OUR PHILOSOPHY: Grow our client's business first. It is only through our client's success that we succeed.

BANYAN CONSULTING

Client Information Newsletter – Tax & Super – September 2020

Inside

Note: The material and contents provided in this publication are informative in nature only. It is not intended to be advice and you should not act specifically on the basis of this information alone. If expert assistance is required, professional advice should be obtained.

Has COVID-19 devalued your business?

If you are selling your business, merging, acquiring, or inviting in new investors, you need to understand the value of your business. But, to what degree does the pandemic impact on value? Should you discount or hold firm to pre COVID-19 performance on the basis that 'we're going to come out of it eventually'?

Fair market value is the price that would be negotiated in an open market between a knowledgeable, willing but not too anxious buyer and a knowledgeable, willing but not too anxious seller dealing at arm's length within a reasonable time frame. Value and price may not be the same thing. The price you are offered (or offer), will often depend on the anxiousness of the parties.

For example, a seller that does not need to sell where the business being sold adds synergy value to the purchaser, may look to obtain a premium on value. And, even where a quick sale is required it may not be discounted if the liquidated asset value of the business remains high (i.e., the assets of the business are worth more broken up and sold off than as a whole).
However, to understand the value of a business, the pandemic necessitates a depth of investigation beyond the norm.

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About this newsletter

Welcome to Banyan Consulting's client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know.

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You cannot simply ignore the pandemic and rely on pre-pandemic performance and financials, even if you are enthusiastic about the future. Previously, anyone looking to buy or sell a business would likely analyse the past three years trading figures to help determine a value but this historical analysis may no longer present an accurate picture. For some businesses, history is no longer a reliable predictor of fair value. The Government controls put in place to contain COVID-19 transmission - closures, social distancing, border and travel restrictions - have a material economic impact. Closures and distancing impact in different ways and need to be considered at both an industry sector and individual business level. Government stimulus packages may also be providing abnormal short-term outcomes.

For some businesses, the operating and financial impact is material. And, this may flow into the underlying value of the business.

All valuations consider present and emerging risks and the current and anticipated business environment. This analysis is then brought into the modelling and valuation conclusion. COVID-19 creates its own set of considerations for analysis including:

- COVID-19 impact at an economic, industry sector and business level.
- The supply chain across the customer and supplier base with a view to identifying possible COVID-19 impacts in the supply chain.
- Earnings normalisation including the removal of stimulus support measures. For the 2020 year, a deeper analysis is likely to be required with possible segmentation by quarter.
- Current and forward year position (see Forecasting during a pandemic)
- COVID-19 risk in applying earnings multiples
- COVID-19 related assumptions

A hypothetical investor might have been prepared to pay $1 million for a business. That business might be on offer for $800,000 and appear as if the investor has struck a bargain. But, the business might actually only be worth $600,000, and not such a good deal after all.

Take the hypothetical example of a printing business. The business has been established for more than 10 years and has a history of profitable operation, with revenues of $5-6 million and EBIT of $800-900k per annum for each of the past 3 years. The business has a large client base of just over 400 active accounts. Trading patterns seem consistent to prior years up to March 2020. Between March and June 2020 there was a 40% downturn with the business closed or working on a limited roster for an 8 week period during the initial COVID-19 lockdowns. The business is currently moving back to normal operations but this is not yet reflected in revenues. The impact of COVID-19 in this scenario might be discounted as the business appears to be returning to normal conditions and it has a solid history of trading and profitability.

The largest customer of the business represents less than 2% of total revenue and the next two largest customers represent just over 1% of revenue. Two of the three customers have resumed their pre COVID-19 printing order levels. A large number of customers seem to spend between $5-20k per annum with the business.

However, during a customer sensitivity analysis, it's found that 70% of customers are from the live entertainment sector (although their two largest clients are not in this sector). As a result, the business is likely to have a material downturn until the entertainment industry resumes or the business is able to replace the business it has lost. A consequence of this is that value may be impacted.

Almost all businesses are valued by one of two methods. The first is the industry approach, where sales of similar businesses are used for comparison. The basis of this method is that the market provides a reliable indicator of value. This method works best in a stable and active market and where recent history is a reliable indicator of the present. But, COVID-19 casts doubt on the reliability of past sales that occurred outside of pandemic conditions.

The other typical method of valuing a business is based on its maintainable earnings. This method is used for businesses with a trading history where it's likely that the value of the business will exceed the underlying value of its assets. This method determines the future maintainable earnings of the business, an appropriate earnings multiple, and the value of any assets surplus to the core business. The multiple applied to the business may be impacted by COVID-19 as the multiple falls as risk increases. For example, a business that was valued at four times earnings pre-pandemic might achieve a lower multiple as the pandemic presents a risk to the likelihood of the business achieving earnings consistent with pre-pandemic conditions.

