BusinessPlus+ Newsletter

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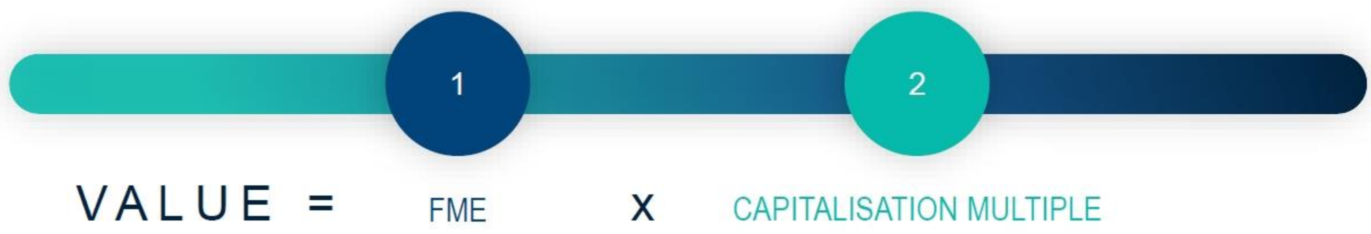
Understanding the Value of your Business

By Lyall Bear

Most business owners do not fully understand what factors impact on the value of their business, nor how they can make changes that positively influence that business value. They do in many cases, somehow have a figure in their head as to what they think the business is worth – however they cannot clarify how they arrived at that value. The figure is perhaps intuitively derived by determining a good retirement capital sum that they would *like* to have, but this would usually have no reference to the actual business valuation position.

To positively impact your business valuation, you usually need time to implement the necessary changes – in many cases for years prior to any actual sale of the business taking place. So, it pays to better understand the basic factors that affect a business's value even if you are many years away from sale, succession or looking to sell down some of your business interest/equity.

A small to medium enterprise ("SME") business with several years of earnings history and a solid track record of operating in its market, is ordinarily best suited to an earnings basis of valuation – commonly referred to as a ***maintainable earnings methodology***. The formula for calculating a business enterprise's value is shown in the diagram below:



There are five key factors that can affect this basis of valuation: -

- **Net Income/Profit:**
  This is usually calculated as the business net profit before tax, interest and depreciation – adjusted for normalising factors such as market rate salaries for owners, adjusting business premises rent to market if they are leased from a related party at other than market rental rates, excluding abnormal non-recurring items (such as COVID support payments and credits) and the like. This then will give you a figure commonly referred to as *future maintainable earnings ("FME")*.

- **Business Risks Assessment:**
  Both external market/competitor risks and internal business risks need to be considered in terms of how they may adversely impact the future maintainable earnings position for the business. One of the really important risks is key owner risk – where there can be an over-reliance upon the current business owner(s) who work in the business, as contrasted with independently employed management, who look after the day-to-day business operations and management - with the owners taking a more passive role.

- **Business Growth:**
  This factor looks at where and how the business continues to grow in a sustainable manner. Usually, the insights for future growth should be documented in a current and annually updated business plan - it is a living and breathing reference for the business management and is used to guide the future growth plans for the business.

- **Capital Structure & Management**:
  How are the working capital and growth plans for the business funded or planned to be funded? Many business owners shy away from the use of debt for funding their business, yet in today's low interest rate environment - debt is a very cost-effective financing tool for funding working capital, plant & equipment and some growth/expansion objectives. By adopting this approach, cash generated by the business will not get caught up on the balance sheet. Hence it can be available to fund dividends or distributions to the owners (particularly bearing in mind these monies are ordinarily taxable to the owners – so they need the cash).

  A common business myth is the less the business borrows, the less risky is the business. However, there needs to be the right balance achieved between debt and equity funding for a business and this will be dependent on many factors, including owners objectives, bankers, taxation and operational perspectives. Remember the interest component incurred on business finance is added back when calculating the business future maintainable earnings, as discussed above – so it does not affect the business value.

- **Earnings Return from the Business:**
  In very general terms, the business capitalisation multiple for many businesses is around 3 times *future maintainable earnings ("FME") – a higher capitalisation multiple implies a more premium (or niche) business and hence a stronger valuation outcome*. A 3 times capitalisation multiple implies a business return on capital tied up in the business of 33% pa. So, if you are re-investing some profits back into your business and it is not delivering a return of at least this amount annually, then arguably you would be better re-investing your earnings elsewhere, unless you are an early start-up business or there are some other short-term considerations at play, that are impacting on earnings returns.

In summary, the business value equation can be summarised as shown in the diagrams below. The two diagrams differentiate between a whole of business enterprise value, as compared to valuing an equity or business interest.

