The latest in small and mid-market sales, mergers, acquisitions, investments and advisory

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February Industry Scan

Merger & Acquisitions | Business Sales | Corporate Advisory | Funding

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What's my business worth: comparison of common valuation techniques :

One of the most common enquiries we receive from clients is: "what is my business worth, and how do you know?"

There are several legitimate valuation techniques that may be employed, and in some cases it may be diligent to apply multiple methods to establish an estimated valuation range. The following provides an overview of some of the key methods and how they may be applied in practice.

Technique: *Capitalisation of future maintainable earnings (FME)*

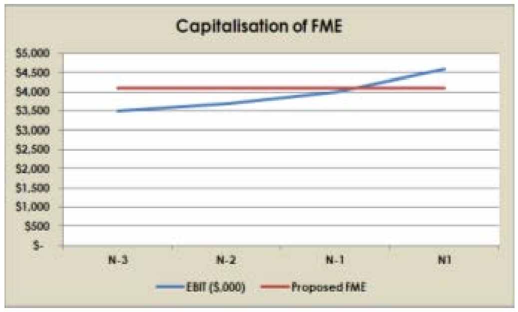
Description: A market relevant capitalisation rate is applied to an estimate of future maintainable earnings (normalised and typically predicated on prior year earnings). As mentioned in our **last newsletter**, determining the FME of a business requires careful consideration of historic earnings, trend and likely future earnings (and is therefore not necessarily an average of prior earnings). Similarly, the capitalisation rate will be determined based on a variety of factors relating to the perceived level of risk associated with the future earnings and the sustainability of the business (refer below).

Application: This is a standard technique that may be applied to established and profitable businesses.

Example: An engineering business established for 8 years, generated EBIT of $3.5M, $3.7M and $4.0M in the prior 3 years. Due to a new 4 year contract the next financial year EBIT is forecast to be $4.6M. On this basis, future maintainable earnings are estimated to be $4.1M (eg using a weighted average of 30% x next year's EBIT, 40% x the prior year's EBIT and 30% x EBIT 2 years prior)

Using a capitalisation rate of 28 to 32%, the business value range is recommended to be between $12.8M to $14.6M plus working capital.

The business is marketed through an Expression of Interest (EOI) process.



Technique**:** *Discounted Cashflow (DCF)*

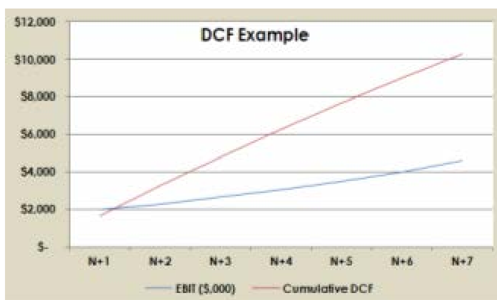
Description: The future cashflows (eg 5-10 years) of a business or asset are forecast and are discounted back at a rate applicable to the market and the risk associated with the forecast. As a result, this provides an estimate as to the net present value of the business or asset.

Application: This is an appropriate technique for early stage or high growth companies or assets where the future cashflows can be forecast with some credibility.

Example: A company has recently commercialised proprietary products and has appropriate IP protection in place. In the past 6 months the products have generated sales of $1.5M at a GP of 70% and EBIT of $750k.

EBIT is forecast to increase to $2M for the next 12 months with 15% annual growth thereafter. The lifespan of the products is expected to be at least 10 years.

Using a discount rate of 20% applied to 7 years' earnings, the products are valued at circa $10M.



Technique: *Internal Rate of Return (IRR)*

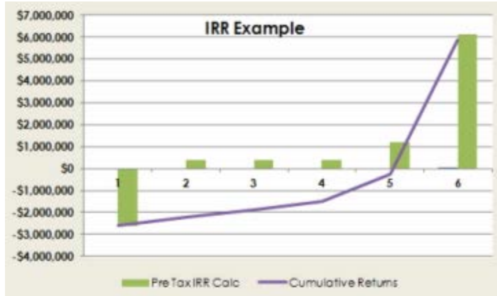
Description: Closely associated with DCF, IRR is the discount rate at which the Net Present Value of all cash flows from a particular asset equal zero.

Application: This is an appropriate technique to forecast a return to investors based on a particular acquisition cost and forecast future cash flows.

