The valuation of franchises:

A restaurant case study

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DISSERTATION SUMMARY

TITLE: The valuation of franchises: A restaurant case study

KEYWORDS: Franchise, Restaurant, Valuation, Valuation approach, Valuation method

The objective of a business valuation arrangement is to reach a reasonable and acceptable opinion of value. Valuing a business entity has become less of a guessing game than before. Business valuations are two thirds science and one third art according to several theorists and practitioners. The result of a valuation is only definite if it can accurately predict the future, and given that it is not possible, there will always be an element of risk that the actual value differs from the expected estimate.

There are several reasons why business valuations need to be performed. They can be categorised into three groups, namely transaction-based, tax-based, and litigation-based. Most business entities will require a business valuation at some stage. Business valuations can be categorized into different approaches and methods. The three approaches comprise the income based valuation approach, the market derived valuation approach, as well as the asset based valuation approach. Each one of these approaches has different methods that can be used under them. For the purpose of this research study, the methods used under the income based valuation approach are the discounted economic income valuation method and the direct capitalisation valuation method. The guideline publicly traded business entity valuation method and the merger and acquired business entity valuation method are used under the market derived valuation approach. When performing a business valuation under the asset based valuation approach, the asset accumulation valuation method and the capitalised excess earnings valuation method are used.

In this research study a business valuation is going to be performed on a franchised restaurant, namely a Spur Steak Ranch. The particular Spur Steak Ranch that is going to be used is the Tampa Bay Spur.

A franchise is a right granted to individuals or groups to market a business entity's products or services within a particular location. Franchising is a method of expanding a business entity on less capital than would otherwise be possible. The franchisee pays a capital lump sum to enter the franchise and accepts some of the running costs of its outlet. In addition, the franchise offers the franchisee the use of the franchise name and any goodwill related with it, the use of its business structures and support services, its product or service to sell, as well as management and staff training programmes. Franchising has become a dominant force in the distribution of products and services in several parts of the world.

Any facility that prepares separate meals for eating on or off the premises falls under the title ''restaurant.'' Not one restaurant is the same, and by producing meal experiences with unique characteristics, restaurants accommodate the requirements of particular customer categories. A restaurant is as much a financial entity as any other business entity. The most important elements in profitability in restaurants are economy and productivity.

The franchised restaurant used in this research study is the Spur Steak Ranch which has been in South Africa for over 40 years. Allen Ambor, the founder and executive chairperson of Spur, is the person who started it all in 1967 when he invested R4,000 to open the *Golden Spur* in Newlands, Cape Town. Today, Spur restaurants are very popular for having play areas for children, thus, entertaining the whole family, making Spur a very popular fully-licensed franchised restaurant.

The particular Spur Steak ranch used in this case study is the Tampa Bay Spur. The Tampa Bay Spur Steak Ranch is a family-oriented franchised restaurant, based on the widely known Spur concepts. The restaurant is owned by Lungisa Financial Administrators and is located in the Time Square Building, Dias Road, in Jeffrey's Bay. The restaurant spans in the region of 550m^2 and can accommodate up to 180 customers. The Tampa Bay Spur was taken over by new owners in December 2011 and also completed a revamp that ended in March 2011.

The research question and objective in this research study is to find out what combination of valuation approaches and methods seems to be the most reliable and accurate to value a

franchised restaurant, particularly, a Spur Steak Ranch, and more specific the Tampa Bay Spur. To achieve this objective, five secondary objectives must be carried out. The first objective is to critically evaluate and compare popular valuation approaches and methods with each other. The second objective is to deliberate the advantages and disadvantages of each of the methods. Thirdly, to point out the uncertainty factors in valuations, for example, to calculate the discount rate by using the WACC or CAPM formula. The fourth objective is to develop an empirical case study based on actual information of a selected Spur (Tampa Bay Spur) and comparing different valuation approaches and methods with the original amount calculated by Spur after performing a business valuation on the Tampa Bay Spur. The fifth and last objective is to make recommendations regarding the valuation method used by the Spur.

After performing a business valuation on the Tampa Bay Spur by using several valuation approaches and methods, calculating an average value from the different approaches and comparing it to the original value that the Spur calculated after performing a valuation on the Tampa Bay Spur, a conclusion can be made that the valuation method used by the Spur is fair and reliable. However, the method used by the Spur does not give enough insight for the buyer and seller to understand how they calculated the final value and needs improvement.

VERHANDELING-OPSOMMING

Titel: Die waardasie van franchises: ‘n Gevallestudie

Sleutelterme: Franchise, Restaurant, Waardasie, Waardasiebenadering, Waardasie metode

Die doel van ‘n besigheidswaardasie is om ‘n redelike en aanvaarbare mening rakende waarde te kry. Om ‘n sake-entiteit te waardeer sluit nie meer soveel raaiwerk in as voorheen nie. Besigheidsevaluering bestaan uit twee derdes wetenskap en een derde kuns, volgens verskeie teoretici en praktisyns. Die resultaat van ’n waardasie is slegs korrek indien dit die toekoms akkuraat kan voorspel, en aangesien dit onmoontlik is, is daar altyd ’n element van risiko dat die werklike waarde kan verskil van die verwagte skatting.

Daar is verskeie redes waarom besigheidswaardasies uitgevoer moet word. Die redes kan in drie kategorieë verdeel word, naamlik transaksiegebaseer, belastinggebaseer en litigasiegebaseer. Die meeste besigheidsentiteite sal op een of ander stadium ‘n besigheidswaardasie benodig. Besigheidswaardasies kan in verskillende benaderings en metodes verdeel word. Die drie benaderings is die inkomstegebaseerde, die van die mark afgeleide en die bategebaseerde benadering. By elk van hierdie benaderings kan verskillende metodes gebruik word. Vir die doeleinde van hierdie studie is onder die inkomstegebaseerde benadering die afslag-ekonomiese inkomstewaardasiemetode en die direkte kapitalisasiewaardasiemetode gebruik. Die riglyn publieke verhandelde besigheidsentitieit-waardasiemetode en die samevoegings- en verworwe besigheidsentitieit-waardasiemetode is gebruik onder die markafgeleide waardasiebenadering. Wanneer ‘n besigheidswaardasie onder die bategebaseerde waardasiebenadering gedoen word, word die bategebaseerde waardasiebenadering en die gekapitaliseerde oortollige verdienste-waardasiemetode gebruik.

In hierdie navorsingstudie word ‘n besigheidswaardasie uitgevoer op ‘n konsessierestaurant, ‘n *Spur Steak Ranch*, en die *Tampa Bay Spur* is die bepaalde restaurant wat gebruik word.

‘n Konsessie is die reg wat verleen word aan individue of groepe om ‘n besigheidsentiteit se produkte of dienste binne ‘n bepaalde omgewing te bemark. Konsessies of agentskappe is ‘n manier om ‘n besigheidsentiteit uit te brei met minder kapitaal as wat andersins moontlik sou wees. Die konsessiehouer betaal ‘n totaalbedrag om die konsessie te bekom, en aanvaar sommige van die bedryfskoste van die agentskap of konsessie en enige welwillendheid daaraan verbonde, asook die gebruik van sy besigheidstrukture en ondersteuningsdienste, sy produk of dienste om te verkoop en bestuur- en personeelopleidingsprogramme. Konsessie het ‘n dominante mag in die verspreiding van produkte en dienste in verskeie dele van die wêreld geword.

Enige fasiliteit wat afsonderlike maaltye voorberei om op die terrein of elders geëet te word, staan bekend as ‘n ***restaurant***. Nie twee restaurante is dieselfde nie, en deur maaltye met unieke eienskappe te voorsien, bedien restaurante verskillende groepe klante en hulle behoeftes. ‘n Restaurant is net so ‘n finansiële entiteit soos enige ander besigheidsentiteit. Die belangrikste elemente van winsgewendheid in restaurante is ekonomie en produktiwiteit.

Die konsessierestaurant in hierdie studie gebruik is die *Spur Steak Ranch* wat reeds meer as 40 jaar in Suid-Afrika is. Allen Ambor,die stigter en uitvoerende voorsitter van *Spur*, is die persoon wat dit alles begin het toe hy in 1967 R4,000 belê het om die *Golden Spur*in Newlands, Kaapstad te begin. *Spur*-restaurante is deesdae uiters gewild omdat hulle speelareas vir kinders het en sodoende vermaak aan die hele gesin bied. Die *Spur* is ‘n populêre, ten volle gelisensieerde konsessierestaurant.

Die spesifieke *Spur Steak Ranch* in hierdie gevallestudie gebruik is die *Tampa Bay Spur*. Die *Tampa Bay Spur Steak Ranch* is ‘n gesinsgeöriënteerde konsessierestaurant wat op die welbekende *Spur*-konsepte gebaseer is. Die restaurant word besit deur Lungisa Financial Administrators en is geleë in die *Time Square* Gebou in Diasweg, Jeffreysbaai. Die restaurant beslaan ‘n oppervlak van ongeveer $550m^2$ en kan tot 180 klante akkommodeer. Die *Tampa Bay Spur* is in Maart 2011 deur nuwe eienaars oorgeneem wat ook die opknapping in Maart 2011 voltooi het.