The pandemic has added significantly greater complexity to the valuation process, meaning buyers and sellers should work even more closely with their advisers before making a decision.

If you are purchasing a business and would like a due diligence completed, or looking to sell, merge or engage with investors, contact us for more details on the steps to take.

JobKeeper Alert

With the employee test date for JobKeeper moved to 1 July 2020, some additional employees might have become eligible for JobKeeper. The August JobKeeper monthly business declaration is due by 14 September and is different to the previous form as it covers three JobKeeper fortnights. Employers need to ensure that they identify all additional employees who could be eligible for JobKeeper to ensure that they comply with the "one in, all in" principle and that they meet the nomination requirements.

To receive JobKeeper from 28 September 2020, employers need to reassess their eligibility with reference to actual GST turnover for the September 2020 quarter (for JobKeeper payments between 28 September to 3 January 2021), and again for December 2020 quarter (for payments between 4 January 2021 to 28 March 2021). However, we are still waiting on the rules relating to these periods to be released.

Question of the month – tax on COVID-19 grants

My business received a grant from the State Government. Do I pay tax on it?

Short answer; probably.

Income tax - Grants are likely to be taxable unless they are specifically excluded from tax.

If the grant relates to your continuing business activities, then it is likely to be included in assessable income for income tax purposes. The position can be different in cases where the payment is made so that the entity can commence a new business or cease carrying on a business.

Goods & Services Tax - Government grants are not generally subject to GST unless the grant is for a supply of something. The ATO has indicated that the cashflow boost and JobKeeper payments are not subject to GST, this seems to be on the basis that they are not consideration for a supply.

Normally, we look at whether the entity has to do something to obtain the payment / grant. This could include entering into an agreement to do something or refrain from doing something. If not, there won't generally be any GST because no supply is or has been made.

JobKeeper turnover calculations - If GST does not apply to the grant, then it should not be included in the decline in turnover test for the initial phase of JobKeeper or the GST turnover figures that are reported to the ATO on a monthly basis by entities that are participating in JobKeeper.

The exception is the university sector where core Commonwealth Government financial assistance provided is included in the JobKeeper turnover tests.

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Quote of the month

Start by doing what's necessary; then do what's possible; and suddenly you are doing the impossible.

Francis of Assisi

Forecasting during a pandemic

How do you plan for uncertainty when every assumption is subject to change?

Now, more than ever, business operators should have a plan in place to manage during uncertain times. Even if your business is not directly impacted, it's likely your customers, your supply chain, and your workforce will be to some extent.

Understand where you stand now

Businesses fail (or fail to thrive) for a myriad of reasons, but the precursor is often a failure to understand what is occurring and what to monitor. Strategically, managers need to be on top of their numbers to identify and manage problems before they get out of hand. If you do not know what the key drivers of your business are - the things that make the difference between doing well and going under - then it's time to find out.

Understanding your cost structure

Do you know what your real cost of doing business is? Your breakeven point is the level of sales activity where your business is neither making a profit or a loss. Calculate your breakeven point by dividing your fixed expenses by your gross profit margin. This figure represents the level of sales income you need to breakeven.

Understanding your breakeven point is crucial particularly when supply chains are impacted.

Not only will your breakeven point assist you to monitor business performance, it's critical when deciding whether or not to offer a discount. If your breakeven point is well below your current operating level then you have a good buffer in your profits to manage growth, invest in further capital opportunities, and to protect yourself against further downturns in operating performance. And before you say "I know that," ask yourself how many people actually put this theory into practice. Even some of the largest businesses have been caught out on this one and tie up valuable resources in unprofitable projects and products.

Putting up your prices during down times is not an act of social betrayal. If your prices have increased you should flow these through unless you are comfortable making less for the same amount of effort, or you are in an industry that is so price sensitive you have no choice but to follow the lead of larger businesses.

Discounting creates a leverage impact on profits. By discounting you are giving away some or all of your profits. The key is to understand the impact and just how far you can go. For example, a business with a 30% gross profit margin that offers a 25% discount (certainly nothing unusual about that in today's market) needs a 500% increase in sales volume just to maintain the same position – and, in almost all cases, that's just not going to happen. The result generally is that the business trades below its breakeven point and generates a loss. You can only do that for a limited amount of time (and some of your larger competitors might be engaging in a discounting war with you in an attempt to bury you once and for all).

If your business needs cash and needs it quickly, discounting might be the only way to shift stock but understand the implications.