Example: An investment syndicate is assembled to acquire an established company with a prior year EBIT of $1.1M (includes budget for a full-time General Manager). Future earnings growth is forecast to be 5% p.a.

The total acquisition cost is $4.01M (inclusive of fees and working capital). The investors leverage their investment with 35% of the funds secured through a non-recourse bank loan. The investors are to receive a 10% full-franked dividend each year from year 1 and intend to divest of the IP at year 6.

The acquisition model forecasts an IRR of 32%.



Technique**:** *Balance Sheet*

Description: Estimates the value of a business based on the net assets (ie shareholder equity = total assets less total liabilities)

Application: This is an appropriate technique to estimate the value of a company that is generating losses or more generally, where there is limited goodwill in a company.

Example: An established company is currently generating an EBIT of $100,000 which is also the next financial year forecast. In most recent years, the company generated losses.The company's plant and equipment have a market value of $5M with $1M loans remaining and working capital is approximately $1M.

Shareholder's equity is therefore $5M and shareholder's return on equity (ROE) is only 2% in the current year.

The business is marketed for sale at $5M + stock and the owner's retire the outstanding debt from the sale proceeds, collect their debtors and settle their creditors.

Balance Sheet			Settlement Balance Sheet		
Assets			*Assets*		
Plant and Equipment	$	5,000,000	Plant and Equipment	$	5,000,000
Stock	$	900,000	Stock	$	900,000
Debtors	$	600,000	Debtors	$	-
Goodwill	$	-	Goodwill	$	-
Total Assets	$	6,500,000	Total Assets	$	5,900,000
Liabilities			*Liabilities*		
Loans	$	1,000,000	Loans	$	-
Creditors	$	500,000	Creditors	$	-
Total Liabilities	$	1,500,000	Total Liabilities	$	-
Net Equity	**$**	**5,000,000**	**Net Equity**	**$**	**5,900,000**

Technique**:** *Comparables*

Description: Estimates the value of a business or asset by comparing it to a relevant set of recent transactions.

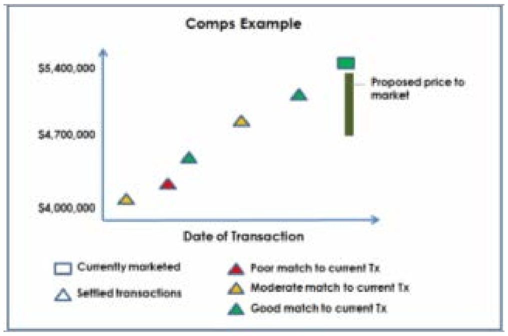
Application: This may be applicable to industries and assets (such as commercial property) where there is a meaningful database of directly comparable transactions. It can also be a useful technique to confirm other more rigorous valuation techniques.

Example: A large childcare centre is to be marketed for sale. Using the capitalisation of future maintainable earnings, a valuation range of $4.5M to $5.3M is estimated.

Five recent sales of comparable centres are identified and these range from $4.2M to $5.1M with higher prices received for the most recent sales.

One comparable centre is currently marketed at $5.4M.

The client elects to market their centre for $5.2M.



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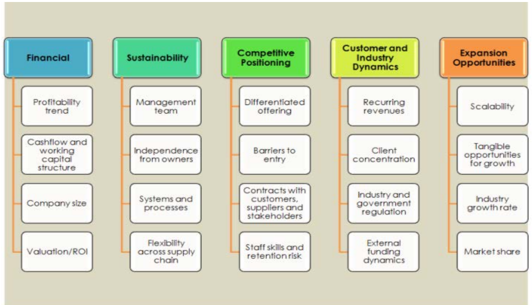
Scancorp's "5 Pillars" Underpin Acquisitions: Pillar 2 - Sustainability

In our last newsletter, we provided an overview of the first pillar of the "5 Pillars" framework that we use to assess the attractiveness of an unlisted business for acquisition by trade or financial buyers.

