

VALUATION OF SME'S

Paper presented by Trevor Vella, Director, Trevor Vella & Co Pty Limited
Chartered Accountants NSW Business Forum 2007
Copyright © 2007, Trevor Vella & Co Pty Limited

1 INTRODUCTION

What is an “SME” and how, if at all, are SME’s different in the valuation context?

I have been asked to speak today on the topic “valuation of SME’s – small and medium-sized enterprises. What is an SME? By definition one would think the term covers all but “big” enterprises. The IASB is currently involved in developing an International Financial Reporting Standard tailored to meet the needs of – and intended for use only by – SMEs. For the purpose of the project SMEs are entities that (1) do not have public accountability¹ and (2) publish general purpose financial statements for external users².

We do not need to get too tied up in defining what an SME is, but the scope of this paper is wider than envisaged by the IASB, which seems to focus more at the larger end of the spectrum. It is intended to be relevant in the context of the valuation of all but large enterprises, ranging from very small businesses to substantial organisations, although generally smaller than their listed counterparts. These enterprises are generally closely controlled (ie have few shareholders). Often these businesses are controlled by persons who are either involved in the business on a day to day basis, or are related to such persons. Many such businesses are what may be described as “family businesses”, or “family owned businesses”, although many are controlled by “partners” who are not related by marriage. Of course, many family or closely controlled businesses are bigger than some of their listed counterparts. These larger businesses are outside the scope of this paper.

The valuation of an SME follows the broad valuation principles applicable to any business enterprise but with some “peculiarities” to watch out for which will affect the application of the methodology. These factors go particularly to the need to carefully evaluate whether the reported results reflect arms length dealings, and to consider the range of likely buyers and the riskiness of such entities.

Features of many SME’s

The following factors may be thought to be relevant in the context of undertaking a valuation of an SME:

“Identity” (or “arm’s length”) issues

- A perception that “the business is the owner”;
- Dividend, investment and other policies may be driven by tax planning and personal considerations rather than commercial considerations;
- Remuneration of family members may not reflect a fair reward for effort on a commercial arm’s length basis (it may be more or less than that amount). There may be no clear delineation between return to labour and return to capital/risk;
- The owner’s perceptions of “value” may be distorted;

1 An entity has public accountability if it has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity

2 Examples of such external users include owners who are not involved in managing the business, existing and potential creditors (such as lenders and vendors), customers, and credit rating agencies

- Dependence upon the owner(s) for financial support, eg by way of guarantees or loans;
- Organisational definition (allocation of management responsibilities) may be “fuzzy”.

Size issues

- Lack of management depth/dependence upon one or two key personnel;
- Dependence upon key customers or suppliers;
- Lack of diversification (if this is important in the relevant industry);
- Inability to capture economies of scale
- Lack of geographical spread where that may be appropriate.

Information issues

- Inadequate internal dissemination of information;
- Availability of relevant external data may be restricted;
- Inadequate availability of information (poor systems, no audit, accounting standards not applied);

Market issues

- Lack and depth and organisation of market for shares – possibly lack of market at all for minority holdings;
- The shareholders may all be related or closely associated which may preclude acting at arms length;
- No mechanism for ownership transition.

A further issue with particularly smaller businesses is that there may be or may be suspected to be, significant cash takings not accounted for.

Scope of this Paper

In this paper I have set out to give an overview of six aspects of valuation of *whole businesses*:

- the date of the valuation;
- what does “value” mean?
- what is a “valuation”?
- what methodologies are commonly applied in valuing an SME and how are they applied?
- how does one select a capitalisation or discount rate?
- what assets and liabilities are included in the “business” valuation?

Along the way I have sought to provide examples and point out some of the common pitfalls of which the valuer should be aware. This paper does not consider the valuation of partial interests in business enterprises.

2 DATE OF VALUATION

A valuation is an expression of an opinion about “value” *at a point in time*. That point in time must be specified. Value continually changes. Normally the client wants a “current” valuation. That requires current financial information. Often that is not available. The valuer then looks to the latest reliable financial statements which may be many months old. The valuer should specify explicitly what is the date of the valuation, which is often the date to which the latest financial statements are made up.

Issues may arise as to hindsight. The general rule (subject to modification eg in the case of assessment of damages for breach of contract in relation to the purchase of an asset³) is that the valuer cannot use hindsight.

3 WHAT DOES “VALUE” MEAN?

In every valuation assignment the valuer faces two threshold issues. The first is “*what does “value” mean in the context of the assignment?*” We shall refer to each possible answer to that question in this paper as a “**standard of value**” or “**valuation standard**”. It is only once the valuation standard is determined that one can turn to consider the second question - “*what method, or methods, of valuation is, or are, best suited to enable the formation of an opinion about the quantum of value?*” The answer to that second question involves a consideration of the various “**valuation methodologies**” outlined below.

The term “value” has no precise generally accepted meaning. For that reason, there can be a great deal of ambiguity about what an opinion about “value” signifies if the valuer has not sought to define the term. The essential message of this part is that the valuer must define what he or she means by “value” in order that the opinion in a valuation report is to be meaningful. In adopting a particular definition of value the valuer is generally guided by the purpose of the valuation and the needs of the user.

On one view, there are only two fundamental conceptions of value viz “market value”, and “value to the owner”. We shall also touch on two other constructs: “fair value”, which is a term whose meaning must be interpreted in the context in which it is used, and “fundamental value”.

Market value

The common conception of “value” has to do with the “cash equivalent” of an asset in the sense of “what amount would I get if I sold the item today” – “value” is a price. This notion of “**market value**” is a reasonably simple one which most people can readily grasp. It can be surmised that both the number of buyers and sellers in the market and the degree of willingness or anxiety of these players to transact (which will be, to some extent, interdependent) will affect the price. If there are any purchasers to whom the asset is likely to have special value one can make whatever enquiries are thought reasonable and appropriate to try and ascertain what those purchasers might pay. While there may be practical issues involved in estimating the selling price if there is not a deep and transparent market, these problems are not definitional – the standard of value remains unchanged. At the extreme, if I can’t identify any buyers the market value is nil.

The International Valuation Standards Committee⁴ (“**IVSC**”) basic conception of “value” is “market value” defined as follows:

“market value: the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.”

Although it is not known what is in the draft standard prepared by the Business Valuation Special Interest Group of the ICAA it seems likely that there will be international convergence both by

3 See eg *HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd* [2004] HCA 54 (12 November 2004)

4 Although real estate has been the main focus of this body, the valuation of businesses is within the scope of the IVSC standards and there is a reasonable likelihood, in the author’s view, that this will ultimately become the world-wide standard setter.

valuation bodies and accounting bodies towards this type of definition which is now commonly seen in international accounting standards [where the term used, unfortunately perhaps, is “**fair value**”, rather than “market value”], and in day to day practice in published valuation reports, normally arising in the context of public company mergers, acquisitions and investments, where the common term used is “**fair market value.**”

Value to the owner

Even if there is a clearly identified market for a particular commodity it is not the case that every holder or prospective holder of units of that commodity believes that the asset is worth the ruling market price. In general, holders who do not sell believe the asset is worth to them at least the market price and possibly significantly more (otherwise they would sell). One reason why potential buyers who do not buy is because they believe the asset to be worth (to them) less than the ruling price. These circumstances are an illustration of the conception that market prices are determined by the interaction of participants who may have, and normally will have, different conceptions of the worth of an asset. In the case of assets such as businesses or shares the “worth” is essentially a function of the economic benefits (from use, income generation, and/or disposition) which the asset is expected to produce. Each person’s individual assessment of those economic benefits is a “**value to the owner**”, or value to a prospective owner.

Where there are no buyers for an asset being valued the valuer must consider what standard of value is being applied before being able to conclude that an asset has “value”. In the context of a valuation prepared for “statutory” revenue purposes it may be appropriate to assume a notional purchaser. Without exploring this topic it is suggested that many cases dealing with valuations (particularly of minority interests) in this context look not at market value but at value to the (actual) owner – this is what happened in one of the leading of most often quoted case, the decision of the High Court in *Spencer v The Commonwealth*⁵:

"In my judgment the test of value of land is to be determined **not by enquiring what price a man desiring to sell could actually have obtained for it** on a given day, i.e., whether there was in fact on that day a willing buyer, but by enquiring: ‘What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for **a fair price** but not anxious to sell.’” (emphasis added)

The “fair price” is a “deprivation value” [value to the owner] standard commonly adopted in resumption cases. Indeed, *Spencer* was not a share valuation case but dealt with compensation for resumption of real estate by the Commonwealth.

It is sometimes said that the standard of value adopted in the Family Court is always value to the owner. It is submitted, however, that in the usual case, when valuing the *whole* of the business or company, the standard of value adopted will be “market value” – ie what amount would be realised on the sale, [or there is implicit recognition that the value to the owner is the market value.]. The “value to the owner” concept assumes significance when valuing minority interests where there is no market or a very limited market: see in the Family Law context , for example, *Turnbull and Turnbull* (1991) 15 FamLR 81; (1991) FLC. 92-258, *Georgeson and Georgeson* (1995) FLC. 92-618 and *Harrison and Harrison* (1996) FLC. 92-682.

“Fair value”

Mainly in the context of shareholder disputes involving minority interests the Court may be concerned with the “fair value” of a parcel of shares. The meaning of fair value in this context is not anywhere

⁵ (1907) 5 C.L.R. 418, at p432, per *Griffiths* CJ. See also per Sir Edmund Barton at pp 435-6. Contrast the greater focus on the “prudent purchaser “ by Isaac J at pp440-1 .

clearly defined. In essence the Court is applying a remedy for a wrong and the outcome will be tailored to the facts of the case. Again this aspect of valuation need not trouble us for present purposes.