Die navorsingsvraag en –doelwit in hierdie studie is om te bepaal watter kombinasie van waardebenaderings en metodes die betroubaarste te en akkuraatste skyn te wees om ‘n konsessierestaurent te waardeer, in besonder ‘n *Spur Steak Ranch* en meer bepaald die *Tampa Bay Spur*. Ten einde hierdie doelwit te bereik moet vyf sekondêre doelwitte uitgevoer word. Eerstens moet populêre waardasiebenaderings krities geëvalueer en met mekaar vergelyk word. Die tweede doelwit is om die voor-ennadele vanelk van hierdie metodes te bepaal. Derdens moet die onsekerheidsfaktore in waardasies aangedui word, bv. Om die afslagkoers te bereken deur die WACC of CAPM formule te gebruik. Die vierde doelwit is om ‘n empiriese gevallestudie te ontwikkel wat gebaseer is op werklike inligting verkry van ‘n bepaalde *Spur* (die *Tampa Bay Spur*) en verskillende waardasiebenaderings en –metodes te vergelyk metdie oorspronklik bedrag deur die *Spur* bereken nadat ‘n besigheidwaardasie van die *Tampa Bay Spur* gedoen is. Die vyfde en laaste doelwit is om aanbevelings te maak rakende die evalueringsmetodes deur die *Spur* gebruik

Nadat ‘n besigheidswaardasie van die *Tampa Bay Spur* gedoen is deur verskeie waardasiebeanderings te gebruik om ‘n gemiddelde waarde van die verskillende te verkry en dit met die oorspronklike deur die *Spur* bereken te vergelyk, kan die gevolgtrekking gemaak word dat die waardasiemetode deur die *Spur* gebruik regverdig en betroubaar is. Die metode deur die *Spur* gebruik verskaf egter nie voldoende insig aan die koper en verkoper om te begryp hoedat die finale waarde bereken is nie, en moet verbeter word.

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LIST OF ABBREVIATIONS

APT	Arbitrage-pricing model
APV	Adjusted present value
ARM	Appeals and review memorandum
ASA	American Society of Appraisers
ASE	American Stock Exchange
B	Beta
CAP	Capitalisation rate
CAPM	Capital asset pricing model
CCH	Canadian income tax book and software publisher
CF	Adjusted cash flow
CICVB	Canadian Institute of Chartered Business Valuators
CIMA	Chartered Institute of Management Accountants
D	Dividend
DCF	Discounted cash flow
EBDT	Earnings before depreciation, other noncash charges, and taxes
EBIT	Earnings before interest and tax
EBITA	Earnings before interest, taxes, and owner's compensation
EBITDA	Earnings before interest, taxes, depreciation and amortisation
EBT	Earnings before tax
EDGAR	Electronic Data Gathering and Retrieval
EMRP	Equity market risk premium
EPS	Earnings per share
ESOP	Employee stock ownership plan
EVA	Economic value added

FDD	Franchise disclosure document
FIFO	First in first out
FMV	Fair market value
FTC	Federal Trade Commission
G	Growth
GAAP	Generally accepted accounting principles
GDP	Gross domestic product
IBA	Institute of Business Appraisers
IFA	International Franchise Association
IPO	Initial public offerings
JSE	Johannesburg Stock Exchange
LIFO	Last in first out
MVIC	Market value of invested capital
NACVA	National Association of Certified Valuation Analysts
NAICS	North American Industry Classification System
NAV	Net asset value
NPV	Net present value
NYSE	New York Stock Exchange
P/B	Price/book
P/CV	Price/cash flow
P/E	Price/earnings
P/G	Price to gross
PwC	PricewaterhouseCoopers
Re	Cost of equity
ROA	Return on assets
ROE	Return on equity
SIC	Standard Industrial Classification

UFOC	Uniform Offering Circular
USPAP	Uniform Standards of Professional Appraisal Practice
WACC	Weighted average cost of capital

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CHAPTER 1

1. INTRODUCTION

1.1. Background

The goal of a business valuation arrangement is to reach a reasonable and acceptable opinion of value (Modica, 2010:191). Knowing the value of business entities is as significant an issue for owners of small or closely held business entities as it is for shareholders and management of the largest corporations (Gomes, 1988:23). The owner of a business entity seldom feels the need for a formal valuation, until it is required, as in the case of death of the owner. Likewise, curiosity rarely motivates the owner to go to the expense of hiring someone to value the business entity (Fodor & Mazza, 1992:171). In some cases, owners of business entities want accountants to tell them what their business entity is worth, or at least offer an opinion as to a range of values (Sliwoski, 1999:8). Valuing a business entity has become less of a guessing game than it used to be. Each business entity is different, even when they are in the same industry (Burton, 1999). Still, it remains an art (Parker, 2009; French, 2004:484; Gabehart & Brinkley, 2002:2). According to Modica (2010:187), business valuations are two thirds science and one third art. The outcome of a valuation is only certain if it can accurately predict the future (French, 2004:485). Given that it is not possible, there will always be an element of risk that the actual value will deviate from the predicted estimate.

There are numerous reasons why business valuations are performed, which can conveniently be categorised into three groupings, namely transaction-based, tax-based and litigation-based (Reilly & Schweihs, 2004:1; Gabehart & Brinkley, 2002:16; Lannom, 1999:5; Fodor & Mazza, 1992:171). Most business entities will need to do a valuation at some stage (Gabehart & Brinkley, 2002:16). Examples of transaction-based valuations include mergers and acquisitions, divestitures, buy-and-sell agreements, and exchange ratios. Gift and estate taxes are used for tax-based valuations. The most common category is the litigation-based valuation that is used for divorce, condemnation, bankruptcy, shareholder actions and breach of contract (Lannom, 1999:5). It is important to understand that numerous valuation myths exist, including that

valuations are quantitative, correct, objective, have precision, are valid over an extended time, and only the answer matters. Valuations are a function of estimates about future cash flows, profit and estimates of the cost of capital. Therefore, even in the most perfect circumstances they are approximations (Correia, Flynn, Uliana & Wormald, 2010:6.2; Penman, 1998:294).

A professional valuation is commonly the most formal type of value opinion because it requires the knowledge of the valuation process that includes understanding value theory and the proper application of accepted approaches, methods and procedures (Lannom, 1999:5). South Africa does not have a professional institute for specialist valuators, such as the Canadian Institute of Chartered Business Valuators (CICVB) or the American Society of Appraisers (ASA) (Dellinger, 2010:59; Modica, 2010:188; Pratt & Niculita, 2008:10; Lannom, 1999:7; Pratt, Reilly & Schwiehs, 1998:6). Becoming a business valuer can mean going through a relatively straightforward licensing process in some countries (e.g. the USA), where licensing is controlled on a state basis and the recognition of licences between states is very limited and entry requirements are low (Gilbertson & Preston, 2005:124). In other countries (e.g. Canada), a more demanding approach is required, involving a minimum of a university degree and period of supervised experience, further professional examinations, and a peer assessment (Gilbertson & Preston, 2005:139). Not having professional or specialist valuers can be a big problem in South Africa because valuation is a public interest profession and every self-respecting country should have such an institute (Gilbertson & Preston, 2005:123; Burton, 1999). It is important for business entities to get good quality data, because accurate and reliable valuations depend on these. Where the supply of objective comparable data is poor or the evidence is incomplete, the person conducting the valuation is forced to apply professional judgement, which is often subjective and increases the scope for error (Rowley, Fisher & Holmes, 1998:99). It should be expected that the valuer will be independent and will provide the best estimate of value according to the applicable standard of value, without unfairness (Pratt, Reilly & Schwiehs, 1998:791).

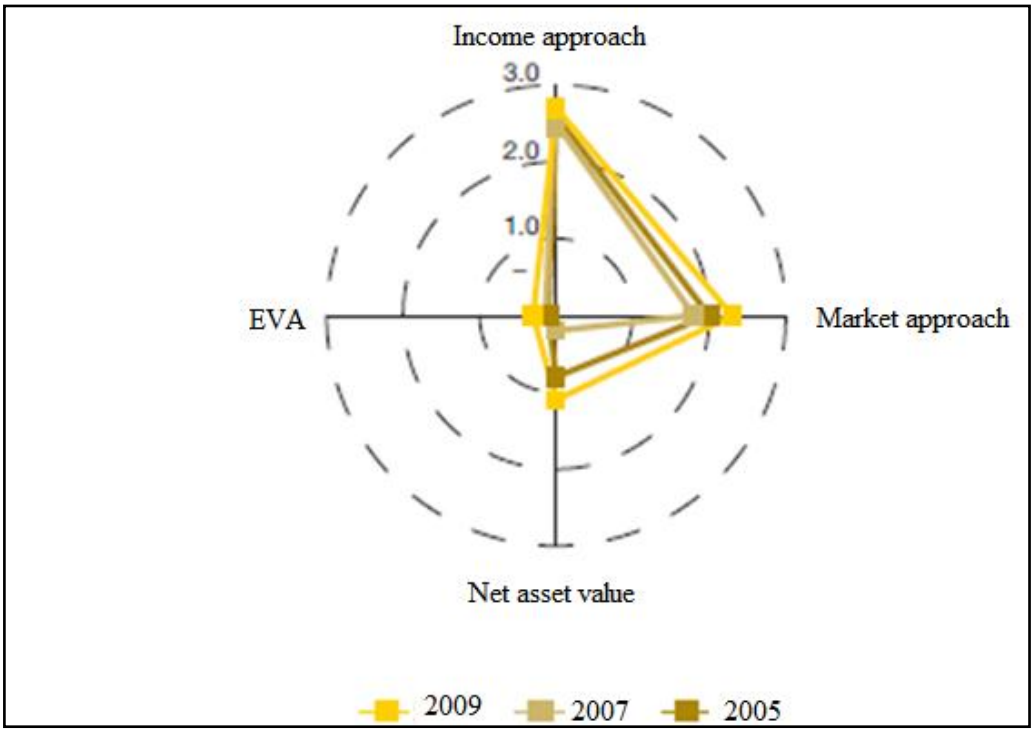
1.2. Business valuations

For the reason that there is more than one approach and method of valuing a business entity, and each industry often uses different valuation approaches, it is often difficult to grasp whether business valuations are more of an art or more of a science. According to Scarlata (1999:80) and Smith and Smith (2005:18), valuing business entities is part art, part science, wherein logic must prevail. Avoiding overstated and unsustainable valuations requires an artistic approach, along with a scientific foundation to valuation methods. The *science* of valuations is grounded in academia, based on three key approaches, namely the *income*, *market*, and *asset-based* approaches, while the *art* of valuations is rooted in the experience of the valuation experts (Smith & Smith, 2005:18). Over-reliance on the science aspect can be deceiving when not enough attention is paid to the art aspect (Smith & Smith, 2005:18).

