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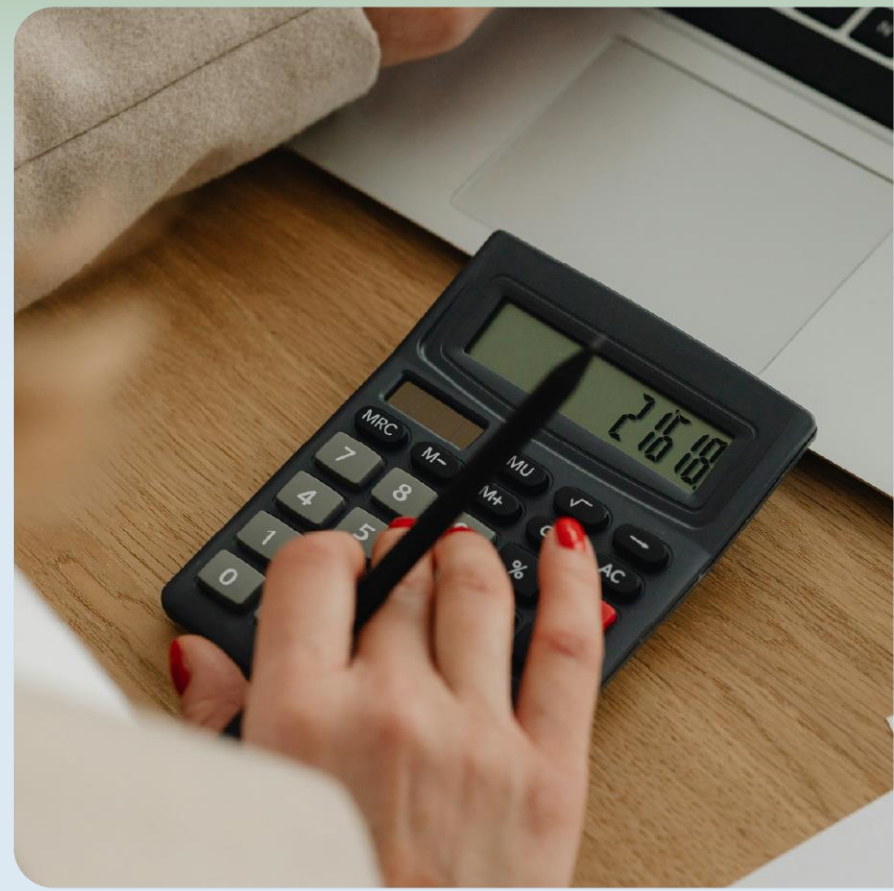
Valuation Methods *and* Normalisations

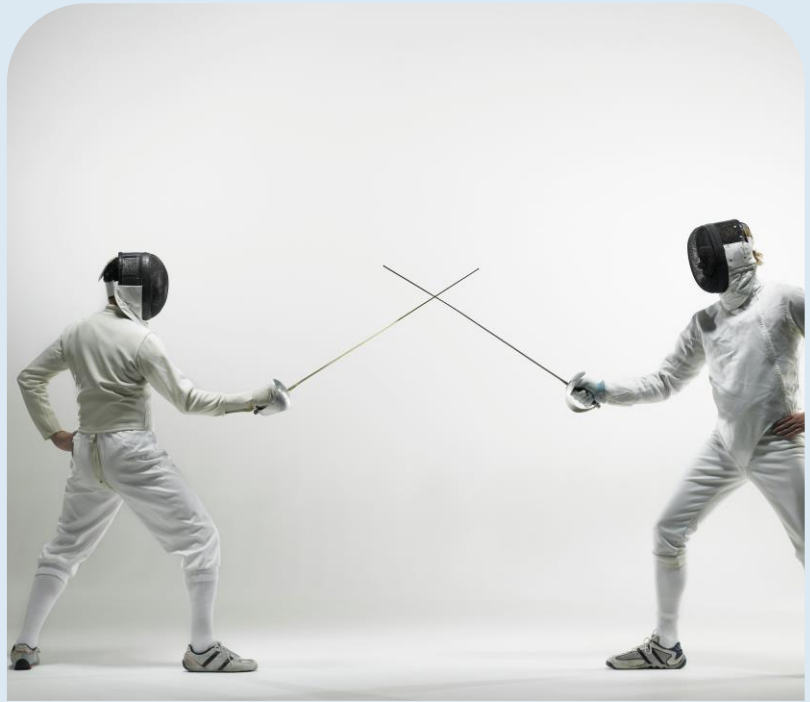


Explore the key methodologies behind small business valuations and learn how to apply normalisations to reflect true business performance.

Poll Time

What do *you* think *matters* most *when* valuing a business?

Value Vs. *Price*



Price = What did it transact for?

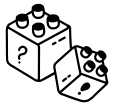
Fair Market Price = The hypothetical value that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious selling acting at arm’s length.

What Are *We* Valuing

1. Enterprise
2. Entity
3. Shares
4. Books of Clients
5. Future Cashflow

How Are *Businesses Generally* Valued?

Today we will focus on the types you most likely see in practice:



The income approaches (DCF, CFME)

The market approaches (Comparable Transactions, Multiples)

The asset approach

Discounted Cashflow Valuations (DCF)

The value of a business is the Net Present Value (NPV) of its future net cash flows.

The discount rate applied represents the opportunity cost of capital reflecting the expected rate of return which investors can obtain from investments having equivalent risks.