“Market value” and “price”

The Oxford Dictionary for the Business World defines “price” as (in part) “[the] *amount of money for which a thing is bought or sold*”. Price is an observed *historical* fact. It is the result of a dealing between at least one buyer and at least one seller. The term “**market value**” is the amount that an asset is *expected* to realise if sold on a particular day. An opinion as to market value may be based on a consideration of market prices but the two are not necessarily the same. Some observations may be made:

- market prices change continually – even if I acquired a share in Market Ltd (a listed company) for \$1 ten minutes ago it is not necessarily the case that the market price is \$1 now. The historical price is just that;
- the volume of the good sought to be bought or sold can influence the price. The fact that I can buy/sell 500 Market Ltd shares for \$1 each does not mean I can buy/sell a 500,000 shares at that price;
- where there are no prospective buyers there can be no “market” and no market price. Whether or not there can still be a “market value” depends upon what I mean by that term – if I mean “*the amount I would get if I sold at the market price*” (a la the Oxford Dictionary – see above) there is no market value.

It is not uncommon for commentators to opine that, for example, “*the shares in Xco are overvalued at their current market price*” or, as one real estate broker put it, “*properties are still selling at market value*”. Unless these types of comments have no meaning at all, they suggest that there is another standard of value being applied, that is, that market price is not the same thing as “market value”, or just “value”. In that context, and for the sake of completeness, we shall note that Pratt’s work includes⁶ a standard of value described as “intrinsic value or **fundamental value**” [we shall use the latter term in order to avoid confusion as regards the meaning of the former⁷] which is said to denote “*an analytical judgement of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but tempered by how these perceived characteristics are interpreted by one analyst versus another.*” The term is used by Pratt to describe the product of work of analyst who decides that a particular listed company stock is a “buy”, “hold” or “sell” on the basis that he or she believes, based on “fundamentals analysis”, that the stock is undervalued, fairly valued or overvalued respectively.

Even when there exists a readily observable market it is generally the case that the ruling price for the commodity is based upon the different perceptions of each of the buyers and sellers as to the value of the commodity. What can be said in relation to an arms length transaction is that the price paid is equal to or greater than the value to the vendor and equal to or less than the value to the purchaser. As we have said, it seems intuitively obvious that it is not possible to speak of the “value” of anything except in the context of worth *to someone*. There may, of course, be several or many people who view the commodity as having the same or a similar value, but, particularly when we are talking about business interests, it will be an unlikely scenario that all prospective buyers would place the same value on the same business at the same time. There is then, in this sense, no “intrinsic value” for

6 Pratt et al, *Valuing a Business*, McGraw Hill, 4th edn at pp31-2.

7 The term “intrinsic value” can mean the same as “stand-alone” value - the value of a company without the inclusion of prospective synergies, so that it is a little confusing when used also in the sense described by Dr Pratt. The term *intrinsic value* has also been used in some decided cases to meant the same as “value to the owner”.

anything – it is a matter of how much it would be worth to someone, either to the owner or to one or more prospective buyers.

Simplistically, the connection between some of the valuation concepts mentioned so far may be represented in the following diagram. The position is shown in relation to one share in a listed public company and on the assumption that the various prospective buyers and sellers (including all holders) have access only to publicly available information. The bands above and below the market price may be wider or narrower for each category depending on the views of the various market participants.

\$1.20	“Value to owner” - prospective acquirer of control ⁸
\$1.15	“Value to owner” - present holder who has control
\$1.05 - \$1.10	“Fundamental value” as perceived by analysts recommending “Buy”
\$1.01 - \$1.10	“Value to owner” (present holders and intending purchasers)
\$1.00	Ruling market price
\$0.95 - 0.99	“Fundamental value” as perceived by analysts recommending “Sell”
\$0.80 - \$0.99	“Value to owner” (intending sellers and potential buyers if the price falls)

Special purchaser

Special value may accrue to one or more prospective purchasers of a business enterprise because of potential reductions in competition, economies of scale, acquisition of access to particular suppliers, customers, employees or management skills, and so forth. The valuer should consider the position of the prospective special purchaser vis-a-vis the property being valued⁹. The valuation may be based upon acquisition by a special purchaser where it is common knowledge that several such purchasers exist and where it is possible to quantify the value of benefits which might be obtained by such buyers. Commonly, it is not possible to know if special purchasers exist or, if they do, what will be the value of potential synergies or other benefits. In such cases it is common that the valuer states specifically that no account is taken of the possible existence of special purchasers and the valuation is on a “stand alone” basis. Difficulties may arise where it is known that one special purchaser exists. Stated broadly, in what we term the “statutory” context [where the valuation is for fiscal purposes, and the principles derive from the line of cases starting in Australia with *Spencer*], there is a strong view that the value to that person must be taken account of. That may not generally be the position in the commercial context. However, again, it is important that the valuer states what he or she has set out to do and makes sure that that is appropriate in the light of the purpose of the valuation and the needs of the user.

Valuation in the context of this paper

In day to day practice there is generally no question:

- that “fair market value”/“market value”/“fair value” (in the accounting standards sense) is the appropriate standard in the context of valuation of whole businesses or entities;

8 Although the control is value is here shown as a per share value, the incremental value of control stems from the holding of sufficient shares to control the board. Normally control does not attach to particular shares. Assuming only one class of shares exists the control value per share is also the “fair value” a that term is defined in section 667C of the Corporations Act

9 Care should be taken to ignore what may appear to be “comparable” transactions if the prices set were based on special value to the purchaser, unless the property now being valued has the same advantages to one or more potential purchasers.

- that a “market” exists in relation to whole private companies or businesses. But it is not a deep market for a uniform commodity, nor is it readily observable. In some cases listed companies will acquire private companies and some information is available but it may be incomplete. Such acquisitions form only a small part of the market.

For the purposes of this paper I am focussing on market value in an assumed context that there are in fact a range of prospective buyers for a **whole business** being valued.

Importance of purpose

The definition of value must depend upon the objective - the purpose of the valuation. If, for example, a client seeks an opinion as to what a business might fetch on a contemplated sale, the valuer may not be providing the best service by waxing lyrical about what a hypothetical willing but not anxious buyer might pay who is not a special purchaser. What the client wants to know is what he or she can expect to get from (real) people who are likely to want to buy the business, and are able to do so.

As several judges have commented, the valuation methodology should not obscure the objective, that is the determination of “value” in accordance with a particular standard.

4 WHAT IS A “VALUATION”?

A “valuation” is an expression of an opinion about “value”. Once we have defined what we mean by “value” the meaning of the word “valuation” should be reasonably clear. So, if we mean by value the price at which I could sell my Honda Prelude today in its existing condition in its existing location, then a valuation is an expression of an opinion about what that price would be (or perhaps a range of prices which might be obtained). Two points may be made initially:

- the expression of opinion may given based on much or little examination by the valuer of the relevant circumstances. There is nowhere set out a “rule” as to the scope of the work to be done to support the expression of opinion;
- a valuation represents an opinion, not an exact measurement. As we have said even where there is a deep public market for trading in a homogenous commodity a vendor cannot be certain of obtaining a particular quoted price for an unlimited quantity of the goods he has to sell.

Scope of work supporting a valuation opinion

There are obviously opinions and opinions. I might have a rough idea of what my Honda is worth and I could opine on that. Alternatively, I might conduct a review of advertisements for similar vehicles and form a more informed opinion. Alternatively again, I might seek the advice of someone who actually knows something about cars and the motor vehicle market. In the same way, the expression of an opinion about the value of the business might be based on a few rough calculations, or on a detailed study of all factors which might be relevant, or something in between. The issue is what is the scope of work to be performed to form an opinion.

The American Society of Appraisers has released various pronouncements styled “Business Valuation Standards”. Standard BVS-III, entitled “General Performance Requirements for Business Valuations”¹⁰, sets out three categories of what are described as “acceptable scopes of work”:

10 Released January 1992

- “appraisal” - a procedure undertaken with the objective of expressing “an unambiguous opinion as to the value of a business, business ownership interest, or security ... supported by all procedures that the appraiser deems to be relevant to the valuation”;
- “limited appraisal” - a procedure undertaken with a view to expressing “an estimate as to the value of the business “... based upon consideration of limited relevant information [and] ... the conduct [of] only limited procedures”; and
- “calculations” - a procedure undertaken to provide “an approximate indication of the value based upon the performance of limited procedures agreed upon by the appraiser and the client.”

No similar standards exist in Australia. The Institute of Chartered Accountants of New Zealand has promulgated Advisory Engagement Standard No.2 Independent Business Valuation Engagements which applies “*when a member is providing a business valuation report in the role of an independent business valuer*”. The standard appears to envisage that the valuer would ordinarily conduct what amounts to an “appraisal” in the ASA terminology. Paragraph 59 of the standard provides that:

“Where the member has been limited in scope of review or where information provided to a member was incomplete, disclosure must be made of the limitation, the reasons given and, where possible, the potential impact on the business valuation conclusion.”

However, perhaps curiously (because there are then no standards or guidelines applying), the standard does not apply where independence is not asserted or reasonably assumed by the report user, or in relation to¹¹:

“indicative valuation engagements, where the valuation conclusion is based upon the consideration of limited information provided to the business valuer, with no requirement to assess the reasonableness of the information or to gather further information, provided that the basis on which the valuation conclusion is to be formed is clearly set out in the terms of the engagement and any report produced by the business valuer as a result of the engagement;”

In any event, the New Zealand standard clearly envisages that a “business valuation” is not a homogenous product. Where it applies, it places an onus on the valuer to comply with the requirements of the standard as to performance, selection of the appropriate “approach” (or standard of value), the appropriate valuation “technique” (“methodology”), consideration of valuation parameters, gathering of evidence (and documentation of the evidence) and so forth. If these things are not done the valuer must say so in the report.

Reference may be made to the Scope of Work Rule promulgated by the US Appraisal Foundation in the Uniform Standards of Professional Appraisal Practice (USPAP). The following passage is instructive:

“The scope of work must include the research and analyses that are necessary to develop credible assignment results.