For the reason of the human element and the great importance of management, no matter how well a business entity may be valued, it is still subject to failure. A good valuation report must be thorough, balanced, readable, coherent, and well supported (Ellenstuck, 2006). It is possible to consider valuations from two perspectives, namely from the seller's and from the buyer's perspectives respectively. Sellers are often over optimistic regarding the price they want for their business entity, regardless of what price range the business brokers or appraisers show them from their books and records, while the buyers often feel the business is overpriced (Allen, 1999:9).

There are many different valuation methods. Some are more complex than others, or more suited for a certain size business entity or specific industry (Taub, 1999:23). According to Booth (2007:29), theoretically, there is one correct value for each business entity, but in practice, there are multiple ways of calculating it (Modica, 2010:193; PwC, 2010:19; Kelley, 2007:19; Smith & Smith, 2005, 18;). According to PricewaterhouseCoopers (PwC, 2010:21), the most commonly used valuation approaches are the *income*, *market* and *net-assets approaches* (Dellinger, 2010:59; Modica, 2010:193; Pratt & Niculita, 2008:62; Smith & Smith, 2005:18; Van Vleet, 2004:74; Reilly, 2003:94; Gabehart & Brinkley, 2002:4).

Figure 1.1: Valuation approaches



(PwC, 2010:21)

These approaches are briefly discussed below:

- The *income approach* indicates the market value of the ordinary shares of a business entity based on the value of the cash flow that the business entity could be expected to generate in the future. This includes discounted cash flow techniques and real option valuations, which use option-pricing models to measure the value of assets (Modica, 2010:194; PwC, 2010:19). The income approach values a business entity as the present value of the future income expected to be earned by the owners of a business entity. The two most common methods used in the income approach are the *discounted economic income* and the *direct capitalisation method* (Reilly, 2003:94).
- The *market approach* indicates the market value of the ordinary shares of a business entity based on a comparison of the business entity to comparable publicly-traded business entities and transactions in its industry, as well as past transactions in the ordinary shares of the business entity (Modica, 2010:195; PwC, 2010:19). The market

approach values a business entity by reference to market-derived pricing multiples extracted from actual sales of comparative business entities. The two most common methods used are the *guideline publicly traded business entity method* and *the guideline merger and acquired business entity method* (Reilly, 2003:94).

- The *net-assets approach* indicates the market value of the ordinary shares of a business entity by adjusting the assets and liability balances on the business entity's balance sheet to its market value equivalents. This approach is based on the summary of the individual disorganised market value of the underlying assets less the market value of the liabilities (Modica, 2010:195; PwC, 2010:19). The asset-based approach values a business entity by reference to the current value of all its assets, tangible and intangible assets less the current value of all its liabilities. The two most common used methods are the *net-asset value method* and the *asset accumulation method* (Reilly, 2003:94).

Whatever approach or method of valuation is used, the practitioner should be fully aware of its limitations. It is important that practitioners understand all techniques (Peto, French & Bowman, 1996:99). According to Gabehart and Brinkley (2002:44), there is no single best approach or method.

1.3. Franchising in the foodservice industry

1.3.1. Franchising

A franchise is a right granted to an individual or group to market a business entity's goods or services within a certain territory or location (Weaven & Frazer, 2006:225; Gonzalez, Cataluna, Diez-de Castro & Garcia, 2010:1568; Daszkowski, 2011a). According to the Chartered Institute of Management Accountants (CIMA, 2011a:197), franchising is a method of expanding the business entity on less capital than would otherwise be possible. The franchisee pays a capital lump sum to enter the franchise and accepts some of the running costs of its outlet. The franchise offers the franchisee the use of the franchise name and any goodwill associated with it, the use of its business systems and support services, its product or service to sell, and management and staff training programmes. In return, the franchisee pays the franchisers for being granted their

rights. The franchisee has responsibility for day-to-day running and for the ultimate profitability of his franchise. The franchisee supplies capital, personal involvement, and local market knowledge (Luangsuvimol & Kleiner, 2004:63). For the reason that the franchisor receives royalties on the franchisees' gross sales, they seek to maximise system-wide sales, whereas franchisees seek to maximise the net profits of their individual outlets (Nair, Tikoo & Liu, 2009:207).

Franchising has become a dominant force in the distribution of goods and services in many parts of the world. It is predicted that it will become the primary method of doing business and expanding businesses worldwide. Franchising in the international market is expanding rapidly, and particularly restaurant franchises have seen a tremendous increase in recent years, according to Khan (2005:188). Many studies have examined the franchise phenomenon, such as franchising in the Australian restaurant and hotel sectors (Hing, 1999:502), franchising in the catering and fashion sector (Polo-Redondo, 2011:170) and franchising in the bakery sector (Davis, 2005:65). These studies primarily focus on the franchiser's motivations, which are to create a rapid market presence, to get off balance sheet financing and to increase and exploit their trademark and goodwill.

The practice of franchising is widespread in most Western economies, particularly in the hotel and restaurant industry (Hing, 1999:502).With franchising being such a universal force in the economy, eventually the valuation specialists can expect to come across situations involving franchises. These may come up in buy-and-sell agreements, to justify an asking price for possible buyers, as well as in more argumentative areas, like the calculation of damages in franchise litigation, arbitration, or in matrimonial disputes. However, there is not much information available about franchise valuations, for example, the National Association of Certified Valuation Analysts (NACVA) database has no valuation standards that are franchise specific, and the Canadian income tax book and software publisher's (CCH) business valuation guide does not even have the word franchise in its index. It also has nothing on valuing franchises in its tens of thousands of pages (Schaeffer & Ogulnick, 2008:37).

1.3.2. Restaurant valuations

According to Allen and Albala (2007:323), any facility that cooks individual meals for eating on or off the premises falls under the title "restaurant." According to Harris and Mongiello (2007:240), all restaurants are different, and by producing meal experiences with unique characteristics, restaurants cater for the needs of specific customer categories. A restaurant is as much an economic unit as any other business entity. The most important elements in profitability in restaurants are economy and productivity (Harris & Mongiello, 2007:23).

Even though the action of accurately valuating a restaurant is challenging, it does not have to be a devastating task (Parker, 2009). The buyer must always keep in mind that the asking price is not always the purchase price. Sellers are emotionally attached to their business entity and would like to factor their years of hard work into their valuation calculation. Emotional issues, however, have to be discarded in the valuation equation. The most popular methods to value a restaurant are the *rule of thumb* method (Holten & Bates, 2009:134; Parker, 2009) and the *multiple of discretionary cash flow valuation method* (Perkins, 1999:332).

To the inexperienced, the range of concepts that exist within the restaurant industry can be very vague, and many practitioners fail to distinguish between a trend and a concept. A trend tends to be temporary and has yet to establish itself for the long term, while a concept has structure, performance, definition and established brand recognition. Although it may be difficult to distinguish based upon style of service, valuing, and the content of the menu, a general classification of concepts would include *fast food*, *coffee shops*, *family style restaurants*, *gourmet restaurants*, *bars*, *ethnic restaurants*, *cafés*, *nightclubs* and *brew pubs* (Perkins,1999:325). Restaurants often have their own creative accounting systems and unless the valuators have experience in the industry and know what to look for, there are many variables to consider and the valuation can be a difficult process (Perkins, 1999:329).

1.4. Motivation of study

Spur Steak Ranches have been in South Africa for over 40 years. Allen Ambor, the founder and executive chairperson of Spur, is the person who started it all in 1967 when he invested R4,000

to open the *Golden Spur* in Newlands, Cape Town (Makholwa, 2010). It became popular for its tasty, nutritious, value-for-money meals and selling the famous Spur Burger for just 40 cents in the 1960s. The Spur has a reputation for having a warm, relaxed, family-friendly environment. Today, Spur restaurants are very popular for having play areas for children, thus entertaining the whole family and making *Spur* a very popular fully-licensed franchised restaurant (Makholwa, 2010).

The *Tampa Bay Spur Steak Ranch*, used as the research case study, is a family-oriented franchised restaurant, based on the widely known Spur concepts. The restaurant is owned by Lungisa Financial Administrators and is situated in the Time Square Building, Dias Road, in Jeffrey's Bay. The restaurant spans approximately 550m^2 and can accommodate up to 180 patrons. It presently employs 25 kitchen personnel and four floor managers (two *front-of-house* and two *back-of-house* managers). Working above the four managers is one *operating manager*. Currently, 17 waiters work different shifts, which consist of seven hours a shift from 09:00 to 16:00 or 16:00 to 23:00. Transport is organised for staff members living far from the restaurant. The restaurant has been open for nine years and is well established in the area. Jeffrey's Bay is known for the Billabong surfing contest that takes place there twice a year and attracts many people from overseas, including the USA, Australia, New Zealand and England. Except for the surfing contests, Jeffrey's Bay also attracts South Africans with its cultural festivals, such as the '*skulpie*, *naartjie*, and *biltong*' festivals. The restaurant was recently (1 March 2011) taken over by a new owner and was revamped as well.

1.5. Problem statement

Valuing a franchise, especially a franchise in the food sector, is different from valuing business entities in other industries (Schaeffer & Ogulnick, 2008:38). The question asked is which combination of valuation approaches and methods seems to be the most reliable and accurate to value a franchised restaurant. The most popular method used by many theorists is the *multiple of discretionary cash flow*, which is an income approach (Perkins, 1999:332). Parker (2009) argues that it is acceptable to use the *asset valuation approach*, the *income capitalisation valuation method*, the *income multiple valuation method* and *rules of thumb* when valuing a restaurant,

while Holten & Bates (2009:134) only use *rule of thumb* when valuing a restaurant. Pratt (2003: 247-307) demonstrates in a case study in which a restaurant, similar to the Spur, is valued, that it is appropriate to use the *discounted economic income valuation method*, the *direct capitalisation valuation method*, and the *guideline public company valuation method*, using adjusted statements. Spur Steak Ranch, as a South African franchised restaurant, uses *only* the *multiple of cash flow earnings method*. Therefore, the primary research questions that need to be answered are the following:

- Is the current valuation method that the Spur Franchise Group prescribes really the most reliable and accurate method?
- Must they only use one method of doing a valuation, or should multiple methods be used?