The second pillar considers some of the key *sustainability considerations* that concern acquirers. These include:

1. **Management team:** the existence of an experienced and structured management team should lead to more sustainable future earnings. As such, acquirers consider several aspects of the management team such as:
    - *Expertise of the team:* the experience and expertise of the management team will largely determine whether revenues can be sustained under new ownership. It is also a key consideration in the new owner's ability to implement changes and grow the business.
    - *Organisation structure:* a sustainable organisation structure will include key demarcation and definition of roles, KPIs that are linked to the corporate objectives and appropriate employment agreements.
    - *Staff retention:* potential acquirers will make a judgement as to the likelihood that management staff will remain, and will remain motivated post acquisition. As such, the existence of market relevant remuneration and effective performance incentives are attractive to acquirers.
2. **Independence from owners:** in most industries, businesses that are highly dependent on the current owners are significantly less attractive to acquirers. Reliance on current owners may manifest in several forms such as: specialised knowledge and skills, person dependent licensing and relationships with customers, suppliers and staff. Where a business is highly dependent on the current owners, it is likely that the owners would be required to remain with the business post acquisition.
3. **Systems and processes:** businesses that are highly "systemised" are typically more sustainable and scalable. Systemisation may be in the form of well defined and documented business processes, the existence of standard policies, forms and templates and systems that ensure the consistent execution of processes. As such, companies that are highly systemised usually exhibit a greater level of process compliance. They are also better equipped to be able to expand their workforce and make new recruits productive sooner. As such they are more scalable.
4. **Flexibility across the supply chain:** businesses that have a significant dependence on specific suppliers or distributors are higher risk. Some examples may include:
    - *Dependence on proprietary products:* such as a manufacturer who's product has a significant reliance on a specific proprietary component
    - *Dependence on distribution channel:* such as a company that is only able to distribute its products to a specific geography or sector through a single distributor

- *Inflexible contracts:* such as long-term contracts with suppliers that prevent the company from sourcing elsewhere.



We also leverage the "5 pillars" when we assist a Company to prepare for exit (Scancorp's Business Exit Services Overview).

While very few Companies excel in all 20 characteristics, we find the "5 pillars" enables us to readily identify the strengths and weaknesses of a business.

We can then work with the Company's owners and management to address the key issues and prepare the Company to optimise sale within 12-18 months.

Click here for more information regarding **Scancorp's Business Exit Service Offerings**.

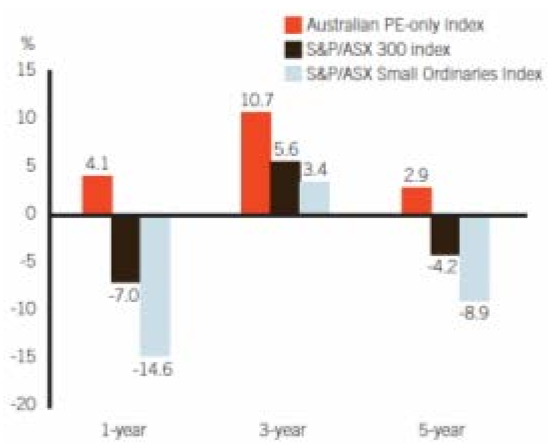
Market Insights

The Australian Private Equity and Venture Capital Association (AVCAL) released the Private Equity (PE) Performance for February 2013

The key findings include:

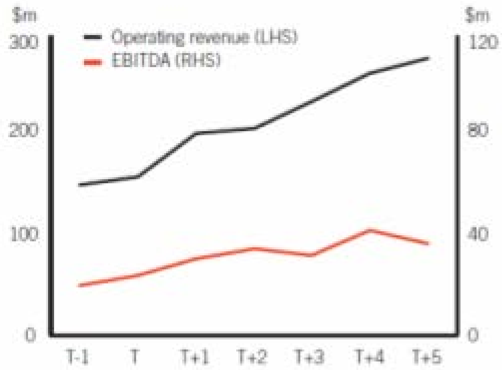
Australian PE funds generated competitive returns in FY12

Australian PE funds have consistently outperformed Australian stock indices over one-year, three-year and five-year horizons. One-year PE net returns to 30 June 2012 outperformed the S&P/ASX 300 Index by 11% and the S&P/ASX Small Ordinaries Index by 19%. Australian PE returns also outperformed all major PE/VC (venture capital) indices over three-year and five-year periods and outperformed most major indices over a 10-year period.



Companies backed by Australian PE funds generated strong revenue, EBITDA and employment growth

A survey of private equity backed companies found that average revenue grew at a compound annual growth rate (CAGR) of 11.0% and average EBITDA grew at a CAGR of 10.7% after acquisition by a PE firm (in year T below). PE-backed companies also expanded their workforce at a CAGR of 27.6% for the same period after acquisition.

