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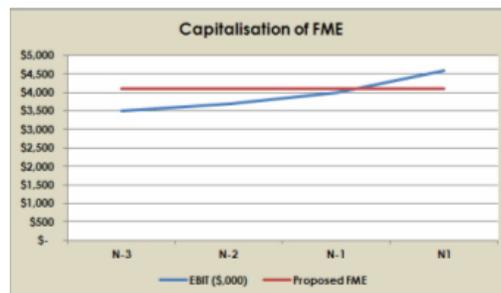
Technique: *Discounted Cashflow (DCF)*

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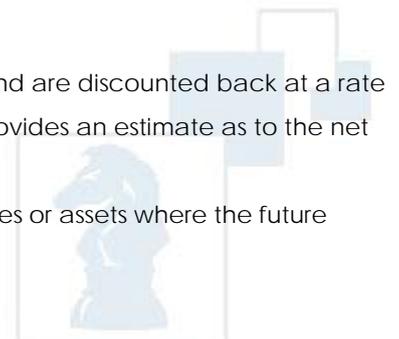
Example: A company has recently commercialised proprietary products and has appropriate IP protection in place. In the past 6 months the products have generated sales of $1.5M at a GP of 70% and EBIT of $750k.

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.
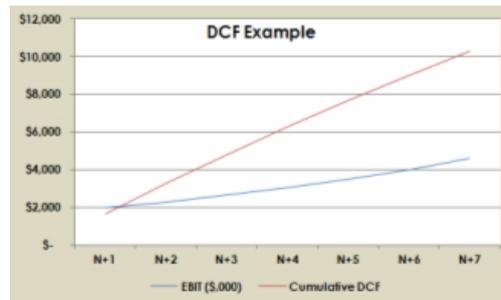
Technique: *Internal Rate of Return (IRR)*

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%.
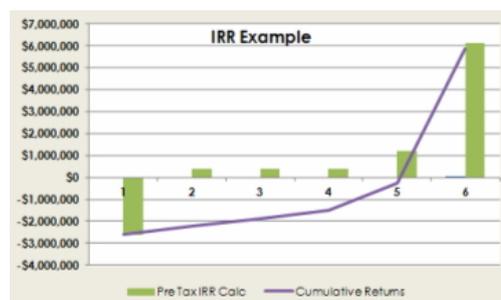
Technique: *Balance Sheet*

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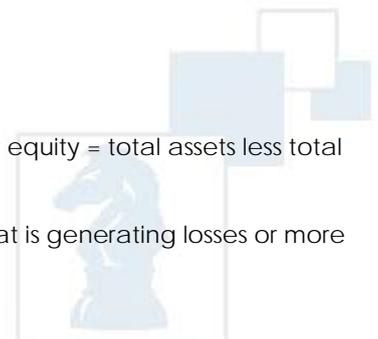
Example: An established company is currently generating an EBIT of $100,000 which is also the next financial year forecast. In most recent years, the company generated losses.The company's plant and equipment have a market value of $5M with $1M loans remaining and working capital is approximately $1M.

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.
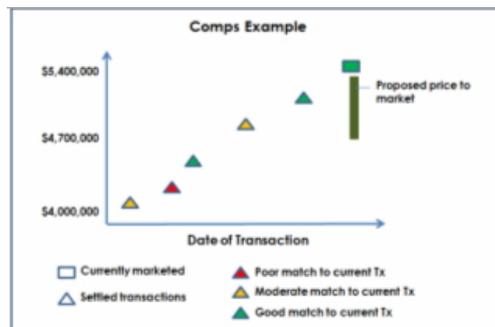
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