1.6. Objectives

The main objective of this study is to determine what combination of valuation approaches and methods is the most reliable and accurate for a franchise in the food sector. The main objective will be achieved by means of the following secondary objectives:

- Critically evaluating and comparing popular valuation approaches and methods with each other.
- Deliberating the advantages and disadvantages of each of the methods.
- Pointing out the uncertainty factors in valuations, like *Cost of Capital* in the income approach and calculating the discount rate by using the *WACC* or *CAPM*.
- Developing an empirical case study based on actual information of a selected Spur, and comparing different valuation approaches and methods with the valuation performed by the Spur Steak Ranch.
- Making recommendations regarding the valuation method the Spur Steak Ranch uses.

1.7. Research methodology

To achieve the above objectives, a thorough literature review with a supporting case study will be conducted.

1.7.1. Literature review

The theoretical study to be conducted will review and consider the theoretical aspects of business valuations. Published academic research conducted locally and internationally will be included in the research, where the opinions of different theorists will be analysed and compared. The reason for doing this is to achieve respectable insight into both the valuation procedure and the extent to which the literature agrees or disagrees on different aspects.

1.7.2. Empirical research

The empirical study will include the analysis of financial data of a franchise in the food sector. In this case, it is a restaurant/steak ranch, namely the *Tampa Bay Spur* in Jeffrey's Bay. Five years' financial information (2006-2010) will be gathered, consisting of the *statement of financial position* and the *statement of financial performance*. Statistical charts will be created of the most important and key data. Various types of valuation approaches and methods will be used to value the franchised restaurant, comparing it to the original valuation and valuation technique used by

the franchised restaurant itself. The results of the different valuation methods will be measured up against each other as well as to the original valuation.

1.8. List of definitions

For purposes of this study, the following definitions are taken as correct.

Adjusted Book Value Method - A method within the asset-based valuation approach whereby all assets and liabilities are adjusted to their fair market values (BVR, 2009; Gabehart & Brinkley, 2002).

Arbitrage Pricing Theory - A multivariate model for estimating the cost of equity capital, which includes numerous systematic risk factors (PwC, 2010; BVR, 2009).

Asset-Based Approach - A general way of determining a value indication of a business entity, business ownership interest, or security, using one or more methods based on the value of the assets net of liabilities (Pratt, 2003; Gabehart & Brinkley, 2002).

Beta - A measure of systematic risk of a stock and the tendency of a stock's price to correlate with changes in a specific index (Modica, 2010; Pratt & Niculita, 2008).

Business Valuation - The performance or procedure of determining the value of a business entity or ownership interest in that (Modica, 2010; Holten & Bates, 2009).

Capital Asset Pricing Model (CAPM) - A model in which the cost of capital for any stock or collection of stocks equals a risk-free rate plus a risk premium that is comparable to the systematic risk of the stock or portfolio (Pratt & Niculita, 2008; Gabehart & Brinkley, 2002).

Capitalisation - A conversion of a single period of economic benefits into value (Holten & Bates, 2009; Gabehart & Brinkley, 2002).

Capitalisation Factor- Any multiple or divisor used to convert anticipated economic benefits of a single period into value (Holten & Bates, 2009; Gabehart & Brinkley, 2002).

Capitalisation of Earnings Method - A method within the income based valuation approach whereby economic benefits for a representative single period are converted to value through division by a capitalisation rate (Correia *et al.*, 2010; Pratt, 2003).

Capitalisation Rate - Any divisor, usually expressed as a percentage, used to convert anticipated economic benefits of a single period into value (Holten & Bates, 2009; Gabehart & Brinkley, 2002).

Cash Flow - Cash that is generated over a period of time by an asset, collection of assets, or business entity. It may be used in a general sense to include various levels of specifically defined cash flows. When the term is used, it should be accompanied by a qualifier, for example, "discretionary" or "operating", and a specific definition in the given valuation context (Holten & Bates, 2009; Gabehart & Brinkley, 2002).

Cost Approach - A general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset (Correia *et al.*, 2010; BVR, 2009).

Cost of Capital - The expected rate of return that the market requires in order to draw funds to a specific investment (Correia *et al.*, 2010; Pratt & Niculita, 2008).

Discount Rate - A rate of return used to convert a future financial sum into present value (Modica, 2010; Holten & Bates, 2009).

Discounted Cash Flow Method - A method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate (BVR, 2009: Pratt, 2003).

Discounted Future Earnings Method - A method within the income approach whereby the present value of future expected economic benefits is calculated using a discount rate (Allen, 1999; Pratt, 2003).

Excess Earnings - That amount of expected economic benefits that exceeds an appropriate rate of return on the value of a particular asset base used to generate those expected economic benefits (Correia *et al.,* 2010; BVR, 2009).

Excess Earnings Method - A specific way of determining a value indication of a business entity, business ownership interest, or security, determined as the sum of the value of the assets derived by capitalising excess earnings and the value of the selected asset base. Commonly used to value intangible assets as well (Holten & Bates, 2009).

Fair Market Value - The price, expressed in terms of cash equivalents, at which property would exchange hands between a hypothetical willing and capable buyer and a hypothetical willing and capable seller, acting at arm's length in an open and unrestricted market, when neither is under pressure to buy or sell and when both have reasonable knowledge of the relevant facts (Pinto, Henry, Robinson & Stowe, 2010; Gabehart & Brinkley, 2002).

Going Concern - An ongoing operating business entity (Correia *et al.,* 2010; Holten & Bates, 2009).

Going Concern Value - The value of a business entity that is anticipated to continue to operate into the future. The intangible elements of going concern value result from factors, such as having a competent workforce, an operational plant, and the required licenses, systems, and procedures in place (Holten & Bates, 2009; Allen, 1999).

Goodwill - That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not individually identified (Pinto *et al.,* 2010; Gabehart & Brinkley, 2002).

Guideline Public Company Method - A method within the market approach whereby market multiples are resultant from market prices of stocks of business entities that are involved in similar lines of business and that are actively traded on a free and open market (Modica, 2010; Pratt, 2003).

Income-Based Approach - A general way of determining a value indication of a business entity, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount (Correia *et al.,* 2010; BVR, 2009).

Intangible Assets – Non-physical assets such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities, and contracts (as distinguished from physical assets) which grant rights and privileges and have value for the owner (Holten & Bates, 2009; Gabehart & Brinkley, 2002).

Internal Rate of Return - A discount rate at which the present value of the future cash flows of the investment equals the cost of the investment (Pinto *et al*., 2010; Gabehart & Brinkley, 2002).

Intrinsic Value - The value that an investor considers, on the basis of an assessment or from existing facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price or strike price of an option and the market value of the original security (Correia *et al.,* 2010; Holten & Bates, 2009).

Market (Market-Based) Approach - A general way of determining a value indication of a business entity, business ownership interest, security, or intangible asset by using one or more methods that compare the subject business entity to similar business entities, business ownership interests, securities, or intangible assets that have been sold (Modica, 2010; Pratt, 2003).

Market Multiple - The market value of a business entity's stock or invested capital divided by a business entity measure such as economic benefits, or number of customers (Pinto *et al.,* 2010; Gabehart & Brinkley, 2002).

Merger and Acquisition Method - A method within the market approach whereby pricing multiples are resultant from transactions of significant interests in business entities engaged in the same or similar lines of business (BVR, 2009; Pratt, 2003).

Multiple - The opposite of the capitalisation rate (Pinto *et al.,* 2010; Holten & Bates, 2009).

Net Book Value - With respect to a business entity, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear on the balance sheet (identical with shareholder's equity). With respect to a specific asset, the capitalised cost less accumulated amortization or depreciation as it appears on the books of account of the business entity (Holten & Bates, 2009; Pratt, 2003).

Net Cash Flows - When this term is used, it should be accompanied by a qualifier (Pratt, 2003; Gabehart & Brinkley, 2002).

Net Present Value - The value, as of a specified date, of future cash inflows less all cash outflows (including the cost of investment) calculated using an appropriate discount rate (BVR, 2009: Holten & Bates, 2009).

Net Tangible Asset Value - The value of the business entity's tangible assets (excluding excess assets and non-operating assets) minus the value of its liabilities (Pinto *et al.*, 2010; Pratt, 2003).

Normalized Earnings - Economic benefits adjusted for nonrecurring, noneconomic, or other unusual items to eliminate irregularities and simplify comparisons (BVR, 2009: Holten & Bates, 2009).

Present Value - The value, as of a specified date, of future economic benefits and proceeds from sale, calculated using an appropriate discount rate (Correia *et al.*, 2010; Holten & Bates, 2009).

Price/Earnings Multiple - The price of a share of stock divided by its earnings per share (Pinto *et al.*, 2010; Gabehart & Brinkley, 2002).

Rate of Return - An amount of income or loss and change in value realized or anticipated on an investment, expressed as a percentage of that investment (Correia *et al.*, 2010; Pratt & Niculita, 2008).

Replacement Cost New - The current cost of a similar new property having the closest equivalent value to the property being valued (Pinto *et al.*, 2010; Pratt & Niculita, 2008).

Required Rate of Return - The minimum rate of return acceptable by investors before they will commit money to an investment at a specified level of risk (Holten & Bates, 2009; Pratt & Niculita, 2008).

Residual Value - The value as of the end of the separate projection period in a discounted future earnings model (Pinto *et al.*, 2010; Holten & Bates, 2009).

Return on Equity - The amount, expressed as a percentage, earned on a business entity's common equity for a given period (Pinto *et al.*, 2010; Holten & Bates, 2009).

Return on Invested Capital - The amount, expressed as a percentage, earned on a business entity's total capital for a given period (Pinto *et al.*, 2010; Pratt & Niculita, 2008).

Risk-Free Rate - The rate of return available in the market on an investment free of default risk (Modica, 2010; Pratt & Niculita, 2008).