Plan, review and adjust

Your budget should be your best estimate of what is likely to occur based on current knowledge. To manage change, you can scenario plan where your budget forms the baseline, but you also forecast best and worst case scenarios based on potential risks and their likelihood (for example, the impact of another lockdown). Or, the simplest method is to use your budget as a baseline and regularly review and adjust depending on current conditions.

The greatest risk to your profit is unlikely to come from your cost structure. It is more likely to be revenue volatility. Keep your eye on your cost structure and make sensible cuts where appropriate. But, in your search for savings don't remove your essential revenue generating capacity that you need.

A lack of profit will eventually erode your business, but not enough cash will kill it stone dead. Businesses will fail because they don't manage their cash position. Plan, track and measure your cashflow. This not only means closely monitoring your debtor collections and inventory but also running a rolling three month cashflow position. This should provide an early warning of brewing problems.

Manage your debt levels carefully (your bank is likely to). While there is nothing wrong with debt, it is likely that the banks will be closely watching customer accounts. Where you have loan facilities in place make sure that you understand the loan terms and any debt covenants that you have entered into. These covenants could include regular reporting to the bank, debtor and working capital ratios, or debt to equity ratios. Where the banks may have been more relaxed about these in the past, this year will be different. If you believe that you need additional funding, talk to your bank early and don't wait until the last minute. You'll need to present your case on why you need it, how much, for how long and when it will be repaid.

Cash flows, operating budgets, cost control and debt management all need to be part of your business management. The more in control you are the lower your risk position.

Understand the external environment

The COVID-19 pandemic has implications well beyond the economy; it has changed how business operates and how consumers act. While comparisons are made to the 2008 Global Financial Crisis and the recessions of the 1980s and 1990s, the reality is, we have no case study. There is no rule book for the post pandemic road to recovery as this is not an economic event. The pandemic pulls the economy up short curtailing both supply and demand; businesses are not operating at capacity and fewer people are working.

The Federal Budget is released on 6 October and we're expecting to see the Government invest heavily in job creating projects. Many of these will be focussed on infrastructure. Each of these projects will have a flow through effect to the broader economy. We'll bring you our insights the day after the budget and you should loom to see if there are opportunities your business can capture.

Understanding your supply chain is important. Risk manage and plan for changing conditions. For example, what is your business's ability to manage a surge in demand, do you have a small supply base and what would happen if your primary supplier went into bankruptcy, do you have a good flow of information across your supply chain or is there a lack of transparency and knowledge, do transport problems risk your ability to supply? Assess it, understand it, and manage the risks.

When it comes to demand, there is no instant fix. The RBA suggests the decline in GDP in the first half of 2020 is around 7% and the contraction in hours worked around 10%. The economic impact of the restrictions in Melbourne extend well beyond Victoria and are impacting more generally on consumer sentiment. This week we expect Australia to have a formal "recession" label added to our economy, formalising what most business operators already know.

But it is not all bad news with confidence lifting on early signs that revenue is no longer declining for the majority of Australian businesses. The latest ABS data on the impact of COVID-19 shows fewer businesses reported a decline in revenue in August (41%) compared to July (46%), and fewer still expect a decline in September (28%).

However, 35% of businesses expect it to be "difficult or very difficult" to meet financial commitments over the next three months, with small and medium businesses almost twice as likely as large businesses to fall into this category. Understandably, the response to this question is heavily weighted towards those operating under Government required restrictions and lockdowns.

The RBA is working with three scenarios for Australia's economic outlook: a baseline, upside and downside scenario. In the baseline scenario, conditions improve in the second half of 2020 and slowly improve over 2021 and 2022 but fall short of returning to pre COVID forecasts with Victoria's lockdown not materially extended and Australia's international borders remaining closed until mid 2021. The upside scenario saw no extension of the Melbourne lockdown, and further easing of Government restrictions nationally, which in turn bolster consumer confidence, encouraging spending and the reversal of GDP decline over 2020-21. The downside scenario envisages a global resurgence in infections with Australia facing periodic outbreaks and rolling lockdowns. The RBA notes that the downside scenario has a sharper fall than the increase of the upside scenario because of the damage to consumer confidence of further lockdowns.

Business investment is also expected to be relatively flat with the ABS survey showing that 37% of those surveyed had no actual or planned expenditure. Of those that are spending, IT hardware and software, and equipment and machinery topped the list. The instant asset write-off is helping to stimulate business investment in the small and medium business sector. In general, large businesses are paying down debt rather than spending and small and medium businesses have not sought to extend debt to fund investment.

We can help give you insight into the performance of your business. Contact us at 02 9283 9888 to find out the gain you need.