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Business valuation
methodologies

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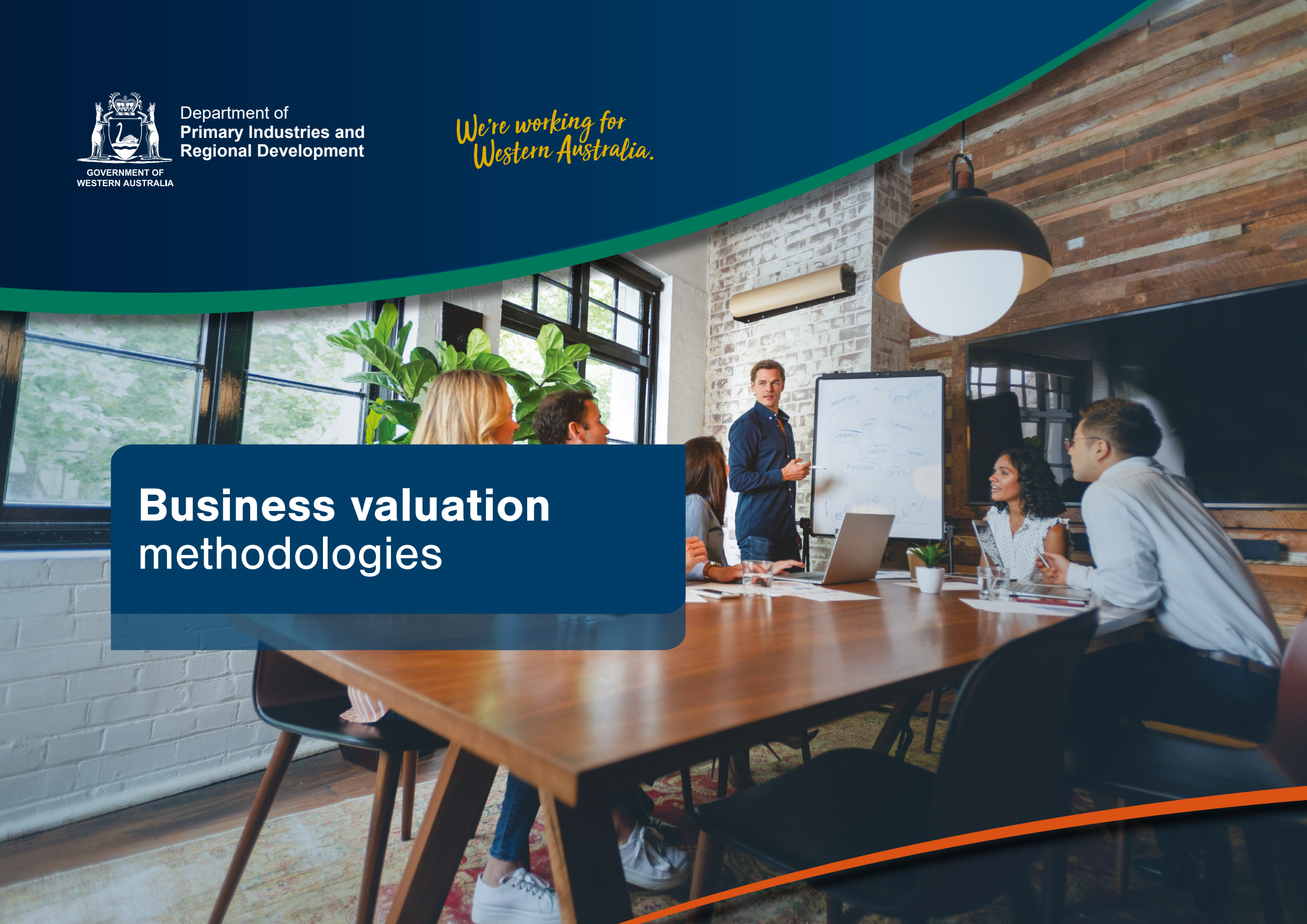
The Investor Readiness Program is an initiative of the Department of Primary Industries and Regional Development delivered in collaboration with BDO Australia.

Business **valuation**

Valuing your business is an important part of obtaining finance, attracting investors or selling.

There are a number of methods that can be used to calculate the value of a business and sometimes a combination of methods may be used throughout the valuation process.

Understanding common business valuation methodologies

Typically, a business is best valued using a sum-of-parts approach which involves attributing a value to each of the individual parts of the business or company. The sum-of-parts approach can incorporate one or a combination of the valuation approaches below. Although there are several business valuation methodologies, below are the most generally used and accepted methods.

1. **Capitalisation of earnings** – This method uses an estimate of future maintainable earnings, which is often based on normalised historical earnings or forecast earnings. An earnings multiple is then applied to the assessed future maintainable earnings.

2. **Discounted cash flow** – This method involves the discounting of estimated future cash flows to present value, using a discount rate based on the level of risk in the business. In order to use this approach, it is preferable that a financial model is prepared with the ability to flex key assumptions and inputs.

Broadly, this is the preferred approach for valuing assets. However, this can differ on a case-by-case basis depending on the stability of the business, stage of development and availability of information.