Risk Premium - A rate of return added to a risk-free rate to reveal the risk (Pinto *et al.*, 2010; Pratt & Niculita, 2008).

Rule of Thumb - A mathematical formula developed from the relationship between price and certain variables based on experience, observation, unfounded information, or a combination of the above. They are usually industry specific (Modica, 2010; Pratt, 2003).

Systematic Risk - The risk that is common to all risky securities and cannot be eliminated through modification. The measure of systematic risk in stocks is the beta coefficient (Pratt & Niculita, 2008; Pratt, 2003).

Tangible Assets - Physical assets such as cash, accounts receivable, inventory, property, and plant and equipment (Pinto *et al.*, 2010; Pratt, 2003).

Unsystematic Risk- The share of total risk specific to an individual security that can be avoided through change (Pratt & Niculita, 2008; Allen, 1999).

Valuation - The act or procedure of determining the value of a business entity, business ownership interest, security, or intangible asset (Pratt, 2003; Allen, 1999).

Valuation Approach - A general way of determining a value indication of a business entity, business ownership interest, security, or intangible asset using one or more valuation methods (Pinto *et al.,* 2010; Gabehart & Brinkley, 2002).

Valuation Date - The specific point in time as from which the valuator's opinion of value applies. It is also referred to as "effective date" or "appraisal date" (BVR, 2009; Allen, 1999).

Valuation Method - Within approaches, a specific way to determine a value (Pratt, 2003; Allen, 1999).

Valuation Procedure - The act, method, and technique of performing the steps of an valuation method (Holten & Bates, 2009; Allen, 1999).

Valuation Ratio - A fraction in which a value or price serves as the numerator, and financial, operating, or physical data functions as the denominator (BVR, 2009; Allen, 1999).

Weighted Average Cost of Capital (WACC) - The cost of capital or discount rate determined by the weighted average at market value of the cost of all financing sources in the business entity's capital structure (Modica, 2010; Pratt & Niculita, 2008).

1.9. Overview

The study will be divided into six chapters as follows:

Chapter 1: Introduction

The first chapter in the study will serve as the introduction to the research study and will contain the following:

- Backgrounds of valuations, valuation approaches and valuation methods, franchises and restaurants as industries; and some history of Spur Steak Ranches;
- Problem statement;
- Research objectives; and
- Methodology and overview of the study.

Chapter 2: The fundamental principles of business valuations

The second chapter in the research study will evaluate various approaches and methods of valuations used by different theorists and practitioners. This will be done to obtain an insight into the valuation procedures. The six most popular business valuation methods used by different theorists and practitioners will be identified and evaluated. References and published academic research, nationally and internationally, will be obtained and included.

Chapter 3: Franchising in the foodservice industry

The third chapter of the research study will give the history and background of franchises and restaurants, explaining how they work and why they are used, and will provide acceptable information on how to understand them. The background and history will be provided about Spur Steak Ranches, and more specifically the Tampa Bay Spur Steak Ranch. In addition, the two most popular methods used by theorists and practitioners to value a restaurant in particular will be identified and evaluated.

Chapter 4: Research methodology

This chapter has a twofold purpose. Firstly, to explain how the data of the literature review were obtained, and secondly where the data for the empirical study came from and the use of these in the research study.

Chapter 5: Empirical case study

This chapter presents the case study that will be based on actual information of a selected franchised restaurant in the food sector, namely the Spur Steak Ranch. Various valuation

methods on that franchise will be done and compared. In addition, statistical charts will be drawn up to compare the values calculated with different valuation methods and approaches as well as the original valuation done by the Spur.

Chapter 6: Conclusion and contribution

This chapter will give a summary in light of the objectives given in the first chapter, discussing the conclusions and recommendations of the study. In addition, a new valuation model will be constructed to value a franchised restaurant.

CHAPTER 2

2. THE FUNDAMENTAL PRINCIPLES OF BUSINESS VALUATIONS

This chapter's purpose is to assess various approaches and methods of valuations used by different theorists and practitioners. This will be done by obtaining a comprehension of the valuation procedures. Six popular business valuation methods used by different theorists and practitioners will be identified and assessed. References and published academic research nationally and internationally will be obtained.

2.1. Background

Before any business valuation can be made, the financial statements of a business entity are required (Holten & Bates, 2009:112). In terms of the Corporate Laws Amendment Act 24 of 2006, the published annual financial statements are the financial statements that must be placed before the annual general meeting (Benade, Henning, du Plessis, Delport, de Koker & Pretorius, 2009:211). The financial statements contain the statement of financial position, the statement of comprehensive income, the statement for change in equity, the cash flow statement, and notes to the financial statements (Sowden-Service, 2009:8; Voster, Koornhof, Oberholster, Coetzee, Jansen van Rensburg, Binnekade, Leith, Hattingh & de Klerk, 2009:28). Usually there are three areas to take into consideration when adjusting the financial statements, which include Generally Accepted Accounting Principles (GAAP) adjustments, normalising adjustments, and tax adjustments (Modica, 2010:193).

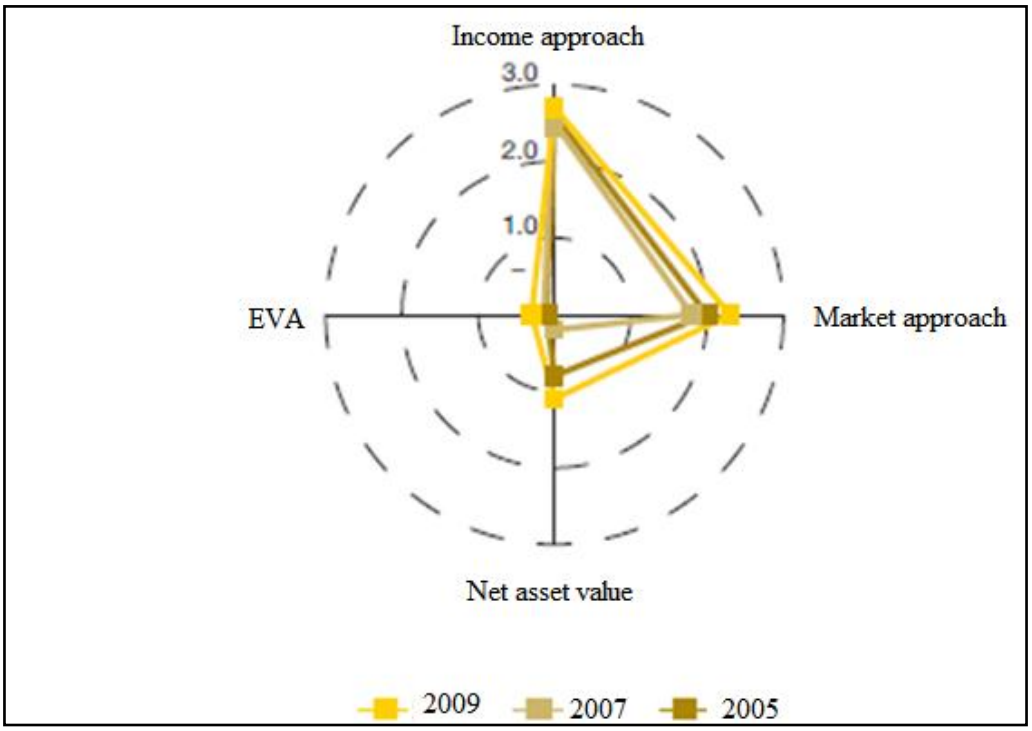
Valuation standards have been round for decades. IRS Revenue Ruling 59-60 that was issued in 1959 is considered the most significant work on the valuation of ownership benefits in closely held business entities. Revenue Ruling 59-60 is a document which is still legally appropriate to federal gift, income and estate tax valuation (Modica, 2010:193). The valuation procedures that it plans continue to work as the template for business valuation assignments of all varieties of business valuations, indicating its significance for the complex business entities that exist today. The Revenue Ruling 59-60's continuing effect is noticeable in the comprehensive business

valuation standards. The business valuation standard began to appear in the late 1980's. The most significant of these standards was the Uniform Standards of Professional Appraisal Practice (USPAP) that was issued by the Appraisal Foundation in 1987. That was followed by standards from specialized associations such as the American Society of Appraisers (ASA) in the year 1992, the Institute of Business Appraisers (IBA) in the year 1993, and the National Association of Certified Valuation Analysts (NACVA). The first edition of USPAP was published in 1987 by the Appraisal Foundation, a non- profit organization established by a group of specialized appraiser associations (Lieberman & Anderson, 2008:22). According to Fodor & Mazza (1992: 174), Revenue 59-60 makes it clear that a thorough opinion of value must be grounded on all relevant facts and conditions, and no arbitrary, general formula can be applied to all business valuations.

2.2. Primary valuation approaches and methods

Valuations have three approaches that are primarily used. Under each of these approaches is a variety of methods. For the purpose of this research study, only the most common and popular methods are going to be examined. In addition, the methods mostly used in the restaurant industry are going to be examined in Chapter 3. According to PricewaterhouseCoopers (PwC, 2010:21), the most commonly used valuation approaches are the income, market and net assets approach (Dellinger, 2010:59; Modica, 2010:193; Pratt & Niculita, 2008:10; Smith & Smith, 2005:18; Van Vleet, 2004:74; Reilly, 2003:94; Gabehart & Brinkley, 2002). The primary valuation approaches used in South Africa are the income and market approach (PwC, 2010:21). South Africa will primarily use the income approach because the market has reasonably few listed companies that can be used as a dependable source for market multiples (PwC, 2010:21).