Comment: The scope of work is acceptable when it meets or exceeds:

- the expectations of parties who are regularly intended users for similar assignments; and
- what an appraiser’s peers’ actions would be in performing the same or a similar assignment.

.....

11 AES-2, para 3

An appraiser must not allow assignment conditions to limit the scope of work to such a degree that the assignment results are not credible in the context of the intended use.

.....

An appraiser must not allow the intended use of an assignment or a client's objectives to cause the assignment results to be biased.

.....

The report must contain sufficient information to allow intended users to understand the scope of work performed."

One would normally expect an "appraisal" (in the US terminology), or a business valuation conducted in accordance with AES-2 to include a review of such factors as:

- the business financial history;
- prospects (including budgets and business plans, if available);
- forecast cash flows (if available);
- financial position, including funding sources;
- extent of gearing (debt);
- industry prospects in the light of economic factors;
- customers;
- key employees;
- key strengths and major risk factors.

For various reasons, such an analysis may not be appropriate. However, if a detailed analysis is not undertaken, care should be taken to set out clearly what are the limitations inherent in the opinion given.

With no guidelines in Australia as to the scope of work to be undertaken in the area of private company valuation an opinion on valuation may be based on an exhaustive analysis or a few quick calculations based on a whole range of assumptions or even without explicit consideration of what assumptions are being made. This is an obvious issue in the face of pressure from clients to minimise fees. The client should not assume that one valuation is as thoroughly performed as the next but clients are often unable to assess the quality of performance of a valuation assignment. In the Family Court and other courts there has for some existed a concern with the cost of obtaining expert evidence. Assuming valuers do not wish to, or are unable to, reduce their time charges, the only practical solution is to spend less time on the valuation. Unless time can be saved by efficiency the inevitable result is that the valuation is less thorough. In some cases that may be appropriate. However, if a matter comes to trial, cross-examining counsel will rarely hesitate to point out any areas where (he or she asserts) the valuer should have done more work. Paragraph 15.62(2) of the Family Law Rules 2004 requires that the expert must state, *inter alia*:

"I have made all the enquiries I believe are necessary and appropriate and to my knowledge there have not been any relevant matters omitted from this report, except as otherwise specifically stated in this report."

The exact scope of this requirement may be debated but, in any event, the purpose of the valuation will obviously bear directly on the scope of work. For example, a "calculation" would normally be of little use as expert evidence in any sort of litigation but it might be very useful in assisting a party to decide whether or not litigation may be worthwhile.

Once one has determined what is meant by "value" there are several possible approaches to valuing any asset. That is not to say, however, that these approaches are equally appropriate alternatives, or that one is necessarily a useful "cross-check" on the other.

Example 1: The value of Splendiferous Pty Limited on a capitalisation of maintainable earnings basis (determined by the valuer to be appropriate) is \$1 million. The net tangible assets value, based on going concern values, is also \$1 million. It is wrong to conclude that the net asset methodology is a "cross check", in the sense that it is an appropriate alternative methodology. The net assets basis is generally not an appropriate valuation methodology for a going concern business (see below).

It is a matter of determining which approach is the most appropriate and using that methodology. If another methodology serves well as a cross-check, so much the better, and that methodology should be considered also. There are four types of methodologies that are usually referred to in texts on valuing whole businesses:

- by reference to "comparable sales" [we include in this category "rules of thumb"] - see paragraph 6 below;
- discounted cash flow - see paragraph 7 below;
- capitalisation of maintainable earnings - see paragraph 8 below; and
- by reference to the values of assets and liabilities - see paragraph 9 below.

The presentation of an array of possible methodologies can be confusing. The simple fact is that, leaving aside emotional considerations, people buy businesses because of the cash (not profit) they can get out of them. That cash will comprise:

- the "free cash flow" of the business – essentially that cash generated which is not required for reinvestment or debt repayment – so long as the business is owned; and
- either:
 - i. the proceeds of sale of the business; or
 - ii. the proceeds of a winding up.

It follows that, one way or the other, we are trying to estimate the present value of *cash* which will accrue to the owner (or buyer). The DCF approach is fundamentally the only way to do that.

The maintainable earnings basis is generally seen as a proxy for DCF methodology, with profit as a proxy for cash flow, and growth built into the capitalisation rate. The comparable company, and rules of thumb methodologies, essentially try to estimate a selling price directly (rather than indirectly through valuing cash flow/earnings) by reference to either to current sales of similar listed companies (or interests therein) or benchmarks established by industry experience in private dealings in similar businesses. Generally the scenario is that the assets and liabilities won't be sold off piecemeal, so that the values of tangible assets and liabilities are not directly relevant.

In *Crane*¹² Stephen J opined that "*The use of comparables having a known market value is perhaps the most commonplace and the most reliable of all aids in the valuation of an asset ...*" A real estate valuer offering an opinion on the value of a residential property, for example, will commonly consider the prices achieved in recent sales of "comparable" properties.

In the case of a privately held business or company, one would expect that the best evidence of value would be the current selling prices of identical businesses. Of course, "businesses" are not homogenous products. Even if their "get up", methods of operation and product are identical (e.g. a franchise business) their size, location, quality of management and other factors may make direct comparisons unreliable. Even if one could find evidence of similar dealings, the price may not be comparable because, for example, the vendor may have been anxious to sell, or the business sold may have had special value to a particular buyer because of, say, its synergy with another of his businesses. Notwithstanding these difficulties, if information on recent private business sales was generally available, a valuer could make appropriate adjustments to form an opinion as to the price a prospective buyer would pay for the business being valued.

Information about dealings in private businesses or companies is rarely publicly available in Australia¹³. Even if the fact of a particular transactions having occurred is reported (for example, where a public company buys a private company or business) the financial information publicly available is generally minimal. In the absence of such information a valuer seeking to identify "comparable" transactions has three possible avenues to consider:

- evidence of prices paid in sales of shares in the company being valued or, possibly, offers made for such shares;
- some sort of industry rule of thumb; and / or
- sales of shares in "comparable" listed companies.

As to the first of these, recent dealings in the company's shares are generally highly relevant. The valuer must consider, however, inter alia, whether the parties were dealing at arms' length, the size of the parcel, the spread of other shareholders, and allowance for minority and marketability discounts - these considerations are beyond the scope of this paper.

"Rules of Thumb"

"Rules of thumb" are generally frowned upon by text-book writers. Although they must be treated with considerable caution these rules should not be overlooked, especially in the case of small businesses. For example, if there is clear evidence that small accounting practices with certain types of clientele are selling for 80 to 90 cents in the dollar of fees, it would be unwise to prepare a valuation on a conventional earnings basis showing little or no goodwill, without seeking at least to explain why the "rule" should be disregarded.

Such "rules" are commonly developed as "short-cuts" based on historical sales. Sometimes this is to avoid the need for extensive analysis of businesses which are often run in "eccentric" ways by sole proprietors. Sometimes the rule is applied on the basis that what "everybody else" does can't be wrong [?!] and the buyer can always sell out to someone else who believes the same. Many such "rules" reflect the principle that goodwill does not necessarily depend on historic profitability, although they generally depend upon the assumption that profitability will be generated in the future.

12 *Crane Estate v FC of T* 75 ATC 4001, at p4004.

13 There are several databases maintained in the United States and at least one in the United Kingdom on private business sales.

Example 2: In the *Golden Bread* case¹⁴ the Full Court of the Queensland Supreme Court found that it was appropriate to use a "rule of thumb", "industry norm", based on the average weekly units of bread purchased to value a bakery business, notwithstanding that the business was insolvent, had not made profits for many years, and had little prospect of doing so in the short term.

Multiples Obtained from the Listed Company Market

Valuations of SME's which are profitable trading operations are commonly effected by the application of a multiple to an earnings figure. The multiple may be drawn from "comparable" listed companies or may be developed by the valuer by reference to other market indicators, sometimes by way of a "build up" from a risk free rate with allowance for a market premium and further adjustments to allow for relative risk, possibly, (but rarely, at least as evidenced in reports) applying the capital asset pricing model or a modified form thereof which might involve adjusting for size and company specific risk. These methods other than the "comparable company" method are discussed below. If listed multiples are used as a base it is necessary to consider:

- whether or not it is appropriate to add a so-called "premium for control"; and
- whether the multiple, so adjusted by that premium if appropriate, should be reduced (discounted) because of "non-comparability " factors.

Ideally, the data used should be that applying in recent acquisitions of comparable listed companies - however, it is hard enough, particularly in Australia, to find companies which are comparable at all, let alone comparable companies which have recently been taken over.

The first and obvious concern is as to whether or not listed public companies can *in any way* be compared meaningfully with the private company we are seeking to value – are we seeking to compare apples with pears, or mice with elephants?

Example 3: Valiant valuers have been engaged to value "Bruce's Boyzwear". The business has been operating for three years in a local shopping centre. It has a turnover of \$250,000 and is operating by Bruce and his wife Beryl. Profits before owners' salary are \$100,000 per annum. Valiant estimate the appropriate valuation multiple at 2.6 times historic after tax profits by the following calculations:

Comparable listed company multiples:		
- Company A	A	7
- Company B	B	9
- Company C	C	14
Average	$D=(A+B+C)/3$	10
Control premium	E	30%
Base multiple	$F = D * (1+E)$	13
Discount for size	G	20%
Discount for lack of marketability	H	20%
Discount for individual risk factors*	I	40%
Total discount	$J = G+H+I$	80%
Multiple to be applied	$J= F * (1-J)$	2.6
* dependence on key employee, low asset backing, high gearing etc		

14 *Re Golden Bread; Qld. Co-op Milling Association v Hutchinson* (1977-78) CLC 29,490.

