EXIT VALUE ADVISERS

High Valuation Checklist: Financial Performance

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INTRODUCTION

Most people have some concept of the value of their business, and some may be extremely confident that the "market will pay me $X" – where $X is a very large number in the hundreds of thousands or millions.

But the real questions for most business owners are:

- **DO you understand what creates this value?**
- **What features do others consider indicative of a highly valuable business?**

Usually a business owner monitors and reports on a small number of financial metrics to understand how the business is performing:

- Net profit margin.
- Available Working Capital.
- Net Assets (sometimes).

The business value metric is the ONLY financial measure that can combine profitability, investment and risk in a single measure.

But these metrics do not communicate clearly both the cash generation and the balance sheet – which is where a business valuation is useful.

The business valuation process not only takes all these factors into account, but also seeks to identify the key features that make the business attractive – and valuable.

SO WHAT MAKES A BUSINESS HIGHLY VALUABLE?

Over many years and hundreds of valuations, we have found some key features that appear to be common to highly valuable businesses. Typically these businesses have price premiums of between 50% - 200% of market value.

Highly valuable businesses are not common – otherwise everyone would be doing it and a highly valuable business would simply be the market expectation. However there is no reason why more business owners cannot implement strategies that help them create a more valuable business.

It is not a "hard and fast" list, but the Top 5 most common features that we see in highly valuable businesses are:

- **Consistent financial results.**
- Size and scale.
- Lack of reliance on key individuals.
- Effective and innovative use of technology.
- Visible, transparent and empowered management reporting

We have developed a series of checklists for these common features to give business owners an idea of what we look for in a highly valuable business, and help in developing strategies to become more valuable.

WHY ARE CONSISTENT FINANCIAL RESULTS SO IMPORTANT?

Would you pay a high price for the hope that a financial benefit will accrue someday, even though there is no history of it happening to date? Probably not!

The goal of investing in a business and taking a risk is to increase the owner's wealth. Consistent financial results give the buyer the assurance that an increase in wealth is going to happen. It shows that there is a path to a financial return, that the business is in good health and that there is a return that is likely to happen.

In most cases the buyer wants to see steady growth in revenue, healthy profits, a low risk balance sheet and an increasing level of equity. These features become the bedrock for confidence in the future of the business and reduce the fear in the buyer that something will go wrong.

CONSISTENT FINANCIAL RESULTS

#	Valuation Metric	Key Targets
1	**EBITDA (Post Market Level Owners Salaries)** • A commercial profitability exists as EBITDA margin ○ Industry dependant and should be compared to industry or competitor average • Return on assets • Increasing EBITDA result over past 2-3 years	• 10% – 25% • > 25%
2	**Revenue** • Increasing revenue as % of prev. year over past 3+ years • % increase greater than industry average ○ Evidence of a cycle can substantiate revenue reductions • Revenue dispersed across customer / client base • Agreements or contracts in place that provides some certainty on revenue for the next 1-2 years. • Demonstrated systems of communication and outreach to customers and clients.	• 15% - 20% pa • Prefer < 60% revenue in top customers)
3	**Costs** • If applicable – Gross Profit Margin is steady or increasing over past 3 years ○ GPM at or above industry or competitor average • Top 3 cost items steady or decreasing as % of total costs • Consistently trading above break-even point	• Consistently above 20%
4	**Balance Sheet** • Enterprise value recorded on balance sheet steady, positive or increasing • Net assets stable, positive or increasing • Non-cash working capital consistent and stable or decreasing • Less than 1 year of outstanding ATO debt • Surplus assets and non-operational liabilities clearly identified on balance sheet	
5	**The Future Model** • An expectation that current future cash flow will continue at current levels or increase over next 2-3 years. • Clear action plans in place to drive revenue growth and/or reduce costs. • Future capital investment is within financial capabilities of business.	

Once again, this is not a “hard and fast” list, nor is it compulsory that ALL highly valuable businesses have ALL these features. What we are saying is that these features appear as the most common in highly valuable businesses.

We have provided some additional comments on this checklist in the next section, based on our experience and expertise.

INSIGHTS ON HIGHLY VALUABLE BUSINESS

- The average EBITDA margin over all non-primary industries (excluding Agricultural and Mining industries) as at 30 June 2014 was just 10.9% (ABS Cat No. 8155 - 2014).
    - In our experience EBITDA (post owners salaries) margin is often less than 10% - which doesn't always leave much as a return on the investment.
    - This can be very industry dependent: most service providers will have EBITDA margins in excess of 20%, whilst almost all transport industry businesses have an EBITDA margin of less than 10%.