After considering all of the above factors, it is a useful exercise to determine where your business is at today, from a current indicative business value and to determine if there is a gap between from what the owners thought it may be worth.

Then an action plan can be prepared to take positive steps to improve the business value in the future. This plan should then be reviewed and updated on a regular basis (at least annually) to ensure that good business improvements are regularly being implemented and the identified business risks are being controlled and minimised appropriately. Ideally you want to strive to make the business a premium operation that justifies a higher capitalisation multiple and thus a higher value. Also remember that the business value is generally concessionally taxed under current capital gains tax rules – particularly for SME businesses – and hence another reason to be strategically focused on this attractive "end-game" outcome.

Our Business Advisory specialist at CBSW – Lyall Bear – can assist you in looking at the five factors discussed above and help guide your business towards achieving a better business value. Please contact Lyall if you would like an initial consultation.

Business Essential Briefs – October

(1) Business Technology Report 2021

A recent survey of businesses in the Asia-Pacific region has provided some useful information for SME business operators to contemplate for their own business. **The survey was completed by CPA Australia in May/June of 2021.**

Some of the key findings were: -

- The survey found that video conferencing and group collaboration tools, new payment technologies and cloud technology were the technologies that businesses were most likely to have used in the past 12 months.
- Improving operational efficiency and cost savings were the key reasons for using technology. Most respondents expect their business to invest in additional technology in the next 12 months.
- The survey findings demonstrate the strategic importance of organisations investing in and effectively using technology and enhancing their digital capability. Businesses that have been digitally transformed are better placed to deliver additional value to customers and handle future disruptions.

The key lessons for businesses from the survey are:

- Consider implementing a digital transformation strategy that aligns technology with your organisation's culture, employees, risks and business objectives.
- Consider using technology tools that increase productivity and reduce capital spending, such as cloud technology.
- Consider using technology tools that improve your understanding of clients' current and future needs, such as data analytics and visualisations software and business intelligence software.
- Enhance your in-house technology capability through training programs and securing top technology talent.
- Ensure that the technology and software you use has strong cybersecurity and data protection features.

For a copy of the full CPA report, please click on the link HERE.

(2) Business Digital Transformation

'***Digital transformation is the process of using digital technologies to create new, or modify existing, business processes, culture, and customer experiences to meet changing business and market requirements. This re-imagining of business in the digital age is digital transformation.***'
Source: Salesforce

The potential benefits that can arise by embracing digital transformation in your business could include: -

- Reducing costs as a result of time savings in processes;
- Improving operational efficiency and productivity;
- Opening the door to new business opportunities and revenue streams;
- Increasing the speed of response to changes in demand in the market;
- Driving the culture of innovation;
- Preparing the business to anticipate any disruption;
- Empowering decision-making by deeper data analysis (Big Data).

A recent insight report on digital transformation was prepared by Icehouse New Zealand and the document can be accessed by clicking on the link HERE.

(3) Casual Employees & Business – New Information Statement

As a consequence of the recent High Court decision in the case *WorkPac Pty Ltd v Rossato & Ors* [2021] HCA 23, the **Fair Work Ombudsman of Australia**, has now issued an important information statement on Casual Employment that **has application for *all but small businesses*** – defined as those that employ fewer than 15 employees. However, there are still opportunities for small business employees to apply under the conversion to permanent staff provisions that need to be considered by those business owners – please refer to the information statement for more details – refer to the link at the end of this article.

Definition of a Casual Employee

Following the passing of the Industrial Relations Omnibus Bill by the Federal Government, the meaning of 'casual employee' is now defined under section 15A of the Fair Work Act 2009 (Cth) (Act).

A person is considered a casual employee if: -

- *an offer of employment is made on the basis that the employer makes no firm advance commitment to continuing and indefinite work according to an agreed pattern of work;* ***and***
- *the person accepts the offer on that basis;* ***and***
- *the person is an employee as a result of that acceptance.*

For the purpose of determining whether the employer "***makes no firm advance commitment to continuing and indefinite work***" at the time an offer is made, regard can only be had to: -

- *whether the employer can elect to offer work (and whether the employee can elect to accept or reject that work);* ***and***
- *whether the employee works as required according to the needs of the employer;* ***and***
- *whether the employment is described as casual employment;* ***and***
- *whether the employee will be entitled to a casual loading or a specific rate of pay as a casual employee.*

The subsequent conduct of the parties has no bearing on whether a person is or is not a casual employee.

For a copy of the Casual Employment Information Statement issued by the Fair Work Ombudsman, please click on the link HERE. The statement has effect from 28th September 2021 in relation to casual employees of employer organisations.

