BusinessPlus+ Newsletter

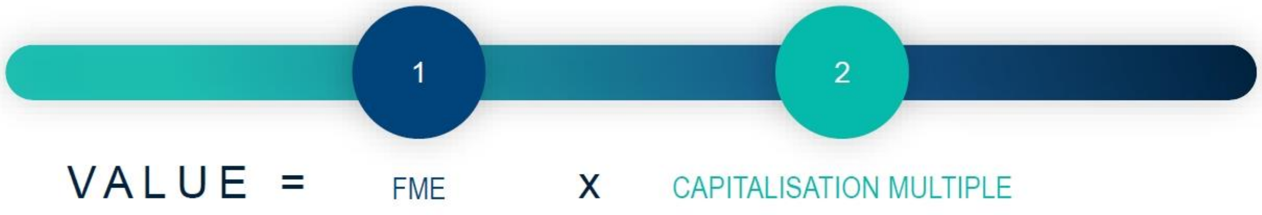
Issue – September/October 2021

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.

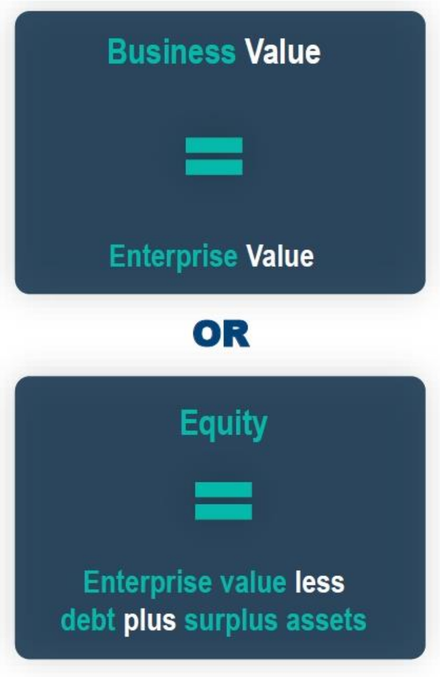
- **Business Growth:**
  This factor looks at where and how the business continues to grow in a sustainable manner. Usually, the insights for future growth should be documented in a current and annually updated business plan - it is a living and breathing reference for the business management and is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



Business Value = Enterprise Value

OR

Equity = Enterprise value less debt plus surplus assets

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.

Disclaimer:

Business Plus is distributed monthly by CBSW Tax & Business Advisors to provide information of general interest to our clients. The content of this newsletter does not constitute specific advice. Readers are encouraged to consult their CBSW advisor for advice on any specific business matters.

Providing you professional direction

Our liability may be limited by a scheme approved under Professional Standards Legislation.