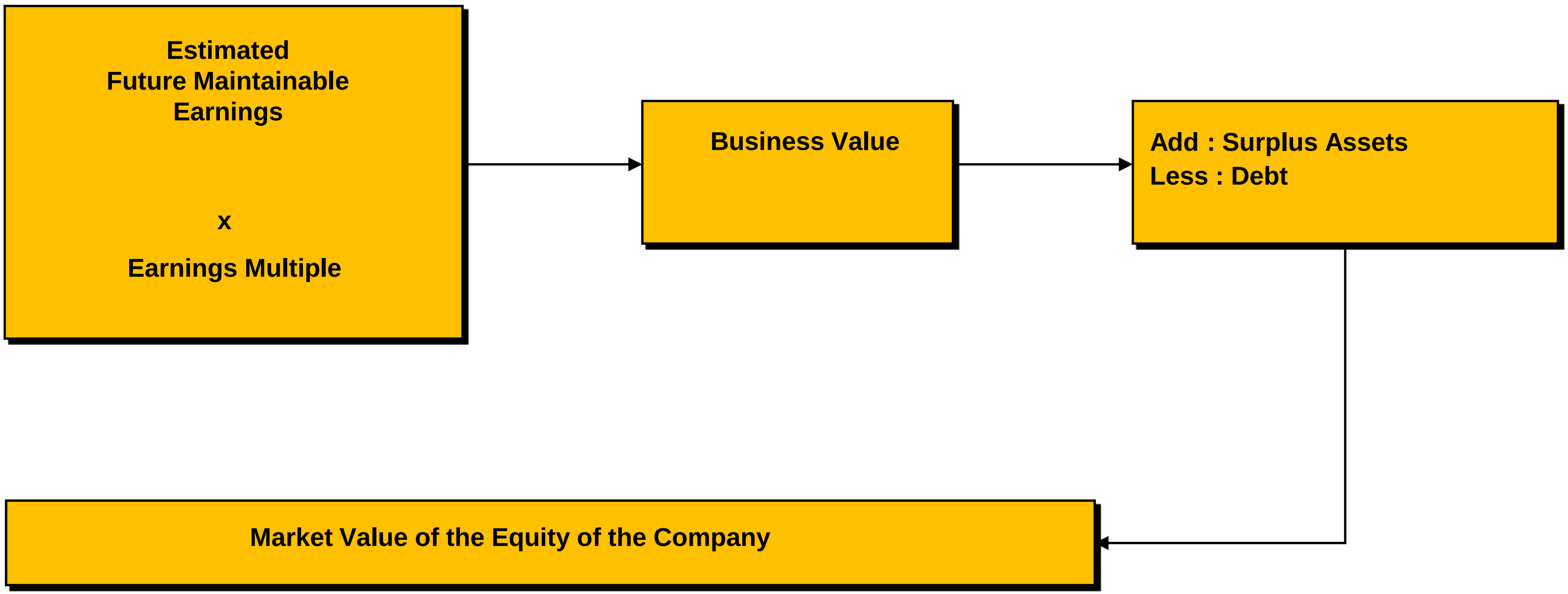
Capitalisation of Maintainable Earnings (cont'd)

Valuation process

- Valuations of small to medium business are generally determined based on a multiple of maintainable earnings, generally referred to as either earnings before interest and tax (EBIT) or alternatively earnings before interest, tax, depreciation and amortisation (EBITDA).

- The valuation of this type of business therefore necessarily ignores any debt / funding structure in place and the different tax structures quite often found with small businesses.

Valuation principles and methodologies (Cont'd)



Valuation principles and methodologies (Cont'd)

Capitalisation of Maintainable Earnings (cont'd)

Future maintainable earnings

- Consider historical and forecast earnings when determining future maintainable earnings

- Normalisation adjustments
  - One off items
  - Known changes to business
  - Related party transaction
    - Ensure all are identified
    - Examples – rent, salaries and package items, intercompany sales and purchases

Valuation principles and methodologies (Cont'd)

Capitalisation of Maintainable Earnings (cont'd)

Earnings multiple – "Guesswork or science?"

- They are a function of risk i.e higher the risk the lower the multiple
- Comparable companies – trading multiples
- Comparable transactions – transaction multiples
- Comparison with public companies is useful but not always possible due to size and profile differences
- Deal Tracker research
  - Industry multiples vary (risk profile)

Valuation principles and methodologies (Cont'd)

Earnings multiple

The selection of an appropriate multiple is a matter of judgement and involves consideration of a number of factors including:

- the stability and quality of earnings;
- the nature and size of the business;
- the quality of the management team;
- comparable company trading multiples which have been attributed by share market investors;
- the implied multiples of recent acquisitions of businesses involved in similar activities;
- future prospects of the business; and
- cyclical nature of the industry

Valuation principles and methodologies (Cont'd)

What drives the valuation multiple?