This type of calculation is sometimes made in practice in valuing small and very small businesses. Obvious issues arise as to the use of historic or prospective earnings, the basis of selecting an average of “comparable company” multiples, the estimation of a control premium, gearing issues, and the basis of estimating the various discounts. However, the present concern is whether the above calculation has any meaning at all. On one view, the two businesses are fundamentally different and no amount of “adjusting” can be made to make them “comparable”. No number of compensating adjustments can enable an elephant to be compared to a mouse. This is to say that some factors in common affect both businesses. A review of the circumstances facing the listed companies operating in the retail clothing industry may give some insights into how the industry operates and the risks it faces. But beyond that, this approach is of very limited utility unless the business we are valuing has a substantial size and sophistication so that many of the key features can be compared with the listed “counterpart”. Of course, in some cases the firm being valued will be very much larger, and indeed may be much more “sophisticated” than, similar listed companies.

The effect of size on discount rates/capitalisation rates is well canvassed in the literature. In general, the perception is that smaller companies are riskier than larger companies and that a size premium should be added to the discount rate/capitalisation rate, or the relevant multiple reduced, to allow for this – see, for example, Pratt, op cit, at pp.170-1.

Dependence on key personnel, suppliers, key clients/customers all increase risk to the buyer of the business. In some cases the risk can be mitigated and in fact turned into an advantage by the existence of, or entering into, contracts to bind the relevant employee/client/customer/supplier. The quantum of any discount must depend upon the circumstances of the case. One would normally expect multiples applying to SME’s to be significantly less than for listed companies in the same industry because of factors such as size, lack of depth of management, small geographical spread/market penetration and so forth.

Use of multiples

In considering prices paid for shares in listed companies the benchmark generally adopted is the relationship between earnings and the share price (the “**PE ratio**”). The term “earnings” is generally defined to mean profit after interest and tax. However, a comparison may be made by reference to some other performance benchmark, for example, earnings/profit before interest of tax (“**EBIT**”), or profit before interest, tax depreciation and amortisation (“**EBITDA**”). The earnings figures used may be historical or prospective. Alternative approaches include considering the relationship between the share price and turnover (“**price to sales**”) or between share price and book values of net assets (“**price to book**”).

The reported PER is normally based on historic rather than prospective earnings. However (at least in theory) the market price has built into it all the information available about a company including expectations about future earnings. The market does not necessarily expect (and indeed rarely expects) future earnings to be the same as past earnings. Accordingly, and leaving aside other issues of comparability such as gearing levels, reported PER’s are only applicable to the valuation of a private company if the relationship between the past and expected future earnings of the companies compared is the same.

Because it is common for analysts to estimate future earnings of listed companies it is often possible to ascertain PER’s (and EBIT multiples) based on such forecasts. Obviously, if future earnings are higher than historic earnings, the PER based on forecasts earnings will be lower than that based on historic earnings. It follows that one reason why a company has a high (historic) PER is because the market expects earnings to increase. It would obviously be an error to apply such a historic PER to value a company with no growth prospects.

Assuming one is valuing a private company which is otherwise (i.e. by reference to size, gearing, growth prospects and so forth) in all respects comparable with a listed company, one must

nonetheless consider whether it is appropriate to adjust the PER by adding a premium for control and discounting for lack of marketability.

“Premium for control”

It is generally understood that the share market (ie the stock exchange) reflects prices for small parcels of shares carrying no influence over the day to day running of the underlying business. It is common, but not invariable, that prices paid on a takeover are higher than the pre-announcement price. The difference is commonly referred to as a **“premium for control”** or **“control premium”**, the latter term defined by the IVSC in International Valuation Guidance Note 6: Business Valuation (**“the Guidance Note”**) as:

“The additional value inherent in the control interest that reflect the power of control, as contrasted to a minority interest.”

Studies of takeovers suggest that share prices paid to obtain control of listed companies often exceed pre-announcement market prices by anything up to 40%, or even more. However, such premiums vary over time and by industry and are difficult to measure because of other factors affecting share prices. Often, also, the offeror already owns a significant parcel of the target’s shares prior to the launching of a takeover bid and no “premium” may have been paid for these shares.

Value may accrue to a purchaser of a controlling interest from:

- the ability to better manage the existing business, as a stand-alone operations; and/or
- the ability to achieve synergies or strategic advantages by, for example, combining two or more similar businesses and eliminating substantial overhead costs, or by obtaining access to new market segments in order to increase the purchaser’s existing product; and
- the flexibility in general of being able to deal with 100% of the underlying assets and the cash flows therefrom.

If the first two types of opportunities exist in the case of the company being valued they may better be evaluated by seeking to adjust prospective earnings or cash flows rather than by increasing the earnings multiple.

Space and time do not permit us to consider control premiums in any detail. Reference may be made to the author’s paper *“Discounts and premiums in the Context of Valuation of Small and Medium Businesses and Interests Therein”*, presented at the Business Valuation / Forensic Accounting Conference 14 - 15 September 2006. However, one aspect worth noting here is the variation in control premiums paid is enormous and leads one to question the significance of any average. The following table shows¹⁵ “deal premiums” for all transactions over the 1998 to 2005 financial years. The transactions were selected by including any transaction involving an Australian target or acquirer where pricing information was available. The deal premium is the acquisition price premium over the trading price 20 days before announcement of the deal.

15 The underlying data was sourced from Bloomberg. This table originally appeared in the 2006 paper referred to in this paragraph.

ANALYSIS OF CONTROL PREMIUMS OVER TIME						
Financial Year	Financial Year	No. of financial years	Including Negatives		Excluding Negatives	
			Average	Median	Average	Median
			%	%	%	%
2005	2006	1	29.45	25.00	40.76	32.47
2004	2006	2	21.44	17.30	27.57	20.86
2003	2006	3	20.14	15.62	27.86	17.99
2002	2006	4	19.46	15.59	27.40	18.09
2001	2006	5	20.78	16.20	28.29	19.55
2000	2006	6	20.90	16.46	28.33	20.12
1999	2006	7	19.64	16.36	27.44	20.08
1998	2006	8	20.37	16.57	27.32	19.89

Can it be maintained the “average” control premium can be applied generally? Which average? Note that the premia are calculated as regards equity; there is no consideration of gearing – see below.

The Significance of Gearing

Quoted PER's of listed companies are "geared". That is, they are calculated based on earnings after allowance for interest on debt. It is inappropriate to value another business/company using the PER of a listed company as a reference point without due consideration of the gearing of the two entities. Allowance can be made by using EBIT multiples (to measure enterprise value rather than equity value) instead of PER's or by notionally re-gearing the company being valued to the public company debt level (based on market values of debt and equity, rather than the book values). The control premia commonly referred to in the literature relate to *equity*, not enterprise values (ie they relate to price earnings multiples, not EBIT multiples, and they cannot be applied without adjustment in calculating enterprise value by reference to EBIT).

Marketability discounts in the context of 100% owner interests

Again, the concept of discount begs the question: discount from what? There are obviously degrees of marketability. At the extreme the term means almost instantaneous realisability at a reasonably certain price. Small parcels of shares in most listed companies are marketable. 100% interests in listed companies are not marketable in this sense and neither are 100% interests in unlisted companies. It then becomes difficult to talk about a discount for marketability when valuing a whole SME by making a comparison with a listed company. There is no such thing as a “freely marketable” 100% interest to which comparison can be made.

In the listed company context the acquisition of control will often be accompanied by a reduction (often substantial) in the liquidity (marketability) of the investment. If marketability has value (see below) then increased control reduces that value. The “premium for control” must then comprise the sum of some positive elements reduced by this negative loss of marketability factor. If one can discover a premium paid in a truly comparable case then that will capture this element and no further adjustment is required.

In the author's experience it is rare to see a marketability discount applied in the context of the valuation of a whole SME.

Difference between “comparable company” and “capitalisation of maintainable earnings” approaches

Bear in mind that the application of comparable company multiple, adjusted as appropriate, is conceptually different from “capitalisation of maintainable earnings approach” described below. The latter derives from the discounted cash flow approach on the assumption that “profit” is a proxy for cash flow and the capitalisation rate is derived from the rate of return and expected growth. The comparable company approach simply assumes that the “relationship” between a price and another variable for company X should apply (albeit possibly with some modification) to determine the price of company Y. The concepts are not identical.

7 DISCOUNTED CASH FLOW

The most logically satisfying method of valuing any asset is by calculating the net present value of all cash flows which will be generated from the holding of the asset. By "cash flow" is meant not profit or profit plus depreciation; it is the net quantum of all cash inflows and outflows associated with the investment.

The discounted cash flow ("DCF") technique builds into the valuation analysis an allowance for the time value of money. Projected receipts and payments (or the net totals in each period) are discounted to present day values at a rate which is commensurate with the risk involved.

The formula used to calculate the present value of any asset is:

$$V = \sum_{n=1}^x \frac{C}{(1+r)^n}$$

where	V	=	the value of the asset
	x	=	the number of years that the asset will be held
	C	=	the cash flow in year n
	r	=	the discount rate

Allowance for inflation is included in the discount rate if the cash flows are nominal (i.e. dollars of the relevant year). If the cash flows are in constant (real) dollars the discount rate must be a real rate. In practice the use of nominal dollars and nominal discount rates will usually be simpler and avoid the necessity to consider adjustments in respect of tax (e.g. depreciation) and debt repayments (if these are allowed for) and the necessity to adjust the discount rate, bearing in mind that market rates of return are nominal, and build in inflation expectations. The discount rate "r" which yields $V = 0$ is the internal rate of return of the relevant project or investment.