3. **Asset valuation** – This method looks at what the business owns, rather than earns. The realisable 'asset base' is used to value the assets of the business in order to estimate the total value of the business. This typically represents the floor value or base value of the business.

4. **Comparable market transactions** – This method relies on past transactions involving the subject asset/business or transactions for comparable assets/businesses. It is accepted that no two transactions are identical, so when using this approach, the valuer will typically calculate a multiple based on a common attribute between the comparable companies. For example, it may be a $/hectare valuation of land, which then gets applied to the subject asset/business. There is subjectivity involved with this approach as it relies on the valuer identifying different risk and other valuation drivers applicable to the assets or the business.

Capitalisation of **earnings method**

The Capitalisation of Earnings method is the most common for valuing existing businesses that have more than three years trading history of generating profits. The method involves multiplying Future Maintainable Earnings (FME) by an earnings multiple. This methodology is predicated on the assumption that the FME level is earned on the business into perpetuity (forever), therefore this approach is typically not appropriate for finite life assets. This precludes it from being appropriate when valuing some businesses.

FME – This is a subjective measure and relies on an understanding of the business historically and how it is likely to be operated going forward. A valuer should be able to justify their assessment of FME with reference to historical and forecast earnings (if available).

Earnings multiple – An investor's expected rate of return on investment after considering factors of risk in the business. This is the most subjective part of a business valuation, however, a valuer should be able to support their assessed earnings multiple with reference to comparable transaction multiples or listed company trading multiples (with appropriate discounts/premiums applied).

Business value – Valuation based on the multiplication of the FME of the business and the earnings multiple.

Normalised **profit position**

> Normalising a business' earnings involves reviewing a profit and loss report (P&L) and adjusting the non-recurring income and expenses so only the usual transactions of the business are reflected.
>
> Financial statements often contain expenses that don't relate to daily business operations and may skew the business' earnings figure.

Items to look for when normalising earnings

When normalising earnings the valuer should identify any transactions that do not relate to day-to-day business operations and/or would not be maintainable by the future owner. Examples of those types of income and expenses that may require normalisation are set:

Unusual or one-off items – Look for expenses that are unlikely to occur again and won't be relevant to the future business owner (e.g, legal fees relating to the preparation of sale documents or abnormal extreme weather conditions, such as bushfires).

Unmaintainable income – Adjust any income on your profit and loss report that will not be maintainable by the future business owner. Set out below are a few examples of events that would require normalisation.

- If a previously productive crop area becomes unproductive, the valuer would remove the historical revenue and costs directly attributable to farming that area in the assessment of FME.

- If government restrictions restrict farming in a particular area that was previously farmed, then earnings would be normalised by removing the revenue and costs associated with farming that area.
- If there was a one-off event which saw a significant (and not sustainable) increase in price for a particular commodity, the valuer may normalise this based on average margins observed following this price spike.

Discretionary expenses – Adjust discretionary items that are not required for day-to-day business operation for example, gifts.

Non-business expenses – Any personal expenses put through the business by the owner should be adjusted in the valuer's assessment of normalised earnings.

Above or below market rates for expenses – If the owner is paying themselves well above or below market rates, the valuer would adjust the salary line item to reflect the current market situation.

Business risk and
value drivers

What influences risk and value drivers in a business?

There are several key drivers a business owner should focus on to optimise business value and ensure maximum return when exiting the business. Assessing the risk and value drivers in your business will help identify areas of risk that could be holding back the value of the business.

Risk management – How does the business identify, manage and mitigate risk areas? This includes areas such as the use of hedging and insurance and the business' compliance procedures. Scalability and ability to leverage will impact business value.

Financial health – How is the profitability of the business, trading history, cash flow, business performance and financial management?

System processes – Do business systems operate efficiently and cost effectively? Does the business have systems and processes documented?

Market competitors – How competitive or aggressive is the market? Can the market sustain the current level of competition?

Relationship with other parts of the supply chain – How reliant is the business on its suppliers? Are its suppliers concentrated? Does it have certainty on its inputs and outputs?

Customers – Does the business rely on a few key customers? Are its customers secured contractually? What is the trend of customer retention and/or customer attraction? Is there a strong market demand for the product offering?

Industry stability – Will the industry remain stable into the future? Is there risk of disruption or changes in legislation that could affect it? Is there risk of larger competitors squeezing out smaller market participants?

Environmental risks – How reliant is the business on favourable weather? Does it mitigate the environmental risks through insurance and similar?

Reliance on business owner or key personnel – Can the business operate without the business owner?

Growth opportunities – Do opportunities for growth exist in the business? Does the business invest in research and development?

Human resources – Does the business have formal strategies for recruitment and staff retention? Is losing key personnel a large risk?

Technology and innovation – Does the business make use of technology to operate? Does the business do regular reporting and analysis? This is particularly important for businesses where typically in a low margin environment, if business owners are not utilising appropriate technology and willing to invest in change, the business can find itself unable to compete with larger competitors.

The Department of Primary Industries and Regional Development is ready to assist you

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