- In 80% - 90% of circumstances, business owners do not record owner's salaries as a cost item of the business. In most cases owner's salary is taken as dividends (for a private company) or distribution of surplus funds (for a business operating through a trust structure).
    - Our valuations take into account the operational and management roles of the owners and expect a market-level remuneration for the roles performed.

- The return on equity investment of most companies is also low with an average return on shareholder funds (ROSF) of just 6.3% in the top 2000 companies as at 30 June 2014 (IBISWorld July 2014).
    - The top 100 companies have a ROSF of between 30 – 80%.

- Only 1 in 20 businesses reach $2m or more in revenue. In an era where the economy has shown growth less than inflation, it is not uncommon to see stagnant revenue growth. This is not of itself bad but the question is what are your competitors doing?

- Revenue (or a major fraction of revenue) spread over a small client base does present some revenue risk – it is not ideal. However the nature of the client base, the longevity and risk of the client base and ability (and inclination) for the customer base to go elsewhere must also be considered.
    - A recent wholesaler had 80% of their revenue with one overseas customer. This presented a lot of risk to the future financial performance, even though it contributed to revenue growth of 30% pa for the past 3 years. Whilst agreements where in place, there was ability for the customer to pursue other supply options.
    - Another SME with revenue in excess of $20m provided services to approx. five clients. One client (40% of revenue) had a supply contract in place for the next five years, relating to infrastructure development. The business owner had systems in place to secure additional clients and contracts. Whilst there is revenue risk, we assessed this risk as low and the nature of the revenue growth a strong indicator of a valuable business.
    - It is the nature of the revenue base and how it is managed and developed that influences the level of revenue risk.

- Customer or client agreements or contracts do provide some security against erosion of revenue and are more attractive than without these in place. However, more often they are only of significant benefit if there are customer management and communication processes evident that support an ongoing relationship. In most SME cases, agreements or contracts can be voided or discontinued. What is more important is how the SME is managing the relationship to ensure ongoing business.

- An increasing cost base is always considered a risk, so when it can be shown that costs have remained at constant levels, or in line with revenue increases, then this is indicative of effective cost management and an attractive feature of a valuable business.
    - We consider that a combination of revenue growth and effective cost control almost always will lead to above average profitability and investment returns.

- In many cases the SME balance sheet has been structured to be tax-effective for the owners – so a "clean balance sheet" is indicative of a business that is operating efficiently. We like look at the enterprise value recorded on the balance sheet and whether this is steady or increasing.
    - Often a profitable business can have negative net assets and we find there is considerable balance sheet risk that detracts from the value. This typically shows up in an increasing working capital requirement.

VALUATION THEORY

VALUATION PROCESS

Valuing a business is the statement of an opinion using substantiated evidence, analysis, transparent reasoning and consistent best-practice methodology. In many cases the valuation process is iterative, in that we first arrive at an estimate of value and then ask "is this a reasonable indication of value that others would be prepared to pay given the same information?"

The key steps in any valuation process are:

- Determine the ongoing commercial returns expected of the business giving consideration to factors such as past performance, industry trends, proposed business strategies, one-off events or considerations.

- Should suitable commercial return be determined as appropriate then an earnings or income basis should be used for the valuation, otherwise other methods should be considered such as Asset or Cost Basis methods.

- Identify and exclude surplus or non-operating assets where appropriate.

- For an earnings based method, the valuer should consider:
  - Expected cash flow over a suitable future time frame (2-3 years or longer if using a DCF method). Where appropriate a number of cash flow scenarios should be considered.
  - Determine the cost of capital or earnings multiple range given
  - Identify sensitivity of valuation to key variables.

- Determine net debt (commercial debt less cash) to convert enterprise value to equity value (if required).

- Take into account any minority shareholder issues or any limitations in governance relating to the equity value (if required).

The valuation methodology typically adopted will comply with:

- AASB 225 Code of Practice for Valuations (Australian Accounting Standards Board)
- IVSC Requirements (International Valuation Standards Council).
- Evidentiary standards for Federal Courts as an Expert Witness report.
- Industry best practice standards and codes of practice.

VALUATION METHODS

There are a number of approaches that are generally accepted for valuing businesses. Most of these valuation methods typically fall within the following categories:

- Market Based.
- Earnings Based.
- Asset Based.
- Cost Based.

In most cases, intangible value over and above recorded asset value will arise from past financial performance that demonstrates that value of past profits will exceed the value of the assets, and that this performance is likely to continue into the immediate future.

So in most cases, the valuation method that gives rise to a premium value will be some form of the income method.

Other methods can be used to infer intangible value, such as:

- Market-based method based on recent transactions that are similar in nature to your business.
- Asset or Cost basis where there is clear evidence for the value of the replacement of intangible assets.