As indicated above, the DCF method requires allowance for all cash inflows and outflow, and exclusion of non-cash items such as depreciation. The inflows must include e.g. the proceeds of assets sales, payments by debtors; the outflows must include acquisition of plant and equipment, discharge of trade creditors and so forth. The cash flow may or may not include borrowing, repayment of debt, and interest but should always be on an after-tax basis. Exclusion of debt-related items means that the analysis separates the investment and financing decisions - this is generally regarded as the preferable approach. If debt and interest are included the discount rate to be used is the opportunity cost of capital [ie the cost of equity capital] - the rate an investor would obtain by investing in investments having a comparable risk profile. If debt and interest are excluded, the discount rate is the weighted average cost of capital (see paragraph 9 below). Allowing for pre and post interest and pre and post tax there are four possibilities

Cash flows	Discount rate	Formula
After i, d and T	Cost of equity	K_e
After i, d before T	Pre tax cost of equity	$K_e / (1-t)$
Before i, d and T	Pre tax WACC	$(K_e/(1 - t)*(E/(D + E)) + (K_d * D/(D + E)))$
Before i, d, after T	Post tax WACC	$(K_e) *(E/(D + E)) + (K_d(1-t) * D/(D + E))$
<i>Where:</i>		
i = interest payments	t = rate of tax	
d = debt cash flows	T = tax payment	
E = market value of equity	K _d = cost of debt	
D = market value of debt		

The following example illustrates a valuation on basis that the cash flows are before debt and interest flows but after tax - the discount rate is the post tax weighted average cost of capital calculated as shown in Note 2.

EXAMPLE 4: DISCOUNTED CASH FLOW						
	2007	2008	2009	2010	2011	
Net profit before tax	900	1,000	1,150	1,270	1,350	
Interest	210	230	245	270	300	
EBIT	1,110	1,230	1,395	1,540	1,650	
<i>Growth rate</i>		10.8%	13.4%	10.40%	7.10%	
Depreciation		80	90	120	120	
Increase working capital		(100)	(130)	-130	-100	
Plant acquisition			(500)	-200		
Cash flow before tax		1,210	855	1,330	1,670	
Income tax	Note 1	369	419	462	495	
Cash flow after tax		841	437	868	A 1,175	
Year		1	2	3		
Capitalisation rate	Note 3				B 11.52%	
Terminal value					A/B 10,200	
Discount rate	Note2	14.52%				
Discount factor		0.873	0.762	0.666	0.666	
Discounted cash flow		734	333	578	6,792	
Value of Business	\$ 8,437					
Notes						
1	<i>Income tax</i>		2008	2009	2010	2011
	As above		1230	1395	1540	1650
	Tax at 30%		369	418.5	462	495
2	<i>Discount rate</i>					
	Cost of equity	K_e		20%		
	Cost of debt	K_d		9%		
	Tax rate	t		30%		
	Proportion of debt	$D / (D + E)$		40%		
	Proportion of equity	$E / (D + E)$		60%		
	WACC (post -tax)			14.52%		

<i>Capitalisation rate for terminal value</i>		
3		
WACC	r	14.52%
Forecast growth	g	3.00%
Cap rate	r - g	11.52%

The DCF method applied to a business requires the calculation of a “terminal value” of the business at the end of the forecast period: \$10,200 in Example 4 above. That value may be estimated by reference to the discount rate adopted in the model, as in the example, or by some other means. Receipts and payments associated with the acquisition, holding and disposal of non-business assets should be excluded - these items should be valued separately. The fundamental merit of the DCF approach is that it forces the valuer to think in terms of cash rather than profit. There is a need then to consider what working capital and investment (plant etc) requirements are necessary to sustain the business.

The DCF approach is appropriate to value a business where cash flow is expected to be non-uniform but can be predicted with reasonable confidence for some years. In the author’s experience many businesses don’t even prepare budgets for one year ahead, let alone multi-year cash flow forecasts [and this may be quite reasonable] and the DCF approach is relatively uncommon, particularly for smaller businesses. Where the cash flow is predicted to grow more or less uniformly in the foreseeable future there is little point in doing anything other than capitalising the future cash flow stream (ie because the answer will be much the same).

8 CAPITALISATION OF [FUTURE] MAINTAINABLE EARNINGS

Where cash flows are expected to grow uniformly and indefinitely at a rate “g” it may be demonstrated that the equation at the beginning of the previous paragraph reduces to:

$$V = \frac{C_1}{(r - g)}$$

where C₁ is the cash flow in year 1, r is the discount rate and g is the growth rate.

In these circumstances, then, the valuer can “capitalise” the maintainable cash flow stream from the business rather than discounting projected future cash flow in each year. If earnings/cash flows are likely to be volatile it may be impossible to predict a “maintainable earnings” figure and the valuer should adopt the DCF approach.

The formula above shows that the “capitalisation rate” is not the same as the “discount rate”. The investor requires a rate of return “r”, not “r – g”. The growth prospects should be considered separately and a realistic scenario adopted, bearing in mind particularly that high growth rates cannot be sustained forever [the capitalisation formula assumes that “g” is a constant].

Although “earnings” is not the same as “cash flow” this formula is the basis of the “maintainable earnings”, or “future maintainable earnings” (“FME”) approach to valuation, which is the most common method of valuing a trading concern. On this approach one seeks to estimate the maintainable earnings of the business (ie the profits that it may reasonably be anticipated will be generated on an ongoing basis), and capitalise those earnings at a suitable rate, that rate being determined mainly by reference to the risk of the investment as compared with alternative investments and with allowance for anticipated growth.

In seeking to establish maintainable earnings ("ME") it is usual to have regard to past years operating performance, making appropriate adjustments for items of income and expenditure unlikely to recur and items of income and expenditure which, having not occurred in the past, may be likely to occur in the future. It is appropriate also to have regard to forecast results, after appropriate analysis to establish the likelihood of their achievement, but having regard to the inherent impossibility of predicting future events with any certainty. The objective is to seek to establish what a prudent buyer would consider to be the likely profitability to be generated by the business on an ongoing basis. The period of review should be long enough to cover any cycle to which the company/industry is subject, if that is relevant to determining FME. Past results should be inflation-adjusted where comparability is otherwise questionable i.e. if a long period is considered/or in times of high inflation.

In seeking to estimate FME, it may be appropriate to weight historical results giving more emphasis to recent results. However, there is no "magic" in simply taking an average, or weighted average, of prior years results unless one can be confident that this is an appropriate basis for a prediction of future outcomes. It may be appropriate in particular cases to reject entirely recent historical results (or some of them) because of factors which will not recur.

Dealings between a private company and its shareholders/directors are often not on an arm's length basis. The earnings must be adjusted so as to reflect the results which would have been achieved if fair arm's length salaries, rent and other outgoings to related parties had been paid.

The formula above relates to cash flow not profit so that the approach will not give an accurate result if earnings are not a reasonable proxy for cash flow. It is necessary to consider at least the following factors:

- is the depreciation charge a reasonable proxy for the cost of maintenance of productive capacity at the levels implicit in the earnings figure. If it is not the method can still be used with depreciation adjusted to a "maintainable" figure, or allowance can otherwise be made in the valuation (e.g. by deducting a "one-off" adjustment for capital outlays);
- is it realistic to assume that the "earnings" can be maintained without additional working capital – if not, allowance can be made by adjusting the earnings figure, or by reducing the growth factor in the capitalisation rate.

Earnings

The valuer needs to consider whether he or she will use in the earnings calculation:

- profit after interest and tax (i.e. the ASX definition);
- profit before interest and tax ("EBIT");
- profit after interest but before tax; or
- some other measure e.g. profit before interest, depreciation and tax ("EBDIT")¹⁶.

The capitalisation rate applied must, of course, be based on what is being capitalised. It should be possible to reconcile the results of using different rates. As said above, use of an EBIT multiple/capitalisation rate applied to pre-interest earnings gives a valuation for equity *and* interest bearing debt (together). Correspondingly, the net assets used in the calculation of goodwill *exclude*

16 This method may eliminate distortions created by depreciation charges.

debt. Applying a capitalisation rate to post-interest earnings gives a value for equity only, with debt being taken up in business net assets: see **Examples 5 and 6**.

In calculating maintainable earnings, revenue streams (and related expenses) emanating from the holding of non-business assets should be excluded. In this context it is usual in the case of smaller businesses to exclude all real property from the business assets and to correspondingly allow, in the earnings calculations, a fair rental charge (with appropriate adjustments for rates and taxes). This is done because the yield to real estate is generally much less than the anticipated return to an investment in a business (because of the different risk). This type of adjustment assumes that the relevant property is suitable for alternative uses/businesses.

Examples of the application of the capitalisation method

The following example shows a valuation by reference to capitalised EBIT. The return is to equity and debt and therefore the value of debt must be deducted from the result to calculate the value of equity in the business enterprise. To that value must be added the worth of any surplus assets to calculate the value of the entity. An adjustment must also be made for the difference between the debt level assumed in the valuation calculation relating to the enterprise [see Note 3 below] and the actual debt of the entity.

EXAMPLE 5: VALUATION BY REFERENCE TO MAINTAINABLE EBIT					
	2003	2004	2005	2006	2007
Net profit before tax	700	803	772	842	860
<i>Adjustments:</i>					
Actual salaries	180	180	200	200	200
Fair salaries	(130)	(135)	(140)	(145)	150
Dividends excluded	(10)	(10)	(12)	(15)	(5)
Trust distribution excluded	(100)	(50)	(40)	(50)	(20)
Rent paid	80	80	80	80	80
Fair rent	(55)	(58)	(60)	(62)	(65)
<i>Total adjustments</i>	<u>(35)</u>	<u>7</u>	<u>28</u>	<u>8</u>	<u>40</u>
Business profit adjusted	665	810	800	850	900
Interest	180	200	190	180	210
EBIT adjusted	<u>845</u>	<u>1,010</u>	<u>990</u>	<u>1,030</u>	<u>1,110</u>
Growth		20%	-2%	4%	8%
Maintainable EBIT say				1100	1100
Capitalisation rate		Note 1		17.70%	13.01%
Value of Business (Enterprise)				\$6,215	\$8,455
Less value of debt		Note 3		1,864	2,537
Value of equity				\$4,350	\$5,919

The following example shows a valuation by reference to capitalised earnings. The return is to equity, therefore, the result is the value of equity in the business enterprise. To that value must be added the worth of any surplus assets to calculate the value of the entity. Again, an adjustment must also be made for the difference between the debt level assumed in the valuation calculation relating to the enterprise [see Note 3 below] and the actual debt of the entity.