Benefits of Reflecting on Business Experiences

The role of reflection is a powerful mechanism behind learning. To learn how to run a better business, you need to be able to reflect on what has worked and what has not.

This confirms the words of American philosopher, psychologist and educational reformer John Dewey:
"We do not learn from experience…we learn reflecting on experience."

As evidence to support this approach, you should see "*Making Experience Count: The Role of Reflection in Individual Learning*" (Di Stefano, Gino, Pisano & Staats, 2016).

In this research paper they ask: -

- ***How do humans learn?***
- ***Which learning source provides the highest benefits to future performance?***
- ***Should individuals seek to accumulate additional experience, or should they focus on trying to articulate and codify the experience accumulated in the past?***

In the paper, they build on research on the micro-foundations of strategy and learning processes to study the individual underpinnings of organisational learning. In addition, they argue that once an individual has accumulated a certain amount of experience with a task, the benefit of accumulating additional experience is inferior to the benefit of deliberately articulating and codifying the experience accumulated in the past. The paper goes on to explain the superior performance outcomes associated with such deliberate learning efforts. They do this by using both a cognitive (improved task understanding) and an emotional (increased self-efficacy) mechanism.

And a quote from Confucius also assists you in better understanding this subject:

"By three methods we may learn wisdom: Firstly - by reflection, which is noblest; Second - by imitation, which is the easiest; and Third - by experience, which is the bitterest."

This supports the notion of adopting a reflective approach to developing your skills at running a more successful business. For more information on this you should also read the **"***Inner Game of Work***"** (WT Gallwey) where he suggests: -

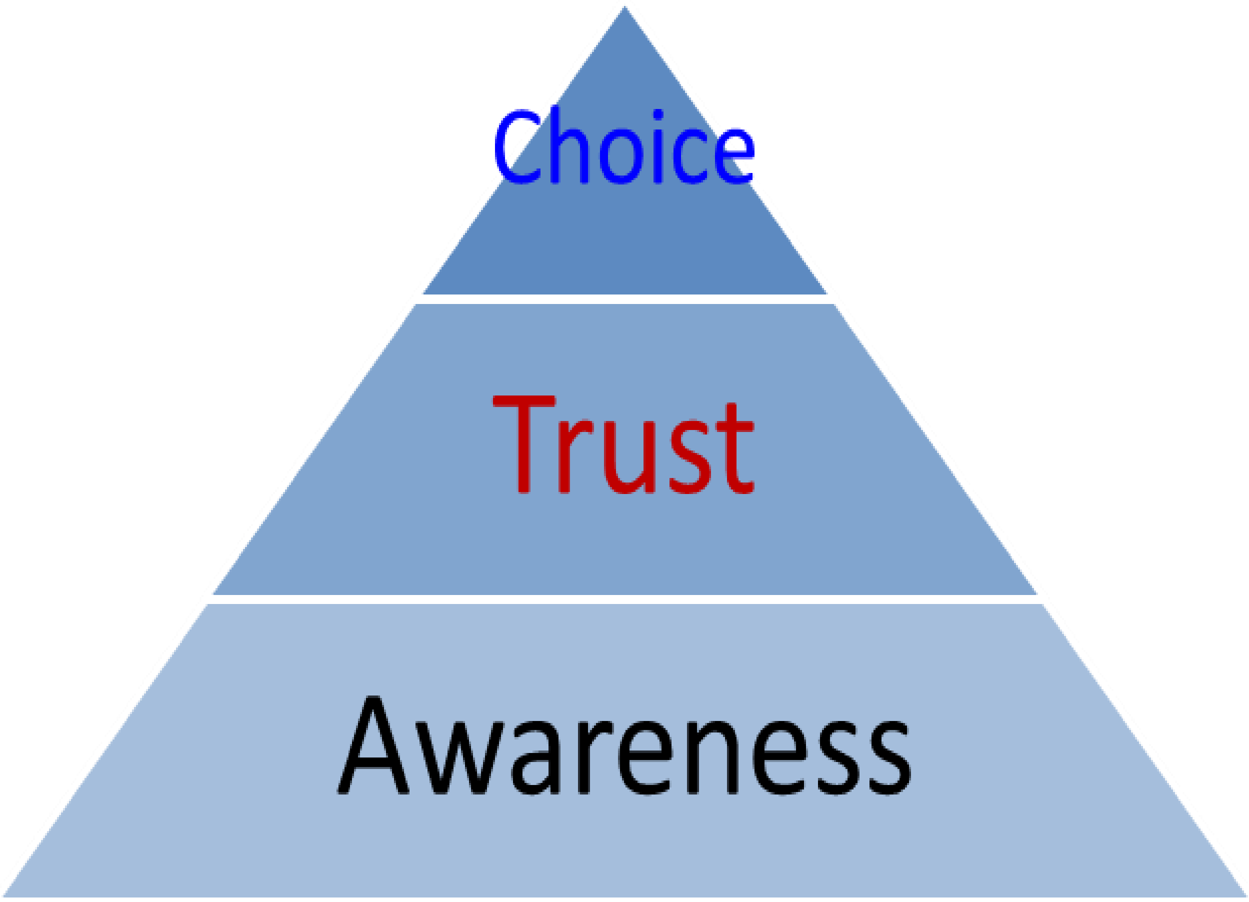
P = p – i
(Performance = Potential minus Interference)

