P+S BUSINESS BROKERS

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Making Your Business More Valuable

Published in the Financial Review and BRW was an article entitled:

> "Why Baby Boomer business owners may retire with nothing" (BRW 25 Feb, 2014)
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> The article profiled a second generation business owner who employed 38 people and consistently turned over $5 million a year. Assets included about $3 million in equipment. The GFC has left the owner with a business that has not made a profit for some time. Assessed value of the business was $zero.

This is not an isolated occurrence and nor is it just a Baby-Boomber thing. We have met many similar examples over recent years; the accountant that let his practice fade away because he didn't want other accountants looking after his clients – losing $250,000; the auto service franchise owner that died 4 months after opening the doors – his widow lost her home; the souvenir business owner whose stock was worth more than the business; many business owners preparing to exit to find their business has little or no value in the market.

For many years a large percentage of business owners, both young and old, have viewed their businesses solely as cash and income generators and tax payers rather than as an asset that has significant value. Value that, when realised, can provide for, and facilitate, change and top up the super fund.

What's the difference? Why the question?

As a cash generator the business will provide the owner with an income, some of which can be contributed to a superannuation fund (trust?). Many steps taken in the business can seemingly increase the cash level but will do little to increase the value of the asset.

As an asset it will still provide that income but can also enhance the business as a saleable item, doubling or at least increasing the owner's retirement fund or financing the next business venture or change of lifestyle.

Most of us will either own or nearly own our own home, an asset. It is insured to protect it and has a market where the value may fluctuate from time to time. Providing it is reasonably well maintained it will always have value. Home improvements are carried out. These improvements enhance the value as well as improve the owner's lifestyle and comfort. Should things go wrong the value of the home will flow to the owner's beneficiaries.

Why not treat your business the same way?

To explore this issue we need to consider three topics:

1. How are businesses valued? (What's the value of yours?)
2. What are the key issues that affect the value? and
3. How do we go about improving the value and protecting it?

How are businesses valued?

There are two main methods used to value small businesses. (There are in fact about 7 different methods, but only two of them are reasonable and matter in this discussion). They are:

1. Market Valuation and
2. Return on Investment.

Before going too far we should understand that when the valuation of a business is being discussed there are two distinct approaches or bases. The first is an appraisal and the second a valuation.

An appraisal generally gives a vendor or purchaser an idea of the business's value should it be taken to market. A range of value is generally provided. The approach is not very detailed and the result serves only as an indication. Whilst it helps for summary decision making the approach is not much use in a formal situation, such as acquiring insurance cover, presenting to a court or use in a matter of dispute.

A valuation however involves an approach set by standards (APES 225), it is far more detailed, requires a detailed report providing information on the methodology, the reason for its adoption, some form of comparison with market realities, limitations on the application of the finding and the qualifications/experience of the valuer. A valuation can be used in dispute proceedings, in legal matters and for financial issues, including applications for insurance.

1. Market Valuation is a method used only in certain businesses where a "market" approach (also known as "rule of thumb") has developed over some time. Typical business types are:
   Accounting Practices, Legal Practices, Travel agents, Property Management (rent rolls), Financial Planners and Insurance Brokerage firms.

2. The Return on Investment (ROI) method is the number 1 method. It is gradually replacing market valuation.

This methodology follows these steps;

1. Review 2 or 3 years' of financials for the business
2. Establish a P-EBITDA or B-EBITDA "profit" figure
   P = Proprietor; B = Business

   Earnings Before Interest Tax Depreciation and Amortisation

3. Consult a database to establish a range of ROI percentages that apply
   a. Any specific examples?

  b. Age and trends in the database?
  c. Sampling?
4. Establish the range applicable in the particular case, and
5. Establish the likely value of the particular business within that range.

Frequently some market research is required and a business diagnostic session may be warranted.

Note that it is important to have this process carried out by a qualified person or firm. One such group are the Registered Business Valuers accredited by the Australian Institute of Business Brokers (AIBB). There are many firms and individuals who say they can carry out the process and do it very badly.

<u>What are the key issues that affect the value</u>?

Type of Business

The type of business has a dominant impact on value.

For example a supermarket with a P-EBITDA of $1 million may have a value range of between $3.5 and $4.2 million. Whereas a printing business with a similar profit level may have a range between $1.9 and $2.3 million.

Market Demand

Certain types of business are in demand. At the smaller end they may be great cash generators. Others may have a limited required time commitment to own and operate them.

A café or fast food outlet which opens 5 days a week and located in an industrial park may well be in high demand where a similar business operating in a shopping strip needing to be open 7 days a week will be less sought after.

Product – Market Matrix (SBU's)

Most businesses are made up of a number of "business units". A business unit can be defined as product or set of similar products being supplied to a particular market segment. Depending on the performance and potential of each business unit the value, and their summation, may be affected up or down.

One business unit may have a problematic future due to changes in technology or some other factor. That part of the business, and its impact on overhead costs, may be excluded from the value.

Level of Profit

Along with the type of business this factor may be the largest determining price factor of a business that's seen as stable.

For example, the supermarket exampled above with a profit (P-EBITDA) of $1 million may attract an ROI% range of 24 to 28%. If the profit were lower, at say $600,000, the ROI% range may become 28 to 32%, developing a disproportionate drop in value.