Figure 2.1: Valuation approaches



(PwC, 2010:21)

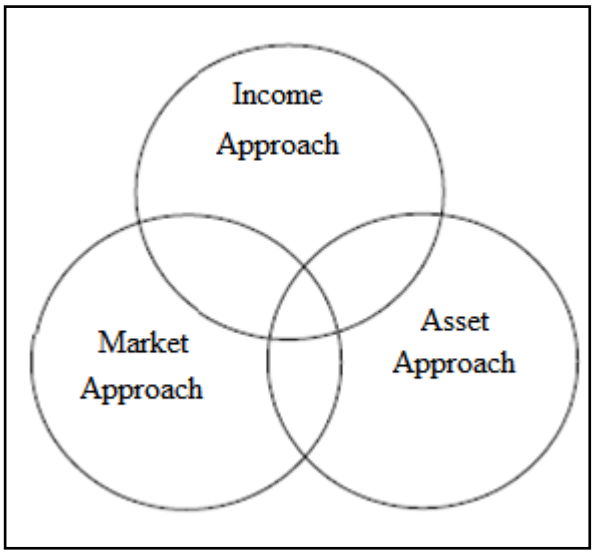
These approaches are briefly discussed below:

- The *income approach* specifies the market value of the ordinary shares of a business entity grounded on the value of the cash flow that the business entity could expect to make in the future. Discounted cash flow techniques and real option valuations are included, which measure the value of assets by using the option-pricing models (Modica, 2010:194; PwC, 2010:19). The *discounted cash flow* (discounted future economic income method) and the *direct capitalisation methods* are the two most common methods used in the income approach (Reilly, 2003:94).
- The *market approach* specifies the market value of the ordinary shares of a business entity by comparing the business entity to comparable publicly traded business entities and transactions in its specific industry, as well as past transactions in the ordinary shares of the business entity (Modica, 2010:195; PwC, 2010:19). Market-derived pricing multiples that are extracted from actual sales of comparative business entities are used to

value business entities in the market based valuation approach. The *guideline publicly traded company method* and the *guideline merger and acquired company method,* are *the* two most common methods used in the market based valuation approach (Reilly, 2003:94).

- The *net assets* approach shows the market value of the ordinary shares of a business entity. This is done by adjusting the assets and liability balances on the business entity's balance sheet to its market value equivalents. The net asset based valuation approach is grounded on the summary of the individual disorganised market value of the fundamental assets subtracted by the market value of the liabilities (Modica, 2010:195; PwC, 2010:19). A business entity is valued in the asset-based approach by reference to the current value of all the tangible and intangible assets, less the current value of all its liabilities. The *net asset value method* and the *asset accumulation method* are the two most commonly used methods in the asset valuation approach (Reilly, 2003:94).

Figure 2.2: Interdependence of valuation approaches



(Kalajian, 2003:5)

According to Kalajian (2003:4), the three mentioned valuation approaches are dependent upon one another as illustrated in *figure 2.2*. For example, a method used under the income approach is reliant on the market to develop its discount and capitalisation rates, and a method used under the asset-based approach capitalises excess income, which relies on the market for capitalisation

rates. Certain methods used under the market approach need to consider revenue and income variables to adjust its guideline business entities for appropriate comparison purposes.

Valuations are integrated disciplines and most methods depend on the interaction of two or more approaches. Certain methods are mutually limited to others, for example, in the income approach, the valuator may choose to select the capitalisation of a single period, or the discounted economic income valuation method using multiple periods. There are guidelines as to which is applicable, however, it would be a gross technical mistake to use both of these methods in the income approach (Kalajian, 2003:5).

The following section of this chapter considers the basic approaches as indicated in figure 2.3 below in more detail:

Figure 2.3: Valuation approaches

Income approach	Market approach	Asset-based approach
Discounted future economic income method	Guideline publicly traded company method	Capitalised excess earnings method
Capitalised economic income method	Guideline merger and acquired company method	Asset accumulation method

2.3. Income approach

The *income approach* is grounded on an analysis of a business entity's income generating ability (Gabehart & Brinkley, 2002:4) and is calculated using discounted cash flow (DCF) that requires a *Weighted Average Cost of Capital* (WACC) (Kirrane, 2009:31). According to Van Vleet (2004:74), the two most commonly used income based methods are the *discounted economic income* and the *capitalised economic income method.* These methods are considered in more detail below.

2.3.1. Discounted future economic income method

The *discounted future economic income method* is presented as the first of all small business entity and professional practice valuation methods. It is important that every analyst understands this fundamental valuation method (Pratt, Reilly & Schweihs, 1998:236). This method is also known as 'the heart of valuation' (Pratt & Niculita, 2008:174). The principle of the discounted future economic income method is twofold. The *first step* is projecting the future economic income and the *second step* is discounting the future economic income into present value. The discounted economic income formula is as follows, which represents the *first step* by projecting the future economic income (Pratt & Niculita, 2008:177; Pratt, Reilly & Schweihs, 1998:237):

$$PV = \sum_{i=1}^{n} \frac{E_i}{(1+k_p)^i}$$

Where: PV = Present value

Σ = Sum of

n = The last period for which economic income is expected and it may equal infinity, for example, if the economic income is expected to continue into eternity

E*i* = Expected future economic income in the *i*th period in the future and is paid at the end of the period.

k = Discount rate which is the cost of capital, for example, the expected rate of return available in the market for other investments of comparable risk and other investment characteristics.

i = The period usually stated as a number of years in the future over which the potential economic income is expected to be received.

This formula is fairly general, meaning that the analyst should be very specific about the following points:

- Are they valuing all investment capital or just the common equity with these calculations?
- What is the measure of economic income that they are projecting to be used in the numerator?
- Is it the net cash flow or net income measure?
- What kind of cost of capital does the present value discount rate represent?

When coming to the income approach, the most common method is the discounted future economic income method, which for common business valuation purposes is presented in an unleveraged or debt free basis and consistently depends on the *WACC* or *CAPM* as discount rate (Kelley, 2007:19). The *discounted economic income* approach is fundamentally thorough and even widely accepted as the most accurate valuation method. However, it can be a problem for analysts if it is not cautiously developed (Fodor & Mazza, 1992: 171). In the 1970s, the discounted economic income analysis developed as the best practice for valuing business entity's assets. One specific version of the discounted future economic income method became the standard. According to that particular method, the value of a business entity equals its expected future cash flows discounted to present value at the WACC or CAPM (Luehrman, 1997a:132).

Due to the requirement to make valuation more transparent, the discounted future economic income method developed. It makes obvious and individual assumptions on depreciation, holding periods, future rental growth, refurbishments, costs of transfer and management, taxation and financing arrangements (Peto *et al.*, 1996:93). The earnings multiplier method's principles are the same as those which the discounted future economic income method is grounded on. The valuator reviews and analyses present and past trading performances and estimates future trading levels, making the assumption that the business entity is operated by a capable operator (Dunse & Hutchison, 2004:251). The discounted future economic income method is grounded on a stronger theoretical basis than any other method in the income approach, but in several situations, it is difficult to estimate future cash flows and a suitable discount rate (Kim & Ritter, 1999:409).

According to Fernandez (2007:853), there are ten methods of valuing a business entity using the discounted future economic income method, namely the following:

- Free cash flow discounted at the WACC.
- Equity cash flows discounted at the WACC prior to taxation.
- Capital cash flow discounted at the required return to equity.
- Adjusted present value (APV).
- Corporate risk adjusted free cash flows which are discounted at the required return to assets.
- Corporate risk adjusted equity cash flows that are discounted at the required return to assets.
- Economic turnover that is discounted at the required return to equity.
- Economic value added (EVA) discounted at the WACC.
- The risk-free rate that is adjusted with the free cash flows discounted at the risk rate.
- The risk-free rate that is adjusted with the equity cash flows discounted at the required return to assets.

All ten methods should theoretically provide the same value (Fernandez, 2007:853).

The discounted future economic income method requires the *net cash flow*, the *terminal value* if the business entity is a going concern business entity, and a *discount rate* before it can be calculated. The determination of the net cash flow and the discount rate will be discussed next.

Net cash flow

The net cash flow is also part of the first step when doing a business valuation that is based on the discounted future economic income method. A *positive net present value (NPV)* shows that the return of the project exceeds the discount rate. A *negative NPV* shows that the return of the project is less than the discount rate. If a business entity's lowest required rate of return is used as the discount rate, then a project consisting of a positive net present value is suitable and a project with a negative rate is unsuitable. The business entity's cost of capital is usually the minimum required rate of return (Garrison, Noreen & Brewer, 2007:659).Within the range of the income approach, most valuation experts prefer to use the *net cash flow* as the degree to what the economic income need to be discounted to (Pratt, Reilly & Schweihs, 1998:238). According to

Pratt & Niculita (2008:177), Evans (2000:39) and Pratt, Reilly and Schweihs (1998:238), the net cash flow to equity is defined as:

	Net income after taxes
+	Noncash charges (e.g. depreciation, amortization, deferred income and taxes)
-	Net capital expenditures (the net changes in fixed and other non-current assets)
+/-	Changes in net working capital
+/-	Changes in working capital
=	Net cash flow to equity

The net cash flow to equity also has an alternative method that looks as follows:

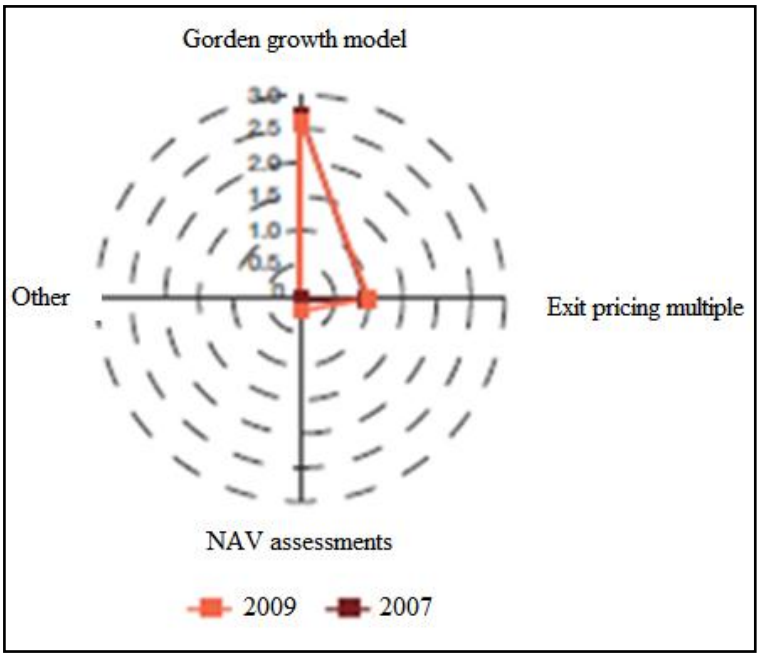
	Earnings before interest and taxes (EBIT)
-	Taxes on EBIT
+	Noncash charges
-	Capital expenditures
+/-	Changes in working capital
=	Net cash flow

There are two reasons why the net cash flow is the preferred measure of economic income in the application of the income approach (Pratt, Reilly & Schweihs, 1998:239). *Firstly*, it is a theoretical preference, meaning the net cash flow is considered theoretically preferable because it represents cash that may be permanently removed from the business entity and used by the owner for other purposes. *Secondly*, most of the capital market and other empirical data that are used to develop a present value discount rate, such as the *Ibbotson Associates data* which are used in the USA, and Bloomberg or Reuters, used in South Africa, are data that relate to net cash flow as the measure of economic income. When using the discounted future economic income method, it is necessary to estimate the year in which growth rates are expected (Hall, 2004:91).

