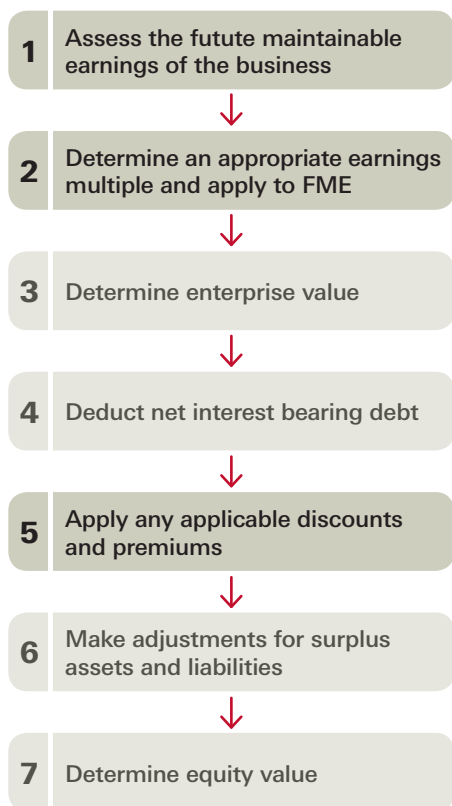


Global Economic Downturn fact sheet

Business valuation methodologies

Series 1 – Issue 7

As part of the Institute's ongoing efforts to provide members with guidance and information on key issues affecting the current business environment, the Institute has developed a practical factsheet series, which presents guidance for members written by members.



Using EBIT multiples

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One of the most commonly used business valuation methodologies is the capitalisation of estimated Future Maintainable Earnings (FME) method. Under the capitalisation of FME method, the valuer applies an earnings multiple to the estimated future maintainable earnings of a business in order to derive its value.

The capitalisation of FME method involves a number of steps as summarised in the **chart to the left** assuming EBIT is used as the earnings base.

This fact sheet considers steps 1, 2 and 5 detailed in the chart in turn, with a particular emphasis on the potential impact of the current global economic climate on the application of each in the valuation of a private company.

Step 1 – Estimating future maintainable earnings

The basics

When estimating the future maintainable earnings of a business, the valuer must choose a measure of earnings such as; net profit after tax (NPAT), earnings before interest and tax (EBIT) or earnings before interest, tax, depreciation and amortisation (EBITDA).

EBIT is commonly used in the valuation of a controlling interest or private business because it removes the bias associated with the capital structure of the business and taxation obligations. The reason for this is that in the case of private business or controlling interest valuations, the purchaser will generally have the power to change the capital structure of the business and implement tax effective strategies.

Estimating FMEs has proven to be problematic recently, as an increasing number of businesses are reporting downgrades in earnings. Regardless of which measure of earnings is used, it is vitally important that the earnings are deemed to be maintainable; the business must be able to sustain the level of earnings forecasted on average, notwithstanding short-term fluctuations in economic conditions.

Global economic downturn impact

The current global economic downturn has resulted in a fall in forecast earnings for many of Australia's top public companies including retailers like David Jones, property investors such as Westfield and resource companies like BHP Billiton.

A downgrade in earnings has also been witnessed by many businesses in the private sector. According to Dunn & Bradstreet Australia (D&B), 44 per cent of Australian firms saw a fall in sales between March 2008 and September 2008 and 45 per cent saw a reduction in profits. D&B's January 2009 National Business Expectations Survey suggests that falling earnings will be a continuing trend in 2009 with 59 per cent of Australian executives anticipating a decline in profits in the March quarter.

An increasing trend towards declining earnings makes estimating future maintainable earnings particularly challenging. Moreover, due to the current lower levels of earnings being forecast by many businesses, there is a risk that they may be valued under the capitalisation of FME method at levels which are far lower than anticipated by affected stakeholders.

Continued overleaf >

Two common methods involving comparable companies used to determine the most appropriate EBIT multiple to apply include:

- > Assessing the multiples at which comparable listed companies trade on a stock exchange
- > Assessing recent merger and acquisition transactions involving similar companies.

Step 2 – Choosing an earnings multiple

The basics

While the chosen future maintainable earnings reflects the level of earnings that the business can realistically be expected to sustain, the earnings multiple chosen should take into account the growth potential and the risks associated with the business.

As outlined in the table to the left, the earnings multiple should reflect variability in the business' earnings and its growth potential. Generally speaking, the higher the variability in earnings, and thus risk, the lower the earnings multiple, resulting in a lower value for the business. Conversely, where a business has a high potential for growth, the earnings multiple will be higher.

Global economic downturn impact

One need only look at the recent fluctuations of share prices on the Australian Securities Exchange (ASX) to witness an increase in investors' perception of business risk following increased volatility in earnings. Shares that were previously considered to be 'safe' investments, such as those in blue chip companies, are being treated with an increased level of scepticism and are thus trading at lower multiples. Moreover, the recent decline in merger and acquisition activity has meant that fewer comparable transactions are being undertaken, which is further affecting the ability of valuers to derive appropriate EBIT multiples.

Step 5 – Private company discounts

Listed companies tend to be valued using higher earnings multiples than private companies. This reflects the benefits of their size (generally considered to be a proxy for lower risk), geographic and product spread, liquidity and the generally tighter corporate governance and disclosure requirements of publicly listed companies. Guidelines released by the International Private Equity and Venture Capital Valuation Board suggest that a marketability discount in the range of 10 per cent to 30 per cent is used in practice, depending on the circumstances. It may also be appropriate to apply a specific size discount or other special purpose discount in the valuation of a private company depending on the significance of the differences between it and the companies from which the multiples are initially derived.

Summary

While the capitalisation of FME method is often praised for its accuracy and simplicity in comparison to other valuation methods such as the Discounted Cash Flow (DCF) method (refer to factsheet three), it is, in practice, proving to be somewhat problematic for valuation professionals. The current downturn in the global economy has proven to be a challenge when estimating an appropriate level of future maintainable earnings and raised a number of questions about commonly used practices for determining earnings multiples and discounts.

For more information, guidance and tools on the global economic downturn refer to charteredaccountants.com.au/news_issues/global_economic_downturn

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