EXAMPLE 6: VALUATION BY REF TO EARNINGS (PROFIT AFTER INTEREST & TAX)		
Maintainable EBIT say	1100	1100

Interest	<i>Note 3</i>	167.8	228.3
Net profit		932.2	871.7
Tax at	<i>30%</i>	279.7	261.5
Maintainable earnings		652.5	610.2
Capitalisation rate	<i>Note 2</i>	15.0%	10.3%
Value of equity		\$4,350	\$ 5,919

The following notes explain some of the calculations in these two examples:

Notes			
1	<i>Capitalisation rate - EBIT</i>		
	Cost of equity (post co tax)(no growth)	20%	20%
	Forecast growth	g	5% 9.7%
	Cost of equity with growth	Ke	15.0% 10.3%
	Cost of debt	Kd	9% 9%
	Tax rate	t	30% 30%
	Proportion of debt	D / D+ E	30% 30%
	Proportion of equity	E / (D + E)	70% 70%
	WACC pre tax: $(K_e/(1 - t)*(E/(D + E)) + (K_d * D/(D + E))$	17.70%	13.01%
	EBIT Multiple	5.6	7.7
	<i>Capitalisation rate - earnings</i>		
2	<i>Capitalisation rate - earnings</i>		
	Cost of equity (post co tax)	Ke	15.0% 10.3%
	Price earnings ratio	6.7	9.7
3	<i>Calculation of debt level</i>		
	Value of Business as above	\$6,215	\$ 8,455
	Proportion of debt	30%	30%
	Target debt	1,864.4	2,536.5
	Cost of debt	9.0%	9.0%
	Interest	167.8	228.3

Interest

The treatment of interest expense is a most important issue in business valuations. Consider:

Example 7 The businesses of Earth Pty Ltd, Wind Pty Ltd and Fire Pty Ltd are identical in every way except as to their level of debt. The following are some key figures for the last financial year:

	Earth	Wind	Fire
	\$'000	\$'000	\$'000
Stock	100	100	100
Debtors	100	100	100
Plant	100	100	100
Creditors	(100)	(100)	(100)
	<u>300</u>	<u>300</u>	<u>300</u>
Debt	-	100	200
Net assets	<u>300</u>	<u>200</u>	<u>100</u>
EBIT	120	120	120
Interest	-	10	20
Profit before tax	120	110	100
Tax	36	33	30
Profit after tax	<u>84</u>	<u>77</u>	<u>70</u>

Let us suppose that a valuer values Earth using an earnings multiple (i.e. a price earnings ratio applied to post-tax earnings) of 5 giving a value for the business of \$420 and implying an intangible value of \$120 [\$420 - \$300]. What is the value of the other businesses? Should it be possible to reconcile the values of the three businesses? It will hopefully be obvious that the multiple applicable to value Wind and Fire C based on earnings cannot be five. Let us use that multiple and see what happens.

	Earth \$'000	Wind \$'000	Fire \$'000
Earnings after tax	84	77	70
Multiple	5	5	5
Value of equity	420	385	350
Net tangible business assets	300	200	100
Implied value of intangibles	120	185	250
Value of equity	420	385	350
Value of debt	-	100	200
Enterprise value	420	485	550

On the face of it, the use of debt increases the value of the business [that is, the value of the business assets, or, more correctly, net assets before interest bearing debt] by 31% [(550 – 420)/420], and more than doubles the value of intangibles [from \$120 to \$250]. If all three businesses were priced based on the multiple of five, an astute investor would buy Business A for \$420, cause it to borrow \$200, put that money into his pocket and sell the business (with debt) for \$350, making a tidy profit of \$130. Intuitively, this can't be right. The multiple for Businesses B and C should be lower than that for A because B and C carry more risk. As well as *operating risk*, they carry *financial risk*, which A does not have. Bear in mind that the risk we are talking about is the risk which is borne by the *shareholders* – we are using a price earnings multiple which is a capitalisation rate for equity.

One way of dealing with this problem is to isolate the financial risk by focussing on the total return to both equity holders *and debt holders*, that is, profit before interest and tax, known as EBIT (earnings before interest and tax). Rather than using a price earnings ratio ("PE ratio" or simply "PER") as our multiple, we use an EBIT multiple. Because we are then considering the return to debt and equity, the valuation obtained using an EBIT multiple is the value of the business net asset *before* debt. The market value of debt (not necessarily equal to its face value) must be deducted in order to calculate the value of equity. Consider the following new calculations:

	Earth \$'000	Wind \$'000	Fire \$'000
EBIT	120	120	120
Multiple	3.5	3.5	3.5
Value of business	420	420	420
Net tangible assets	300	300	300
Implied value of intangibles	120	120	120
Value of business (enterprise value)	420	420	420
Less debt	-	100	200
Value of equity	420	320	220

Again intuitively, one might feel comforted that the value of the assets of each of the businesses now appears to be the same. After all, we have no information about profit or assets to make us think that the overall value (before debt) should be different. The differences in the *net* worth of the businesses logically come about because of the different debt levels, and that is reflected in the last row of numbers shown. Have we solved the problem? Well, not quite. For one thing finance theory tells us that an increase in the level of debt *can* in fact increase the value of the business, and the value of equity. However, for present purposes the important matter to note is that different debt levels *do*

make a difference. It is not appropriate to simply say “well, the appropriate price earnings multiple for a sprocket manufacturing business is 5”. If nothing else, at least it should be appreciated that, all other things being equal, as debt increases the price earnings multiple must fall (the capitalisation rate must increase). Simplistically, going back to our first calculations, in order to obtain the same value of business assets (before debt) and the implied value of intangibles in each case the multiples would need to vary as follows:

	Earth	Wind	Fire
	\$'000	\$'000	\$'000
Earnings after tax	84	77	70
Multiple	5	4.57	3.14
Value of equity	420	320	220
Value of debt	-	100	200
Value of business (enterprise value)	420	420	420
Net tangible business assets	300	300	300
Implied value of intangibles	120	120	120

Essentially, there are three possible approaches to dealing with this sort of issue:

- add back interest and value using an EBIT multiple: see Example 5 above;
- adjust the gearing of the company being valued to a “reasonable” level, assessed by reference to other companies in the industry and adjust interest accordingly, treating the difference between actual and notional gearing as “surplus”; or
- leave interest alone and adjust the discount rate accordingly.

In the last two cases, the valuation will be by reference to earnings (profit after interest) and the valuation will be of equity.

To make the point again, the capitalisation rate applied to earnings, will not remain the same with different levels of gearing (debt). As debt increases the cost of equity (and, eventually, the cost of debt itself) will rise. A valuer must form a view of the cost of equity in light of the debt level assumed.

9 SELECTING THE DISCOUNT OR CAPITALISATION RATE

The “comparable company” approach outlined at paragraph 6 can be seen as one method for obtaining a capitalisation rate or multiple (one being the inverse of the other). If that approach cannot be adopted the valuer is left with the alternative of developing a rate on an “investment approach” based on returns available in the market, having regard to the relative degree of risk involved in the proposed acquisition.

The valuer should be concerned first with the risk of the *business* not the shares in the company which owns the business. The separation of the business risk from the finance risk enables a clearer understanding of what it is that is likely to create volatility in earnings and cash flows – it is this volatility which is the major concern of the investor.

As discussed above, a business may be financed by 100% equity or part debt and part equity. While it is common to speak of the “**cost of debt**” and the “**cost of equity**” for a particular type of business, these two are interdependent. The debt holders and equity holders share between them the risk of the business. That is, the business risk determines the WACC and not the other way round.

Example: If the business is all equity financed, the equity holder has the whole of the assets as security. Let us assume the equity holder wants a rate of return of 15%. If a debt holder is introduced (assume the equity holder is partly repaid by borrowed funds) that financier is allocated a first claim against assets for payment of both income (interest) and the funds advanced. [Bear in mind that risk attaches to capital, not just to the income.] The debt holder will thus normally be willing to accept a lower rate of return, say 10%. The equity holder will now be commercially unwise to continue to be satisfied with a 15% return on its funds, because its risk is now substantially increased.

Is WACC constant?

If what is said above about the sharing of business risk is correct, one might think that the weighted average cost of capital ("**WACC**": ie the cost of debt times the proportion of debt, plus the cost of equity times the proportion of equity, with both debt and equity based on market, not book, values) will remain the same at different debt/equity levels. Consider:

Equity %	Debt %	Ke *	Kd (post-tax)	WACC
100%	0%	20%		20%
90%	10%	22%	5%	20%
80%	20%	24%	6%	20%
70%	30%	26%	6%	20%
60%	40%	29%	7%	20%
50%	50%	32%	8%	20%
40%	60%	37%	9%	20%
30%	70%	39%	12%	20%
20%	80%	44%	14%	20%
10%	90%	47%	17%	20%
0%	100%		20%	20%

That seems to make sense because WACC measures the business risk. Practically, the debt financier will not lend beyond a certain proportion (if it has a choice) regardless of the level of return and will lend up to a certain point with the same rate. Equity holders also may be indifferent to debt levels within certain bands and debt is seen as attractive to some because of the tax shield afforded. There is thus an optimum level of debt which will minimise the WACC. The search for that optimum is usually the least of the valuer's concern and is nowhere near as significant as accurately assessing earnings/cash flow potential and an approximately correct cost of equity.