As a consequence, we need to understand what is causing the interference. The majority of the interference is the monkey on your shoulder, your twitchy alter ego that undermines your best efforts.

His approach can be summarised in three words:

- **Awareness**: Non-judgmental awareness enables one to see what does and what does not work.
- **Trust:** Trust in yourself gives you confidence in your actions and your decisions (so get rid of that negative voice in the back of your head!)
- **Choice:** Choice enables you to decide what you need to work on first (and why). Remember – "*Choice not chance determines your destiny*".

Gallwey's approach suggests that we, as business owners and entrepreneurs, probably know the answers already. We just need someone or something to help us extract it.



SME Bank Lending Insights Report 2021

A recently released report (completed in September 2021) on the Small Medium Business Enterprise ("SME") sector provides some useful information on: -

- **SME Growth across the various Australian states;**
- **SME investment priorities;**
- **Loan funding applications – new versus refinancing and success rates;**
- **Sources of funding – new versus existing and bank majors vs other lenders.**

Some of the major findings from the SME survey include the following: -

1. 46.1 percent of SMEs currently define themselves in a growth phase.
2. The larger the business, the greater the weighting towards outright growth and expansion. 39.2 percent of the A$1-10 million segment are currently in an expansion phase compared to 56.3 percent of the A$10-50 million segment.
3. One in ten SMEs are stuck in a contracting business phase (11.7 percent) while one in four are exiting outright (26.1 percent), interestingly highest in ACT / NT / TAS (43.7 percent) and WA (31.3 percent) and within Construction (30.4 percent) and Wholesale (28.2 percent) sectors.
4. Market wide, just under one in two SMEs applied for new funding in the last six months, with the majority of those comprised of small enterprises (59.7 percent) compared to medium enterprises (40.3 percent).
5. Among SMEs who successfully sourced new funding in full or partially in the last six months (72.3 percent), the funds were primarily allocated to cashflow/working capital requirements (91.1 percent), investment in new plant and equipment (48.1 percent) and COVID related provisions such as bridging finance or managing business closure (45.6 percent).
6. SMEs are more likely to borrow from the Big Four (34.4 percent) than a non-major (6.6 percent) or non-bank (9.2 percent). Noting non-bank financing preference is significantly more prevalent among smaller sized SMEs (11.3 percent) than larger sized (6.1 percent).
7. One in three SMEs plan to apply for a new loan in the second half of 2021 (34.4 percent) while a further 15.9 percent are reviewing their books and refinancing existing debt facilities. Decision making over sourcing finance from a new or existing lender is evenly split, with one in four seeking a new lender (23.4 percent) and a similar proportion turning to their current lender (26.8 percent).
8. In the last six months it took lenders on average 42 days to discharge SMEs existing loans when they change lender, 23 days to approve or reject a loan application/s and 20 days to settle the facility if successful.
9. The manufacturing sector is characterised by considerable lags on discharging loans when switching lender (47 days), loan approval (32.5 days) and settlement (24 days) relative to the market average. Conversely the wholesale sector enjoys sharper turnaround times for switching (35.8 days), approval (18.8 days) and settlement (20.5 days).
10. The 'gap' from reality to expectation is enormous for loan switching, approval and settlement, totalling 37 days for switching, 12 days for approval and 15 days for settlement. Major banks are falling well behind customer expectations, and this is likely to lead to elevated levels of customer switching, dissatisfaction and reduced trust.
11. WA based SME businesses are the most bullish in terms of new borrowing intentions, with almost two in three seeking new lending or refinance in the next six months. Lending intentions are largely even across sectors, with slightly greater than one in two manufacturing businesses intending to seek new lending or refinance. The construction, retail and services sectors are the most likely to switch away from their current lender for both new borrowings and refinancing.

For a copy of the full report from Judo bank, please click on the link **HERE**.

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