Terminal values

Another technical issue that typically arises within the income based valuation approach is the question of *terminal value*s. Terminal values regularly contribute an additional 50% of the discounted cash flow value. As a result, the terminal value calculation is a range that requires to be considered in detail (PwC, 2010:54). PwC (2010:54) did a survey where practitioners were asked how they approached terminal value calculations. The conclusion according to Figure 2.4 was as follows

Figure 2.4: Terminal value calculation methods



(PwC, 2010:54)

Assuming that a steady state is not the appropriate expectation, the common procedure is to project specific cash flows for some separate number of years followed by a *terminal value.* The terminal value could be an expected liquidation value, the expected proceeds from a sale of a business entity or a value based on capitalisation of cash flow starting when the business entity has reached a stabilised state (Pratt, Reilly & Schweihs, 1998:242). The most common multistage variation of the discounted economic income model is a two-staged model that projects economic income for a limited number of periods, usually one business cycle of somewhere between three and ten years, and then assumes a terminal value at the end of the separate projection period, according to Pratt & Niculita (2008:219). If no variability is expected,

then there is no point in forecasting cash flow for interim years, as there are no variable interim years. It is important to note that the capitalisation model indicates a steady rate of growth in perpetuity. This terminal value is sometimes called the *residual value*, the *reversionary value* or *future value* (Pratt & Niculita, 2008:219). The formula for this model is as follows (Pratt & Niculita, 2008:220; Pratt, Reilly & Schweihs, 1998:242):

$$PV = NCF_1/_{(1+k)} + NCF_2/_{(1+k)^2} + \ldots + NCF_n/_{(1+k)^n} + T/_{(1+k)^n}$$

Where: PV = Present value

NC $F_{1,2,n}$ = Net cash flow for the first through the *n* th periods

k = Cost of capital appropriate to the cash flows being discounted (e.g. Cost of equity capital if for equity and the weighted average cost of capital if for invested capital).

T = Terminal value (value as of the end of the *n* th period in the separate projection period.

Discount rate

The *second* step when calculating the discounted future economic income value *is* the more complicated one. It is to select the present value discount rate. A *discount rate* can be defined as an opportunity cost, which is the expected rate of return that investors would have to give up by investing their money in the subject investment rather than investing in available substitute investments that are similar in terms of risk as well as other investment characteristics (Pratt & Niculita, 2008:177). The choice of a particular discount rate is determined by the description of economic income that is used in the numerator. The discount rate used in the analysis must be suitable for the description of the economic income in the numerator as well as for the class of capital to which it applies (Pratt & Niculita, 2008:181). The degree of risk of the investment must be reflected by it (Pratt & Niculita, 2008:182). The discount rate is market driven and represents the projected rate of return required to persuade investors to commit available funds to

the subject investment, given the level of risk it contains. The components of the discount rate include the following elements:

- A *risk-free rate* that is the amount that investors feel confident of realizing over the holding time period, which includes a rental rate for previous use of funds over the holding time period as well as the expected rate of inflation over the holding time period.
- A *premium risk* for systematic risk, which is the risk relating to the movements in returns on investment markets in common and unsystematic risk that is specific to the subject investments (PwC, 2010:29; Pratt & Niculita, 2008:182; Pratt, Reilly & Schweihs, 1998:221).

Measurement of *risk* is the single most difficult task in valuing a security according to Nekrasov and Shroff (2009:1983). The risk-free rate normally used is the rate available on instruments that are considered to have no possibility of avoidance, such as the US treasury obligations (Dellinger, 2010:60; Pratt & Niculita, 2008:182). The risk-free rate is the starting point to the calculation of cost of equity (PwC, 2010:27). Pratt and Niculita (2008:184) define risk as the level of uncertainty regarding the realization of the expected future returns. For a particular level of expected future returns, the market will pay more to the degree that the realization of those particular returns is more certain, and less to the degree that their realization is less certain. For a particular level of expected potential economic income like cash flow, dividends and accounting earnings, the lower the risk is, the higher the present value, or on the contrary, the higher the risk, the lower the present value (PwC, 2010:27). The three most common methods used to calculate a discount rate are Weighted average cost of capital *(WACC),* Capital asset pricing model (*CAPM)* and the build-up model (Modica, 2010:196), which are discussed below.

2.3.2. Weighted average cost of capital (WACC)

From a business entity's viewpoint, the WACC represents economic returns that investors would have to be willing to give up by investing in the subject investment rather than in all of the available substitute investments that are similar in terms of risk. The WACC is calculated by weighting the required returns on ordinary equity capital, preference share capital and interest bearing debt, in proportion to their estimated percentages in a particular industry's expected

capital structure (Modica, 2010:197; PwC, 2010:23). In a WACC based analysis, discount takes place only once. To pick up all of the costs and the benefits of a particular capital structure, the discount rate has to be adjusted. WACC is a weighted average of the *costs after tax* of different sources of capital, in which everyone is weighted by the fragment of the capital structure it characterises (Luehrman, 1997b:145). The general WACC formula is as follows, assuming only debt and equity capital (PwC, 2010:23; Booth, 2007:35; Borgman & Strong, 2006:1; Pratt, 2003:105):

$$WACC = (ke \times We) + (kp \times Wp) + (kd\ (pt)\ [1 - t] \times Wd)$$

Where: WACC = Weighted average cost of capital

ke = Cost of common equity capital

We = Percentage of common equity at market value in the capital structure

kp = Cost of preferred equity

Wp = Percentage of preferred equity at market value in the capital structure

kd (pt) = Cost of pre-tax debt

t = Tax rate

Wd = Percentage of debt at market value in the capital structure

There are three related steps that are involved in the development the WACC, namely:

- Valuing the opportunity cost of equity financing.
- Valuing the opportunity cost of non-equity financing.
- Developing particular market value weights for the capital structure.

Cost of equity is the most subjective as well as the most difficult measure to calculate in the WACC formula, according to PwC (2010:24).

2.3.3. Capital asset pricing model (CAPM)

There are two general approaches to estimate the cost of capital (PwC, 2010:24), namely the *deductive model* and *risk-return model*. The deductive models like the dividend growth models depend on market data to calculate an imputed cost of equity. The dividend growth model is an approach that needs market data that contain the present share price, expected dividends, as well as the long-term stable dividend growth rate. The CAPM is the most commonly used of all the risk-return models (PwC, 2010:24). The CAPM is also a part of a bigger economic theory known as capital market theory. Capital market theory contains security analysis and portfolio management theory which is a normative theory that describes exactly how investors ought to behave when they are choosing common stocks for their portfolios under a particular set of assumptions (Pratt & Niculita, 2008:185). The CAPM is a positive theory that describes the relationship of the market that will be the result when investors behave in the way suggested by the portfolio theory. The CAPM measures risk in relation to the non-diversifiable adjustment, also known as systematic risk, and transmits expected returns to this risk measure. It is a linear mixture of the *risk-free rate*, the *beta*, and the business entity's *equity risk premium*. The CAPM formula is as follows (PwC, 2010:25; Pratt, 2003:105):

$$E(Ri) = Rf + B(RPm)$$

Where: $E(Ri)$ = Expected return or cost of capital for a single security

Rf = Rate of return that is available on a risk-free security as of the valuation date

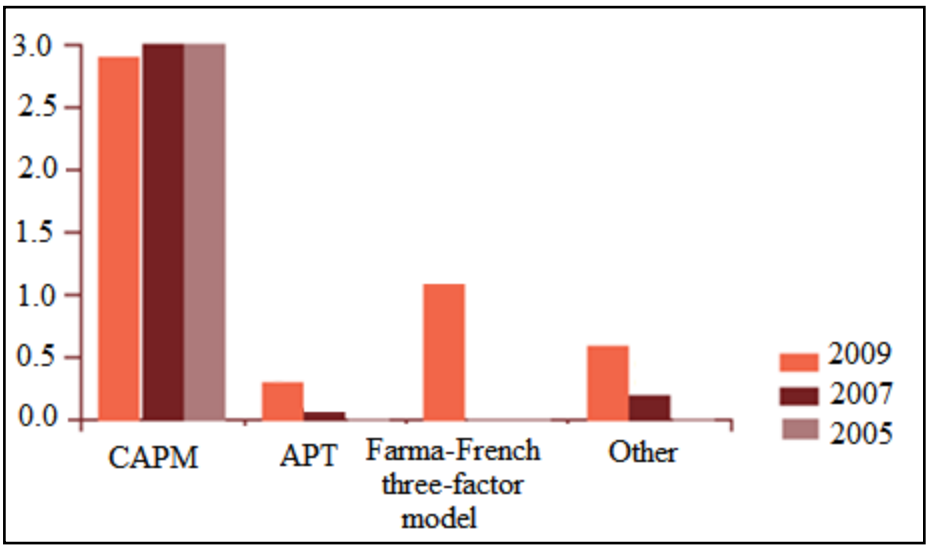
B = Beta

RPm = Equity risk premium for the entire market, or by definition, the equity risk premium for a security with a beta of one.