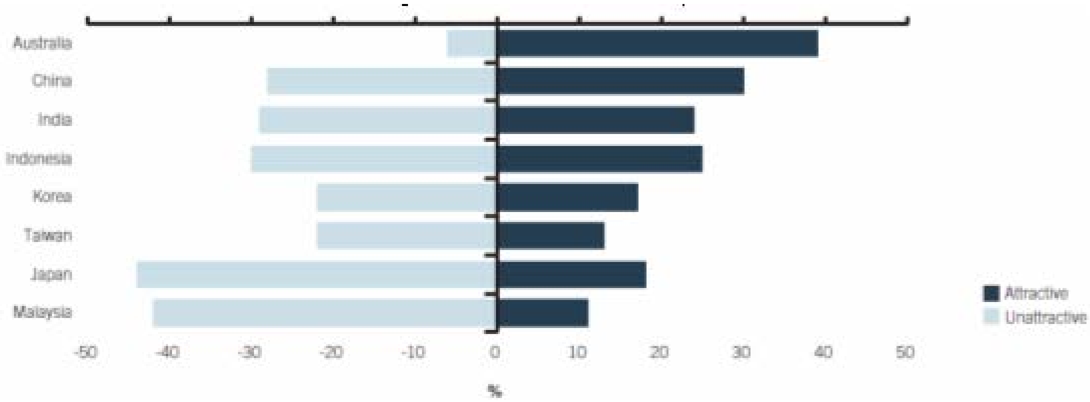


Australia exhibits strong economic fundamentals

Some of the key features that attract international investors to Australian PE funds include solid economic growth, a robust financial regime and exposure to the Asian market. Australia's real GDP growth rate is significantly higher than the OECD average. It has a healthier fiscal balance and lower unemployment rate. Australia also has strong trading ties in Asia (East Asia accounting for over half of Australia's total trade in goods and services).

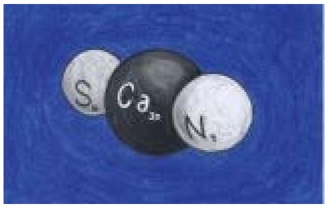
Within Asia Pacific, Australia is the most attractive destination for buyouts

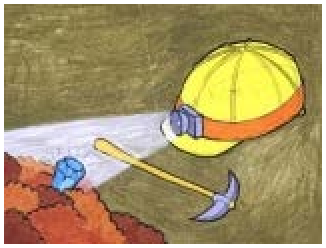
In a survey of 101 global limited partners (LPs) in 2012, Australia was seen by LPs as by far the most attractive place for buyout investments in the Asia Pacific region over the next two years.



Other News

- [Another $350 million for innovation fund under Venture Australia link]
- [IBISWorld releases a free report on The Clean Energy Plan and Australia's Industries link]
- [Government cuts R&D tax break for big business to provide $1 billion boost to SMEs link]





Featured Investment

Commercial glazing business

- Established 25 years
- Majority of revenues from repeat customers (eg 65-70%) and referrals
- Highly profitable with GP > 55%
- Average revenues of $4.6M over past 6 years
- Average EBIT FY11 and FY12 $1.02M
- FY13 EBIT on track for 20% growth
- Premium brand with iconic reference sites
- Full management team in place
- EBIT includes budget for full-time General Manager
- **Total investment:** $3.2M
- **Optional:** freehold available for $1.75M

Featured Investment

Concrete pumping services

- Established 40 years
- Long-term relationships with leading construction companies
- Focus on commercial construction in SEQ
- Operated under management
- Average revenues 2009-1012: $3M
- Exceptional value – offered for sale at below replacement value of plant and equipment
- **Total investment:** $1.5M
- **Optional**: freehold 18,000m^2 available for $2.1M @ 9.1% net yield

Scan Business Brokers

Our Mission

We provide the highest quality advisory services and solutions, previously inaccessible to the small to mid market.

Our Vision

To be the leading boutique provider of advisory services to fellow small and medium companies.

Our Services and Capabilities

Business Exit Service Overview

Scancorp Capabilities

Sellability Score

Last Newsletter

January Newsletter