INCOME METHOD – FUTURE MAINTAINABLE EARNINGS

This conventionally accepted method capitalises the historic earnings or future maintainable earnings ('FME') of an asset / business by an appropriate capitalisation or investment rate. The rate is based on market expectations after giving consideration to all conditions relevant at that time, including the economy in general and the business and industry of that entity in particular.

Surplus, unproductive or unrelated assets are valued separately and added to the value derived by capitalising the future maintainable earnings.

The Earnings Multiple methods are of a generic formula, where:

Enterprise Value = Capitalisation Multiple * Adjusted Earnings

- The Adjusted Earnings is typically some proxy for cash flow that has been adjusted for non-operational items, one-off items or agreed adjustments to revenue or costs that reflect the standard of value being assessed.
- Depending on the circumstances of the valuation, the proxy used for cash flow will be historic EBIT or EBITDA or a forward-looking measure such as future maintainable earnings (FME), also represented by EBIT or EBITDA.

The capitalisation of FME approach is appropriate where:

- The earnings of the business is sufficient to justify a value exceeding the value of the underlying assets.
- Where a relatively stable historical earnings pattern is demonstrated.
- The business operations are expected to continue indefinitely.

EBIT and EBITDA multiples (the inverse of the capitalisation rate) are commonly used in valuing businesses as a whole. Where an equity value is required, it is necessary to then deduct the value of interest bearing debt net of cash.

The benefit of this method is the ease of calculation and simplicity in deriving an indicative valuation. However this also contributes to the method's disadvantages, which include:

- The method's assumption that the risk level of a business' earnings remains constant over time. In almost all business cases, cash flows in future years are always subject to significantly higher risk than cash flows in the following year.

- Significant variation of previous profits makes it difficult to select an appropriate indication of value moving forward. This disadvantage can be exacerbated by variations in accounting policy framework used to construct the EBITDA result. The key here is to ensure that EBITDA represents an "everyday ongoing" operational profit result, and does not include one-off cost or revenue items.

- The selection of a multiple should ideally be based on accurate comparison with other similar businesses, usually in the same region. However this information is not always readily available for SMEs.

When assessing the Capitalisation Multiple we typically consider a wide range of multiples that could be applied to your business, then assess the business based on various key features.

In selecting a broad range we must take into account the industry type and size of the business, recent transactions and expected economic and other external risks the business will face in the short-medium term.

Approximately 80% SME's will sell for an EBIT multiple less than 2.0x, whilst less than 10% will sell for an EBIT multiple exceeding 3.0x.

The checklist below details the key features that we look for to indicate a business has a high level of attractiveness and a low risk profile. We use these features to determine a more accurate EBITDA multiple range for assessing value.

ABOUT US

At Exit Value Advisers we believe the concept of value is at the heart of all successful businesses and should be considered in any business decision.

Our focus is to illuminate the value decisions that privately held business owners make through in-depth business valuations and innovative exit strategies.

We use detailed valuation research and the latest transaction trends to facilitate strategic exits by business owners at an attractive premium price.

Our detailed analysis and research on the value of a business is used to inform and guide business owners when:

- Buying or selling a business.
- Growing a business through organic improvement.
- Making capital investment decisions.
- Developing and implementing succession plans.
- Finding the best exit strategy for owners.
- Negotiating the exit of an owner.
- Defending or resolving a commercial dispute.
- Restructuring for tax purposes.

Our approach to quality is based on two principles:

- Extensive and illuminating evidence-based analysis that explores the roles of the business model, the business and economic environment, systems and processes and people in generating financial results.
- Using systems and processes to cross check our results against the evidence.

Our values are based around the key principles fundamental to those at Exit Value Advisers:

- Understanding the "why" of business outcomes.
- Educating people on the connection between business value and strategy.
- Research on the latest trends and theory and how this can be applied to business.
- Quality outcomes for the client and our associates.
- Embellishing fun into our serious passion.

OUR CEO

Mike Williams B App Sc, MBA

Mike is a small business valuation expert with ten years' experience in valuing privately held businesses and more than 15 years management consulting experience.

He is CEO of Exit Value Advisers Pty Ltd, Founding Principal of Maxell Consulting and a past and present director of a diverse range of small businesses. He has the knowledge, skills and experience to help any business owner when it comes to valuation, business growth, exit strategies and succession plans.

He has valued hundreds of businesses in almost every industry, for a variety of reasons including supporting selling, buying or merging businesses, tax restructuring, commercial disputes, family law matters, seeking investment and making management decisions.

His background has given him a diversity that can be applied to almost any business. He has formal training in science, mathematics, computing and business, more than 10 years management experience in the manufacturing and process industries, and more than 15 years consulting experience.

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