Low multiple

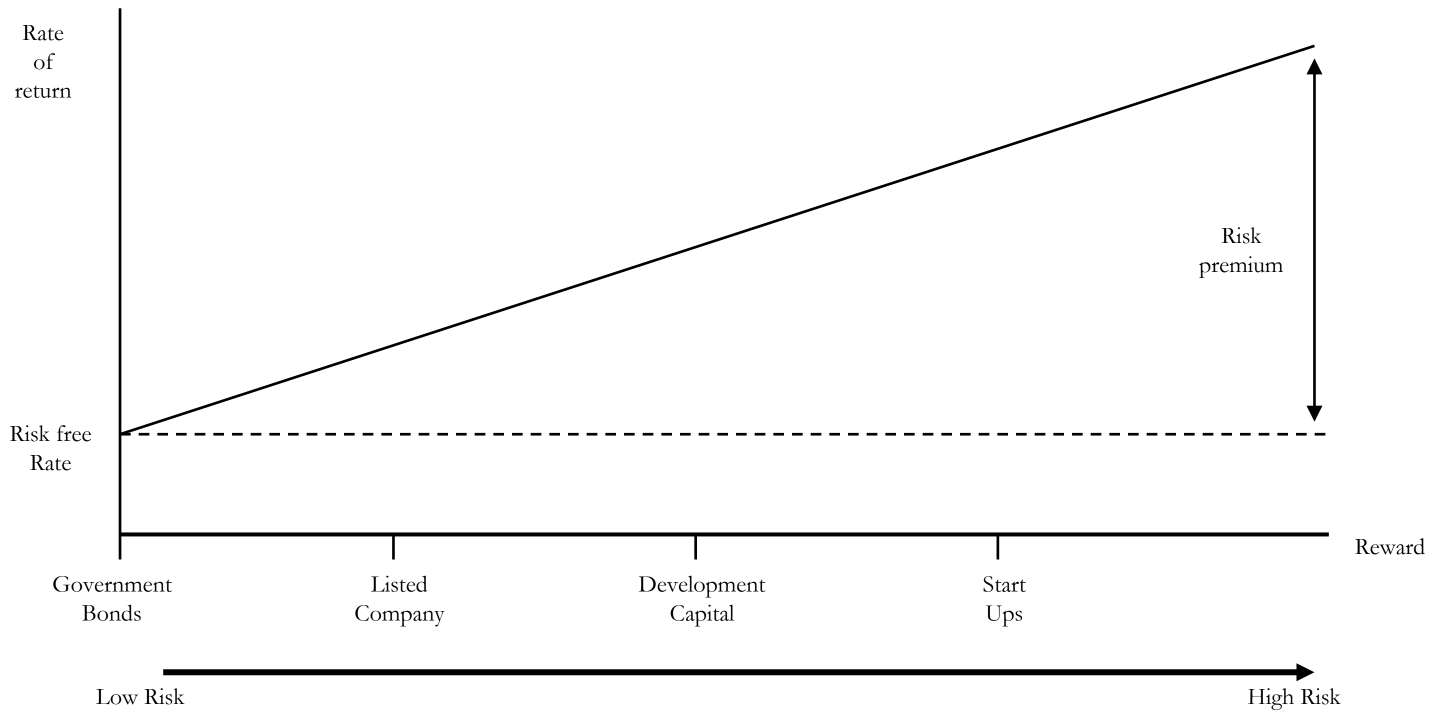
- Low growth rates
- High risk earnings
- Uncertain/non recurring revenues
- Mature or declining industry
- Small business
- High reliance on key customers, owners, etc.

High multiple

- Strong forecast growth rates
- Quality and stable earnings (no major reliances)
- Recurring revenues
- High industry growth prospects
- High margins
- Large business/scale
- Strategic buyer(s)
- Strong cash flows
- Depth of management
- Key competitive advantages
- High barriers to entry
- Appropriate gearing levels
- Strong net asset backing
- Intellectual property
- Strong culture

Valuation principles and methodologies (Cont'd)

Determining the appropriate discount rate



Practical issues in valuation

- Secure revenue streams – customer contracts
- Diversify revenue to mitigate key customer risks
- Identify new revenue streams (car industry)
- Secure key staff – highlight depth of management
- Reduce reliance on "owner" – employ general manager, sales manager
- Pursue "Blue sky" opportunities, bolt-on opportunities and highlight future growth potential

Practical issues in valuation (Cont'd)

- Develop a business plan and update periodically
- Actively manage working capital – extract excess cash
- Identify one-off abnormal items
- Review related party transactions
- Are accounts up to date and prepared in accordance with accounting standards – income recognition?
- Prepare forecasts
- Identify strategic benefits / synergies for potential acquiriers

Practical issues in valuation (Cont'd)

- Protect Intellectual Property / Brand
- Document systems / processes
- Secure tenancy if business requires special operating premises
- Limit exposure to "make good" or onerous lease terms

Minority interest discount

- Typical discounts between **10% to 40%** of the pro-rata control value.
- Factors affecting the size of the discount include, but not limited to:
  - Shareholder rights
  - Dividend payment history and prospects
  - Company/industry growth prospects
  - Size
  - Other shareholders
  - Pre-emptive rights
  - Tag along rights