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Valuation Considerations

What factors impact the value of a business?

While this is not an exhaustive list, some of the factors that may impact on the value of a business include:

- Business' prior performance and future forecasts, eg:
    - Average profitability of prior years
    - Any trend (up or down) in profitability
    - Extent of confirmed future revenue (such as via existing contracts)
- Nature of the business' assets, eg:
    - Quantity and proportion of: physical assets such as plant and equipment, work in progress and goodwill
    - Quality of the underlying assets, including how well equipment has been maintained, how probable it is to collect the outstanding debtors, the extent of obsolete or slow moving stock etc
    - Terms of current contracts such as leases
- Business Structure, eg:
    - Whether the business is or practically can be operated under management
    - Extent of systemisation (documented processes etc)
    - Whether the current owner is offering to retain equity and/or sell via an earn-out
- Industry specific factors, eg:
    - Competitive position including barriers to entry, patents, exclusive supplier arrangements and competitive landscape
    - The impact of relevant recently introduced and/or proposed legislation
    - The number of similar businesses for sale

What processes are used to value a business?

- Business valuations are required for events such as:
    - Complete or partial sale
    - Periodic bank reassessment of lending facilities
    - Refinancing
    - Seeking expansion capital
- There are several approaches to valuing a business. Some examples include:
    - Earnings capitalisation method: considers the annual return on investment in expected future earnings. The relevant earnings to be used will depend on the type of the business and whether the business is to be operated under management. For example, equipment dependent businesses should consider EBIT (earnings before interest and tax) rather than EBITDA (earnings before interest, tax, depreciation and amortisation). A business that is intended to be operated by the buyer may use PEBIT (proprietor's earnings before interest and tax) as it is appropriate to include the owner's remuneration from the business
    - Book value: is based on the company's balance sheet and is determined by subtracting the company's liabilities from its assets resulting in the owner's equity. Adjustments may then be applied to account for non-balance sheet items such as intangible assets
    - Intrinsic value: considers the current market replacement cost of all plant, equipment and stock involved in generating income. Intrinsic value does not include any value for the goodwill component
    - Discounted cash flow (DCF): is a valuation method whereby all future cash flows of a business are estimated and discounted to give their present values. The sum of all future cash flows is the net present value (NPV). The NPV is used as the value of the business.

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The discount rate applied considers both the time value of money and the risk associated with the future cashflows. DCF methods are particularly applicable where future earnings are more appropriate and reliable than historic earnings (such as with an early stage business or a business that has recently secured major contracts).

What is EBIT, PEBIT and why do these differ from the profit declared in the business' tax return?

There are 2 primary reasons why the EBIT (earnings before interest and tax) proposed for a business differs from its declared pre-tax profit:

- Pre-tax profit includes an allowance for interest expenses. When a business is presented for sale the profit measure most typically used is EBIT. This is because the financing arrangement of the new owner(s) will likely differ. Hence a pre-tax measure of profit and interest is used.
- For smaller businesses, numerous adjustments are usually required to quarantine the owner's specific financial situation from that of the business. Other items that may be adjusted from the reported profit include one-time non-recurring events.

Therefore, to calculate the reasonable price for a business, we first calculate its "suggested adjusted EBIT". This is often a complex process and involves:

- Establishing a meaningful timeframe for historical review
- Analysing the income tax returns of the business
- Analysing financial statements prepared by the business' accountant
- Identifying, quarantining and justifying any non-recurring events (eg prior lease expenses that are not relevant post consolidation)
- Where the business includes a freehold property, ensuring commercial lease rates have been accounted for
- Identifying discretionary business expenses (such as donations) that a new owner could potentially take as profit
- Adding back interest expenses, as these are subject to the financial structure specific to the new owner
- Adjusting forecast profitability expectations based on certain or extremely probable events (such as increasing profit to account for the gain of a major contract or reducing profit associated with closing down a particular product line)
- Adding back any remuneration received by the owner(s)
- At this stage, we have the "suggested adjusted PEBIT" ie the proprietor's earnings before interest and tax
- Most of the businesses marketed by Scan are presented as if they were operated under management. When this is the case, we deduct a market relevant management salary from PEBIT to arrive at the "suggested adjusted EBIT"