Impact of the Business Environment

The impact of the business environment may be a very important factor. If the business is projected to suffer in competitive standing due to a shit in technology, change in legislation, climate change or some other factor, its value will be severely impacted.

Premises and lease terms and conditions

Many businesses rely on a particular location or type of building and amenity to operate. If the building or premises are under threat in any way (a lease will not be transferred or permitted, the area is to be re-developed etc.) the business vale may well be impacted.

Longevity – Relevant to Technology

A business that can illustrate a long history of acceptable performance will be better regarded that one only started last year. This, of course, is subject to environmental analysis, as exampled above.

Stability of the Business

A consistent performance in terms of GP% or sales etc. will be more attractive than one that varies widely year upon year.

Level of Competition

This consideration is a “double edged sword”. Little competition or a unique offering to a market may seem highly attractive. However, what happens if a well-resourced competitor enters into the market?

Conversely, a unique offering or lack of competition may drive the value higher. It depends heavily on the next value issue.

However, if there are lots of competitors it can be an advantage in that customers will go to a certain area to have choice (e.g. Vic Market or a group of fast food outlets) or the market is substantially large and maintaining the businesses share of the market may be easier.

Particular IP and Competitive Advantage

The basis of the business’s competitive, whether technological, location, licencing or some other factor can have a substantial impact.

Having the licence from Telstra or Apple can underpin the value of the business. This is the strength of many franchises.

Source of Business

How are the customers, clients or assignments won? If the owner of the business is the key "bread winner" then the value may be lowered considerably. However if the order arrives whether the owner is involved or not the value may well be enhanced.

Marketing Activities

The type, quality and quantity of marketing activity will be important. The more effective and systemised the marketing activity is in generating leads and enquiries the more attractive the business.

Methods of Distribution (Channels)

How does the business get its products to its customers? An importer that wholesales to only one or two major retailers may have difficulty in convincing a buyer that the business would be in trouble if one big customer went elsewhere.

Conversely if the suitor for the business was after a market intro to that channel because they had products that would benefit from the channel, this may be an attraction.

Liabilities and Retentions

Some businesses, particularly those involved in the construction industry sector, are involved in warranty based retentions where a % of the contract value is held for a period to guarantee the performance of supply. This amounts to (a) a risk and (b) slow payment of what is frequently part of the profit component. Conversely this could represent future earnings against which there will be very little cost.

Some business may have pre-sold services, yet to be delivered (e.g. subscriptions, coupons, vouchers etc.). This represents a liability against which there will need to be an adjustment.

Guarantees, especially where there is no statutory regime to cater for them, may also affect the value of the business.

Each circumstance requires individual analysis.

Pricing and Costing Systems

Pricing strategies and cost control systems underpin the maintenance of gross profit in many businesses. Where they are applicable they enhance the business value.

Overhead Structures

The philosophy that businesses are about making money and not spending it should be always born in mind. Overly inflated overhead structures reduce the bottom line, impacting the sale price.

Industry Regulation/Unions/Licencing

Some businesses operate within a statutory environment, a union influenced environment or under a licencing arrangement. Each aspect needs to be considered carefully.

For example an engineering service business that is a signatory to the CFMEU EBA will have labour rates and cost structures that will make them uncompetitive in smaller projects. Conversely a non signatory will not have access to the larger, big dollar sites.

Statutory aspects normally relate to business operators meeting certain requirements, such as contractor's licences, registrations and so on. Prospective purchasers must also meet these requirements, narrowing the target market and the price of the business.

Where specific licences are held by the selling company careful consideration needs to be applied to the structure of the sale and the resultant terms.

Systems

Systems that relate to the reliable and efficient operation of the business

Prospecting, Quality control, Stock management, Accounts and MIS, Debtor control,
Planning (with KPI's), Safety, Training and Induction, Innovation to mention a few areas that may be applicable.

Management

By answering a few simple questions the business owner will be able to understand whether they have written off about 50% of their business value or not. These questions are:

Q1. Does the business rely on the owner?

Q2. Can it operate without the owner being involved in day to day operations?

Q3. Can the owner take a 4 week holiday or trip and know the business will not only continue while they are away, but may even improve?

Frequently people who say yes, no and no to the above three questions believe their business is not big enough to support management levels, which is also frequently not true.

Staff

Focus/Culture

The core of the business; how do things get done in the business?

Are the employees valued? Are they loyal because they feel they can contribute? (See comments under management above).

Training and other aspects such as QA and efficiencies are also important.

Working capital

This is a very important consideration which is frequently ignored by business owners.

A business makes $350k B-EBITDA. Its value (example) is $875k (40% ROI).

Working capital (calculated as Stock at cost + debtors - creditors) is $420k.

Total investment by a buyer in the business becomes $1,295k.

The ROI% impact reduced to 27%. This has become marginal.

The price will be put under pressure. Reducing stock costs/levels and debtors can have a big impact on the purchase price.

<u>How do we go about improving the value and protecting it</u>?

1. Review – Needs of family and Self
2. Business Diagnostic
3. Business valuation (Need for APES 225?)
4. Gap Analysis
    a. Needs versus Value
    b. Value Improvement
5. Business Improvement
6. Update or Projected Valuation
7. Develop Risk Profile
    a. Divest
    b. Transfer
    c. Retain
8. Insure?
9. Legal Protection?
10. Extract Value
    a. Sale
    b. Transition
    c. Succession
11. Time Scale

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