In any event, if we can relatively easily measure the cost of debt (which must be based on a reasonable level of gearing and assuming no third party guarantees of securities) the critical issue is the estimation of the cost of equity.

Cost of equity: The Capital Asset Pricing Model

There is no way to scientifically or mathematically measure the risk attaching to a particular business. The major development in this area, occurring in the mid 1960's, is what is known as "Modern Portfolio Theory" ("**MPT**") and the Capital Asset Pricing Model ("**CAPM**"). While it may be argued that this theory is of limited relevance to the valuation of SME's its tenets are of some assistance in understanding what creates risk and a modified form of the capital asset pricing model can be a useful method of estimating the cost of equity.

In very broad terms the fundamental concepts involved in the CAPM may be summarised in the following propositions¹⁷:

- assets (including shares and businesses) should not be valued in isolation, but in the context of a portfolio of investments;
- by holding a large enough portfolio of assets the investor can diversify a large component of the individual ("unique") risk attaching to each asset;
- because of the possibility of such diversification, whether or not individual market participants *do* diversify, individual assets are priced by the market without regard to unique risk;
- the return to an investor on a risky asset moves in line with the component of the asset's risk that can be diversified away, called the "systematic" risk in accordance with the following formula:

$$k = R_f + \beta (R_m - R_f)$$

where

R_f = the risk-free rate of interest [normally the long-term bond rate is used when valuing a business to be acquired for an indefinite period]

R_m = the expected return [both income and realisation gain] on the market portfolio

k = the capitalisation rate for any risky asset (including a business or share)

β = [beta] the sensitivity of the asset's returns to the market's returns, i.e. a measure of the asset's systematic risk.

The expected risk premium of any particular asset will vary directly proportionately with the asset's beta. Beta measures the sensitivity of the asset's return to the market's return - that "sensitivity" reflects the marginal contribution of the asset to the risk of the market portfolio. The market portfolio has a beta of 1 and a risk premium of $(R_m - R_f)$. For example, if a particular asset's return moves half as much as the return on the market moves then its beta is 0.5.

Although it is an issue of considerable controversy (largely irrelevant in the context of private company valuations) it appears to be that the preferred view is that the long term average market risk premium $(R_m - R_f)$ in Australia is now around 6%, so that, if a stock's beta is say, 0.9, and the 10 year bond rate, say 6%, is used as a proxy for R_f , the expected rate of return will be 11.4% (ie $6\% + (0.9 * 6\%)$).

The CAPM is commonly used in Australia to estimate the cost of equity in connection with valuation of listed companies, divisions or subsidiaries of those companies, or potential acquisition targets of those companies. It is also often used in the valuation of large private companies. It would seem, however, that many valuers of (particularly smaller) SME's (at least outside the United States) have no regard to the CAPM. There are several possible reasons for this including:

- one or more of the key assumptions of the model are invalid;
- whether or not the model is useful in the public company arena, it cannot be applied in relation to private companies (because investors in private companies do not diversify

17 See generally e.g. Haugen, "Modern Investment Theory", Chapter 7; Brearley R.A. & Myers S.C. "Principles of Corporate Finance", Chapter 8

their investments, because the market data used to calculate beta does not contain private company information, or for some other reason);

- there is little useful data on what might be an appropriate beta;
- the theory is difficult to understand and apply;
- many valuers of SME's have never heard of it; or
- valuers believe that there are one or more better approaches.

Assuming that the model has fundamental validity it is possible to modify it to make allowance for its deficiencies. One approach is to consider adjustments for two factors which are clearly significant:

- size: there appears to be strong support for the view that the CAPM gives particularly poor predictions of returns for smaller companies. It is argued that a “size premium” may be added to the result of the basic CAPM formula to compensate for this factor. The amount of the premium would depend upon the size of the company being valued as compared to the size of listed companies generally. So, for example (illustration only) it may be appropriate to add a size premium of 5% for a smaller listed company; if the private company being valued is smaller again, the premium should be higher. [There are many private companies that are larger than listed public companies in the same industry.];
- unique risk - one major difficulty with the application of the CAPM is that many (if not most) investors in closely-held companies do not generally diversify their investments. Arguably, then, it is necessary to take account of the unique risk of the investment in the capitalisation rate. It is possible to do this by adding to the CAPM formula a further term to allow for specific risks relating to the business which are not already captured in the formula. These risks might relate to, for example, the fact of being unlisted (if it is not already allowed for in the size premium), dependence on key personnel, suppliers or customers, or poorly developed systems.

One may then end up with a modified CAPM in the form:

$$K_e = R_f + \beta (R_m - R_f) + \delta_1 + \delta_2$$

Where:

δ_1 = size premium

δ_2 = specific risk factor

The issue then arises as to how to find a suitable beta. Information on betas of listed companies is produced by the Australian Graduate School of Management and others on a regular basis. Unfortunately the information is not inexpensive. Perhaps more unfortunately the number of listed companies in Australia is so small that it is difficult to find “comparables” at all. Even if one finds comparables the beta for the comparables selected may be vastly different, even if allowance is made for different gearing levels. One approach is to take industry betas but these also are geared and it is necessary to notionally adjust the valued company’s gearing to the industry norm – it may be difficult to ascertain what is the industry norm. Some writers have suggested developing a beta “from scratch” on the basis that, for example, companies that are highly cyclical and/or have high operating leverage (high fixed cost) tend to have higher betas. That may be of assistance, but the problem is to estimate a benchmark – higher compared to what?

Cost of Equity: “Build up” approach

If the CAPM is not used the valuer might estimate either a cost of equity [or more often, simply a capitalisation rate for earnings] using “professional judgment” or based on experience. An alternative approach is to “build up” a discount rate having regard to, much the same factors we have talked

about in this section. So, for example, one may add to the risk free rate a market premium, a premium for size and a premium for specific risks relating to the business being valued. Obviously, there remains considerable judgment involved. However, the rate so developed at least requires consideration of specific risk factors, rather than an *in globo* estimation.

Capitalisation rate

As is evident for the equation in the first paragraph of the previous section, the difference between the discount rate and the capitalisation is growth. Once one determines the discount rate it is necessary to deduct “g”. If the discount rate estimated is nominal [virtually all quoted market rates are nominal] the growth rate deducted must also be nominal ie it will include inflation. If the discount rate is real it should only be reduced for growth if real growth is expected.

10 ASSET BASED APPROACHES

Two asset-based approaches to calculating value can be considered:

- going concern basis - the values of assets and liabilities are restated to going concern (or “fair”) values; and
- liquidation basis - the net asset values are calculated taking account of realisable asset values (normally on the basis of an orderly realisation), tax arising on disposal of assets, and liquidation costs¹⁸.

The going concern basis would normally be appropriate where the company is an investment company – each asset [eg real estate, shares] is then valued at its market value. Some or all of the individual assets (eg shares in subsidiaries) may be valued using an earnings or DCF approach.

The “going concern” asset basis is sometimes thought to be applicable where the business is not producing profits which are commensurate with the investment in assets, where it is uncertain whether or not it will do so in the foreseeable future, but where it is anticipated that the potential acquirer will continue the business. In such cases it is often done to add some amount to the value of tangible assets for goodwill/ intangibles associated with the existing business infrastructure, although this figure will normally not be substantial. Such an approach may often be justified on the basis that, if it can be predicated one or more buyers exist, they would be better off buying an existing operation (albeit performing poorly) than starting from scratch.

We have said above that the value of a business, or of any asset, is the net present value of the cash flow which will accrue to whoever is likely to want to buy or hold it. If the net present value of the cash flow from operating the business is \$X then that is its value as a going concern. If the *realisable* value of the net assets is \$Y and \$Y is greater than \$X then the value of the “business” is \$Y not \$X. In this case there is really no “business” because what is being sold or realised is the tangible assets individually (or perhaps together but not as part of an existing business). However, what we are now talking about is the realisable value of assets, not the book value and the assumption must be that the business will cease so that the realisable values may be significantly less than book values.

The liquidation basis is the minimum value that can be attributed to a business although, if a sale is contemplated (rather than realisation by the owner), allowance might be made for some discount by

18 The difference between the value of the business on an earnings basis and a liquidation value is one aspect of the risk assumed by the purchaser.

way of a profit factor to the buyer who otherwise would not bother acquiring the business merely to wind it up for no gain. The liquidation value will be lower if one adopts a “fire sale”, quick realisation, approach.

It is important to bear in mind that a business may be worth more than the realisable value (rather than the book value) of its net assets, notwithstanding that there are no current profits (or that current profits are below a “reasonable return” on tangible assets). Notwithstanding the qualifications expressed by the High Court in *Murry*¹⁹ it would appear that the following comments of McHugh J in *Hepples* case²⁰ remain apposite:

"Although goodwill is commonly valued by capitalising expected future net profits and by estimating the worth of purchasing several years of the past profits of the business, it may exist even though the business has not made any profits and is unlikely to do so for some time. In the case of a new business, money expended on research, advertising and distribution networks, for example, it may create sources of goodwill which will ultimately generate future profits even though the business has not made any profit."

Again one must look at the prospective cash flows, not just the past or current position. Many businesses incur losses in the early stages as products, customer bases, systems, staff and infrastructure are developed. Some of these businesses fail; some are spectacularly successful and most fall somewhere in between. It is always dangerous to assume automatically that loss making businesses are only worth their liquidation values. See also the discussion on rules of thumb above.

11 WHAT ASSETS AND LIABILITIES ARE INCLUDED IN THE BUSINESS VALUATION?

The “value of a business” generally means the value of the legal right of ownership of the tangible and intangible assets associated with a business and the right to operate the business and to take the returns flowing from the business. The valuation may include all, some, or none of the liabilities associated with the business.

The value of a business must not be confused with the value of the equities in the entity which operates that business. The value of these equities in total may be the same as the value of the business if the entity holds nothing other than the business itself. However the value of particularly minority interests in an entity which conducts a business will normally not be a pro-rata share of the value of the business.