It also includes a terminal value, representing the remaining value of all other future income.

DCF *Limitations*

01 The accuracy and reasonableness of the forecast, and reliability of its underpinning assumptions.

02 The highly sensitive nature of DCF calculations.

03 The determination of the terminal value essentially adds all the complexities of a CFME valuation to those already observed.

The *Discounted* Rate

The discount rate represents an opportunity cost of capital reflecting the expected rate of return which investors can obtain from investments having equivalent risks.

The determination of a Discount Rate can be tricky, as there is rarely comparable data available to assist you.

The *Period*

The DCF is generally performed over 3 – 5 years. Generally, the reliability of forecasts diminishes overtime, so I tend to use 3 years as a default.

At the end of the 3-year period, we still perform a CFME valuation, which represents the total value of all future income from that time onward (terminal value).

Can be very complex and yet no more reliable. Use it only when you must.

Capitalisation of Future *Maintainable* Earnings

CFME is the most prevalent, consist of two main factors:

1. Normalised Earnings
2. Capitalisation Rate or “Multiple”

Normalised Earnings

To capitalise earnings, we must first work out what we mean by ‘earnings’ in the context of a valuation.

Utilising (predominately) historical financial results, we seek to determine:

What would the business earn into the future if it continues to trade under current conditions, and we remove all extraordinary, one-off, and non-business transactions?

The Capitalisation Rate

The ‘multiple’ that you see attached to FME based valuations is based upon an inverse capitalisation rate e.g. a capitalisation rate of 25% equates to 1 divided by 25%, or the capitalisation rate is a distillation of all the risks faced by the business reduced to a single number.
It includes industry risks, financial risk, and business risk and should have regard for real world sales and the relevant risk of the business in question against its peers.

The Market *Based* Approach

Observe similar or comparable businesses being sold on the market.
The multiple is then reverse engineered by observing the sales price divided by its EBIT, EDBITDA, PEBITDA to provide a multiple.
The valuation of the subject is then based upon extrapolating an approximate ‘market value’ based upon applying a similar multiple to it.

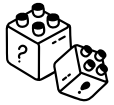
Net *Tangible* Assets *Approach*

Where the majority of assets consist of cash or passive investments or where other methodologies indicate that there is no goodwill, all assets and liabilities of the entity are valued at market value, and this combined market value forms the basis for the entity's valuation.

💡 It is the fallback valuation methodology.

Normalising Earnings

Presents a more accurate picture of the business's historical earnings and its earning potential by removing all anomalies, non-recurring items and non-business-related expenses.



Doesn't just provide a more stable and reliable basis for forecasting future maintainable earnings, it also lets us better compare the business with industry benchmarks and other similar businesses.

Your Measure of *Earnings*

EBIT = Recognises that business need to reinvest their assets.

EBITDA = Allows better comparison across companies and industries by removing the effects of financing and accounting decisions.

PEBITDA = Its not really valuing the business.

NPAT = Values the entity.

Normalising Income

1. Is it derived from a source directly related to the enterprise undertaken?

2. Is it derived from a source that is expected to continue into the future, but is only indirectly related to the enterprise, such as diesel fuel rebates for a trucking company?

Poll Time

What is the *hardest* part of *normalising* earnings?

Normalising Expenses

1. Is the expense a bona fide business expense?
2. Is the expense commercial in nature?
3. Is the expense related to the operation of the business?
4. Is the expense extraordinary in nature?

Common Normalisations

Income	Expenses
Profit & Sale of Assets	Rent
Other Income	Owner's & Related Party Wages
COVID Subsidies	Motor Vehicle Expenses
Non-Continuing Rebates or Grants	Depreciation
	Bad Debts
	Borrowing Costs
	Entertainment
	Personal Expenditure
	ASIC Fees
	Loss on Sale of Assets

Balance Sheet Adjustments

When determining the goodwill of the business, we need to determine the underlying assets of the business: Which assets are necessary for the business to operate?

The key is to determine the net assets from the operating business whilst excluding all tangible assets from the balance sheet: What assets would leave the balance sheet of the owner and transfer to a purchaser if we should the business?

Balance Sheet Adjustments

Exclude surplus assets / liabilities.

💡 *Calculated Business Value – Underlying Business Assets = Goodwill.*

We add the calculated goodwill back to the original balance sheet (sans all previously recorded intangible assets).

We then have the value of the entity that holds the business – be that Company, Trust, Partnership, or any other hybrid structure.

Inventory *Side* Note

Many business owners reinvest their retained earnings into carrying stock, often carrying excess or surplus amounts.

A business that carries too much stock may well render itself void of goodwill.

💡 You may wish to value the business with a minimum stock level and mark the rest as ‘surplus’.

Working *Capital* Requirements

Working Capital = Current Assets – Current Liabilities. But how much do they need?

It will depend upon the industry, the specific business, the transaction, and its specific circumstances.

For a business it is relatively straight forward.

An entity can be difficult with taxes, ageing of creditors, and debtors.

Working *Capital* Calculations

Working Capital Requirements:
Cash Operating Cycle = Inventory Days + Receivable Days – Payable Days

Inventory Days:
Inventory (Stock) / COGS x 365

Receivable Days:
Accounts Receivable / Sales (Revenue excluding normalised income) x 365

Payable Days:
Accounts Payable / Expenses (Costs excluding normalised income) x 365. Then divide Sales by 365 and multiply by the cash cycle days.
Note: Only applicable for businesses that carry sellable stock.


Question
Time

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