

Maximising Value when Buying a Business

By Jeff Robson and Bill Scanlan, published August 2011



Figuring out the Value Puzzle

Determining the true value of a business is not straight forward but a good financial model will point you in the right direction.

When it comes to buying a business it is worthwhile taking every precaution possible to ensure that you get maximum value from the purchase. Good financial modelling can be very useful in determining the real value of a business and enabling you to make an informed purchase decision.

In this article I identify five important points that should be considered in the buying process. For each, I explain how a good financial model can help ensure that you are on the right path to a successful acquisition.

Business longevity

Purchasing a business is a major investment and typically one that will take many years to generate returns so it makes sense that the first major issue to consider is business longevity. It is all too easy to assume that because a business is doing well now, that it will continue to do well in the future. Nothing could be further from the truth.

A truly sound business needs to be able to perform well during the peaks and troughs of the economic business cycle but also during periods of changing consumer habits and sentiments. Of course, in business there will always be ups and downs but some downs are sustainable and others are not.

The key question that needs to be properly answered is: *'Is the underlying business sound over the longer term?'*

One of the best ways to get off to a good start in answering this question is to always aim to purchase a business with a track record. A track record will give you history and trends that can be very valuable in forming forward projections. Existing trends can be input into a financial model and the model can then be used to form forward projections.

One of the great things about a sound financial model is that it can be used to generate a number of different forward projections depending on which inputs are used. This can allow the user to gain a good insight into how the business will look under a range of different scenarios taking into account factors such as future rates of sales growth, input costs, finance costs, new customer generation and so on.





What are the risks?

Neatly following on from taking a long-term perspective is the necessity to identify the inherent risks in the underlying business.

Identifying business risks is the first step toward mitigating them. Good due diligence, coupled with financial modelling, will go a long way toward identifying the risks in the future operation of a business.

A critical factor here is the identification of 'off-balance sheet' risks and an evaluation of the quality of earnings. A good financial model of a business with some history will enable users to identify one-off gains and expenses or unusual transactions. These one-off items need to be identified because they are not indicative of future business outcomes. A potential buyer must also identify any reported earnings of the prospective business that are derived from subjective estimates or assumptions.

By documenting and analysing reported numbers, a financial model enables users to identify aberrant outcomes. Then it is just a matter of determining why such aberrant outcomes exist and assessing how the business would look in the absence of such outcomes.

A thorough risk analysis will allow a potential purchaser to distinguish between internal and external risks. Internal risks are those that the business has some influence over, for example the loss of a key customer. External (or market) risks are those that cannot be influenced by the business, for example changes in political or economic settings.

Risk analyses also provide a potential buyer with some perspective of the consequences of serious and unexpected downturns in business conditions. These are the types of events that nobody can predict but nonetheless they do happen. Sustained recessions, terrorist attacks or a financial panic are examples of these types of events. They are events that can significantly alter the business environment. While a prospective buyer should not base a business valuation on such gloomy assumptions, it is still prudent to undertake some modelling stress tests.

It is also worth bearing in mind that during a transition to new ownership, businesses are especially vulnerable to sudden changes in business environment. Management teams that have been working in a business for a number of years will usually be acutely aware of how to identify the early warning signs of a business downturn and will often be equally adept at knowing what to do in such situations. However, a new buyer may not be as in tune with the operations of the business. What is more, in the early days of new ownership, managers will be spending significant resources in managing other factors such as integration costs and higher than normal financial leverage. In such instances even relatively minor external events can be catastrophic to a recently purchased business.

Identifying and valuing intellectual property

Much of the value in a business comes in the form of intellectual property. The problem for a potential business purchaser is that intellectual property can be extremely difficult to identify and value.

Intellectual property includes things such as copyright, trademarks, domain names, designs, patents, licences to operate and business names. It may also include things like established networks of contacts and relationships, business reputation, and the knowledge and experience of key staff. A rigorous due diligence process and the construction of a sound financial model are the best ways to ensure that these assets are properly identified.

Once identified, a potential business purchaser needs to consider whether the intellectual property is transferable to a new owner; whether it is capable of being sustained over the long term and can be 'renewed'; and whether it is protected or under threat. In cases where the intellectual property is protected the question needs to be asked, 'at what cost is it protected?'

If it is the case that the relevant intellectual property cannot be sustained over the long term, for example, in the case of an expiring patent, then a financial model can be used to determine the effects on the operation of a business. Commonly this can be done using some form of discounted cash flow modelling where the value of cash flow lost due to the abolition of intellectual property is projected forward and then discounted back into present day terms. Other valuation methodologies such as replacement cost, or earnings multiples may also be useful depending on the specifics of each individual situation.





Identifying value to the new owner

As mentioned above, in most instances it takes time before a purchaser yields a positive return from the purchase of a business. A financial model is a very useful tool for identifying when a purchaser can expect to receive returns as well as the size of these returns and how they are generated. Approximate rules of thumb are often used by potential buyers but such approaches only going give a vague approximation at very best. It is only by accounting for factors that are specific to the business itself and taking account of changes to the business that may come into play under new ownership that a clear picture of exactly when returns will be accrued to a new owner can be appreciated.

Such information is very powerful for a potential business buyer as the buyer can then make an informed decision about whether the resources are available to sustain the business while returns are not being generated. Bear in mind that insufficient cash flow is one of the primary reasons for business failure after purchase.

Identifying business weaknesses

A financial model is a very useful tool for highlighting business weaknesses. Existing weaknesses should be seen as potential opportunities for a new owner.

It is often the case that a new owner can implement small changes to avert weaknesses, and that these small changes can result in significant business improvements.

As examples, a financial model is often useful for identifying an ability to dramatically reduce business expenses; or to quickly and easily reduce working capital requirements.



Conclusions

Thorough preparation is critical to ensuring the best possible chance of a positive outcome from the purchase of a business. Business purchase transactions that fail ultimately do so for a relatively narrow range of reasons that are nearly always related to an inaccurate valuation of the business being purchased.

Thorough due diligence, including detailed financial modelling, needs to be undertaken to ensure accurate valuation of a business. A good due diligence review including financial modelling provides a potential buyer with a set of forecasts on which informed purchase decisions can be based. Such knowledge will greatly enhance the chances of completing a successful business purchase.

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