One of the first steps in valuing an entity is to distinguish its component parts. Consider the following representation of a company operating two distinct businesses and holding certain other assets.

19 *Commr of Taxation v Murry* [1998] HCA 42. In that case the majority found that the amount received on the disposal of a licence to operate a taxi was not received for the disposal of the goodwill of a business within the meaning of sec. 160ZZR of the Income Tax Assessment Act, 1936.

20 *Hepples v FC of T* (1992) 173 CRL 492, at 542.

Business 1		Business 2		Other (“surplus”) Assets	
Plant		Plant		Cash	
Debtors		Debtors		Shares	
Stock		Stock		Land	
Intangibles		Intangibles			
Creditors		Creditors			
BUSINESS ENTERPRISE					
Debt			Equity		
First Security	Second Security	Controlling Interest	Minority Interests		

In this type of case the valuer will normally be called upon to value either the whole of the company or one or more of the share interests in the company. The value of the company is obviously dependent upon the value of the components which make up the company, including the two businesses. Unless the businesses are interdependent (in which case there may really only be one business) the value of each business should be assessed separately. In any event, the value of the businesses must be assessed separately from the value of the “non-business” assets.

A business balance sheet is often seen in the form of “assets less liabilities equals owner’s equity”. Another way of looking at it is:

$$\text{Assets* less trade creditors **} = \text{Debt} + \text{Equity}$$

[* Normally debtors, stock, plant and intangibles.]

[** Including accruals.]

The left hand side of the equation could be looked at slightly differently as the sum of “fixed assets” plus “circulating capital” or “working capital”. In any event, the equation highlights that a business is funded by debt holders and equity holders, both of whom demand a return on their funds invested.

Ignoring for the moment the difference between profit and cash flow the return available to meet both sets of stake holders is **EBIT** – earnings before interest and tax. Once interest is deducted to meet debt holders’ returns, the amount available is the return to equity holders [both flows can be considered before or after tax].

It follows that, as we have already said, discounting or capitalising EBIT yields a value for those items on the left hand side of the equation. This is sometimes described as the “**enterprise value**” or “business value”. It is the sum of the values of the debt and equity. One must then deduct the value of debt to calculate the value of equity. The discounting or capitalising of profit after interest yields the value of equity.

Surplus Assets

Surplus assets are those which can be realised without affecting the business earnings or cash flow. [Of course, one needs to consider what constitutes “the business” being valued in order to make a decision on what is “surplus”.] The usual categories of non-business or “surplus” assets are non-business related investments, real property, cash excess to business needs and loans (often to related parties). These items should be valued separately and any income streams (and expenses) attributable thereto (dividends, rent and interest) correspondingly excluded from the earnings used in the cash flow (see paragraph 7) or maintainable earnings (see paragraph 8) computations of business value.

There may be surplus assets “hidden” among what are commonly included in “net business assets”. For example, stocks or trade debtors may be unusually high at the valuation date, trade creditors may be below their usual levels. There may exist plant which could be sold off without affecting the income earning capacity of the business. On the other hand, stock and plant may be at unsustainably low levels or plant may need replacing so that there is a “negative adjustment” required to allow for additional capital required. The valuer is forced to consider these issues explicitly if a discounted cash flow type valuation approach is adopted. However, they need to be considered also if the valuation is by reference to maintainable earnings. A useful test is to consider the balance sheet at some date or dates prior to the valuation date and check whether there appear to be major anomalies in movements in the levels of various components of the business balance sheet. Consider the following example:

Example 7: Impact of movements in working capital

Accurate Valuers have been asked to undertake a valuation of Jack Horner’s Pies at 30 June 2007. Subsequently, they are asked to repeat the assignment at the end of each of the following two years. The profit remains constant and the net asset position remains the same as set out below:

Profit & loss		2007	2008	2009
Sales		1000	1000	1000
Opening stock		200	200	300
Purchases		600	700	350
Closing stock		(200)	(300)	(50)
Cost of goods sold		600	600	600
Gross profit		400	400	400
Gross profit %		40%	40%	40%
Operating expenses		100	100	100
EBIT		300	300	300
Interest		19.0	31.8	20.5
Net profit before tax		281	268.25	279.5
Income tax expense	30%	84	80	84
		197	188	196
Dividend		(197)	(188)	(196)
		0	0	0
Balance sheet				
Stock		200	300	50
Debtors		200	400	100
Creditors		(100)	(50)	(150)
"Working capital"	A	300	650	0
Bank overdraft		150	250	0
Net current assets	B	150	400	0
Plant & equipment	C	200	200	200
Long term debt / cash		(100)	(350)	50
Net assets	D	250	250	250
Issued capital		50	50	50
Retained earnings		200	200	200
		250	250	250
Net tangible business assets		500	850	200
Net tangible business assets (with o/d)		350	600	200
No of days stock		122	183	30
No of days debtors		73	146	37
No of days creditors		61	26	156

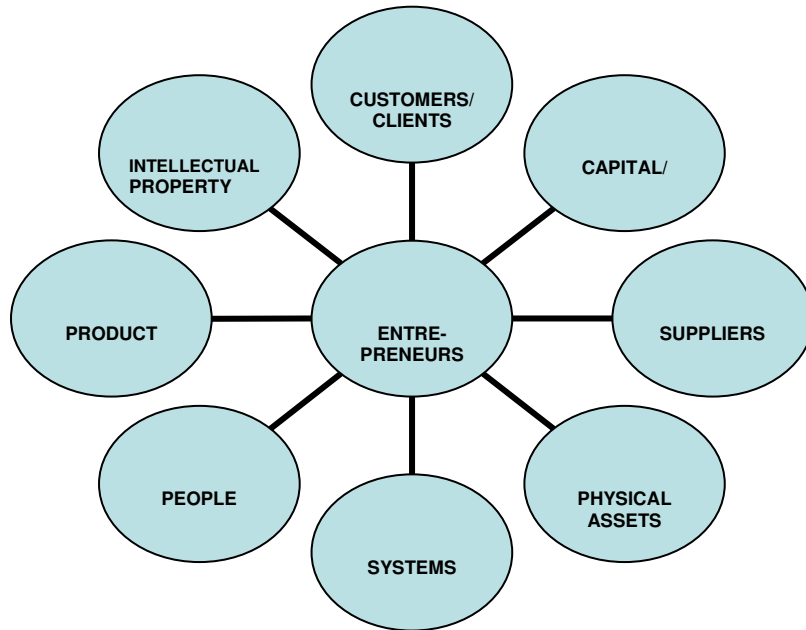
V V apply three bases to arrive at the following results:

Basis 1: Valuations based on capitalisation of maintainable earnings			
Earnings	197	188	196
Price earnings ratio	4.0	4.0	4.0
Value of equity	787	751	783
Net tangible business assets	250	250	250
Implied value of intangibles	537	501	533
Basis 2: Valuation based on capitalisation of maintainable EBIT			
EBIT	300	300	300
EBIT multiple	3.5	3.5	3.5
Enterprise value	1037	1037	1037
Debt	250	600	(50)
Value of equity	787	437	1087
Net tangible business assets	500	850	200
Implied value of intangibles	537	187	837
Basis 3: Valuation based on modified EBIT			
EBIT	300	300	300
Interest on overdraft	(12)	(16)	(10)
Amended EBIT	288	284	290
	3.1	3.1	3.1
Enterprise value	887	875	893
Debt	100	350	(50)
Value of equity Basis 3	787	525	943
Net tangible business assets	350	600	200
Implied value of intangibles	537	275	693
Interest			
Average overdraft (incl cash)	150	200	125
Overdraft interest@	8%	12.0	16.0
Average long term debt	100.0	225.0	150.0
Long term debt interest	7%	7.0	15.8
	19.0	31.8	20.5

This type of issue obviously has a significant impact where capitalisation of EBIT is used as a basis of valuation. The valuer should consider whether there are material temporary “distortions” in working capital which may give an unrealistic indication of the value of the business. As indicated above, similar issues arise with regard to fixed capital / capital expenditure.

12 SME'S: WHAT IS THERE TO SELL?

Consideration needs to be given to what it is that is capable of sale. The key elements of a business are illustrated in the following diagram. A significant feature of many businesses is the personal attributes of one or more key players, giving rise to so-called “personal goodwill”, upon which the success of the business depends, in part or, in some cases, almost entirely. The valuer needs to consider if the keys to success are transferable or replaceable and if there is fact anything saleable.



13 CONCLUDING COMMENTS

Opinions about businesses can, and often do, vary, often because of different, but reasonably held views about the earnings, prospects or multiples. However, there are instances where the methodology applied is clearly incorrect (for example, a liquidation value is applied to value a business which clearly has prospects of continuing as a successful going concern) or where the methodology is applied incorrectly (for example, the valuer treats the capitalised EBIT as the value of equity). Clearly, to the extent that valuation is a “science”, the valuer must apply that science correctly.

A valuer must strive to take an independent, balanced and well informed (within the scope of the assignment) view. Having understood the purpose of the valuation he or she must apply sound logic and what he or she believes to be the most appropriate methodology to undertake the valuation. Understanding the business being valued is obviously vitally important.

It is wise to maintain a healthy scepticism when performing a valuation. While theoretical constructs are useful and, indeed, essential to ensure the avoidance of logical flaws, it is important to re-evaluate any conclusion in the light of simple common sense. The commonly asked question is “would *you* pay this price (your valuation) for this business?” or “would you advise your client to pay this price?” (assuming you are not in fact doing so.) Additionally, the valuer should consider what it would cost to “duplicate” the business “from scratch” (if that is feasible).

Disclaimer: This paper is in the nature of general comment only. No reliance should be placed upon any particular statement as the basis of making or refraining from making, any decision or applying any particular concept or methodology, The author accepts no liability to any party in respect of the contents hereof.