Examples of alternative models include the *arbitrage-pricing model (APT)*, the *equity market risk premium (EMRP)* and the *Fama-French three-factor model*. Risk factors consist of interest

rates, gross domestic product (GDP) growth, and the interest rate outlook. According to PwC (2010:26), the popularity of the following models was as follows:

Figure 2.5: Methods used to estimate cost of equity



(PwC, 2010:30)

Risk-free rate

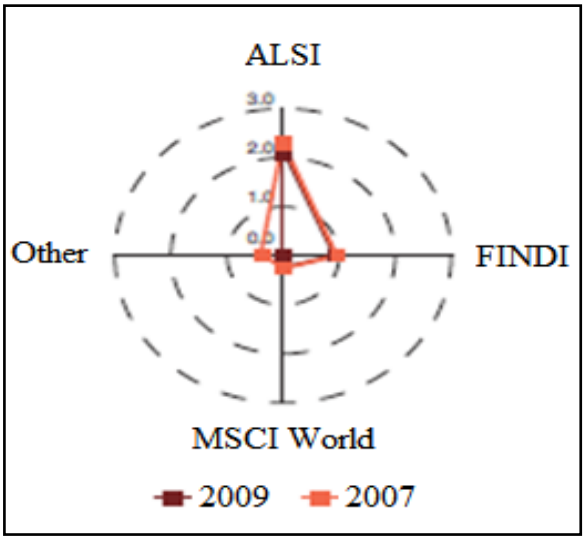
The ***Rf*** in the formula of CAPM represents *the risk-free rate* that is the beginning point to calculate cost of equity PwC (2010:27). The risk-free rate must be the yield that is available to investors as of the valuation date (Pratt & Niculita, 2008:207). If a government security is considered an adequate proxy for a risk-free rate, the maturity of the security as well as its possible influences on the market risk premium also need to be considered to be used later in the calculation. The choice of maturity will be dependent on the circumstances in question. The two common approaches are matching the maturity of the risk-free instrument to the summary of the cash flows, or matching the maturity to an expected investor limit of seven to ten years.

Beta

In the CAPM model formula, *B (Beta)* measures systematic risk. In theory, Beta is a forward-looking risk (Pratt & Niculita, 2008:187). The Beta usually measures the sensitivity of a share price to variations in the market as a whole. The factor of the Beta is the measure of the

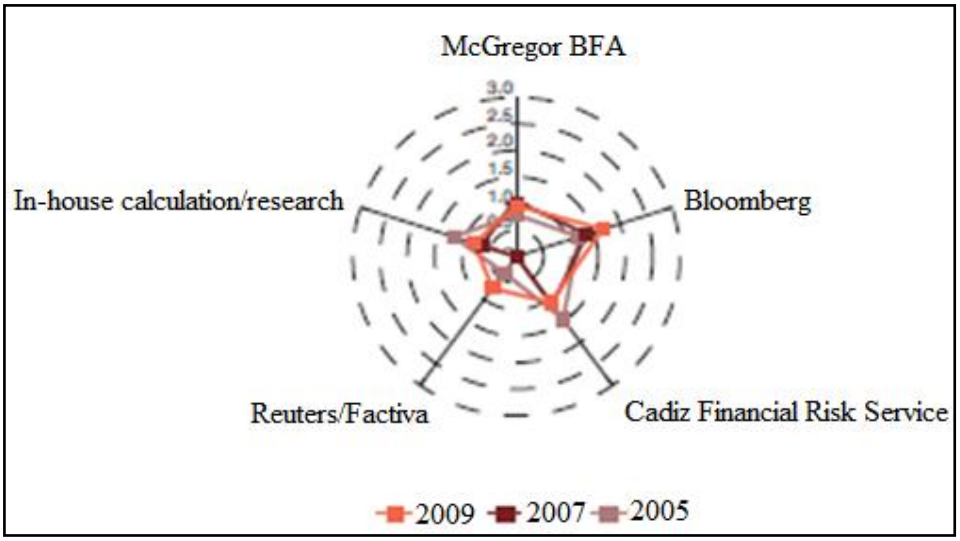
systematic risk of a security to the market portfolio. If share prices were to rise or to fall at double the market rate, its Beta factor would be two. On the other hand, if share prices moved at half of the rate of the market, the beta would be zero (CIMA, 2011b:142). Beta measures the unpredictability of the excess return on a single security in relation to that of the market. Securities that have Betas greater than one are characterised as aggressive securities and are riskier than the market. Securities that have Betas of less than one are characterised as defensive securities and have systematic risks lower than that of the market (Pratt & Niculita, 2008:187). PwC (2010:30) did two surveys concerning the Beta. The first determined which service providers are used as a source information for beta (in figure 2.6) and the second determined what is the appropriate market index used as a market proxy for a beta calculation in the South African market (in figure 2.7).

Figure 2.6: Service providers used to source beta



(PwC, 2010:31)

Figure 2.7: Market proxy for a beta calculation



(PwC, 2010:31)

Equity market risk premium

The ***RPm*** in the CAPM formula represents the *EMRP* that is possibly the most important assumption made in a cost of capital analysis (PwC, 2010:32). Investors expect to earn a return that rewards them for taking on the higher risk involved in investing in equities as compared to bonds. According to CIMA (2011a:144), the CAPM makes use of a standard that returns on shares in the entire market are estimated to be higher than the returns on the risk-free investments. The difference that exists between market returns and risk-free returns is called an excess return, and the difference between the risk-free return and the expected return on a single security can be measured as the surplus return for the market as a whole by the security's factor of Beta. The market rate risk premium is the additional return that equity investors anticipate to earn over the risk-free rate. There are two ways to measure a forward-looking market risk premium. The first one is to use historical premiums based on past data and assume that this will apply into the future. The second way is to undertake surveys of investors and ask them what premium they expect to earn (Correia *et al.*, 2010:7-23).

PwC (2010:32) suggests that calculating market risk premium is a three broad approach, consisting of a *historical approach*, *survey approach* and a *forward-looking estimate*. The

historical approach is the most commonly used approach to estimate risk premiums. That approach is grounded on an assumption that in a well-functioning market, arbitrage will guarantee that required returns and achieved returns should be comparable. The actual returns received on stocks over an extended period are projected and compared to the actual returns received on a default-free asset. The difference between the two returns is calculated on an yearly basis and it represents the historical risk premium (PwC, 2010:33).

As it is not possible to survey all investors, surveys are sent to brokers and portfolio managers requesting their estimation for the risk premium (Correia *et al.,* 2010:7-24). Survey methodology is grounded on estimations of market participants. Survey risk premiums are responsive to current movements in stock prices. Therefore, it's possible that survey premiums are a decent consideration of the current past rather than a decent forecast to the future. Survey results are complex to how the question concerning the market risk premium is supposed to respond (PwC, 2010:33).

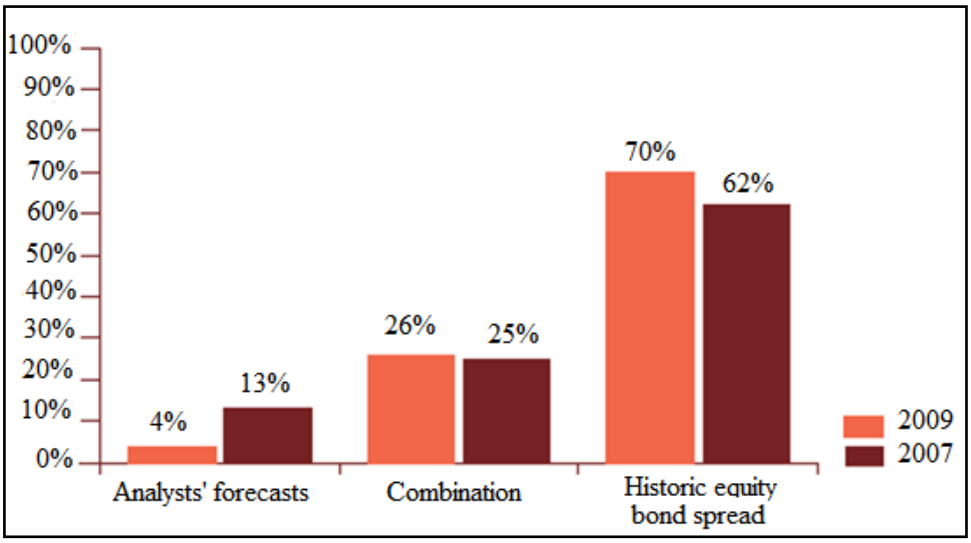
The *forward-looking* estimation of the premium is established using either one of the current equity prices or risk premiums in non-equity markets. The discounted future economic income method uses pricing and assets to achieve required return or use actual or possible dividends on an index to determine the required return. This method will not produce an accurate estimate if business entities do not pay out dividends which they can afford or if earnings are estimated to grow at surprising rates for the short term (PwC, 2010:34). If the market is looked at as one large entity, then the dividend growth model can be applied to determine the cost of equity for the market and deduct the bond yield to obtain the market risk premium. The formula is as follow:

Cost of equity = D1/Market value + g

In this formula, *D1* is the following year's dividend and *g* is the growth. This is essentially the dividend yield plus the expected growth in dividends. The current dividend yield in South Africa is close to 3% (Correia *et al.,* 2010:7-24). For the reason that the dividend growth model refers to a future time, it is described as an *ex-ante* model and the return, which is the price at the end of the time period, and the dividend receivable, are all anticipated values. Three assumptions dramatically simplify the model. The *first* one is that the business entity is a going concern,

which implies there is no predictable prospect of its failure. The *second* one is that the rate of return in future periods is anticipated to be constant, which implies that there is a flat term structure on equity returns. The *third* assumption is that there is an expectation of a constant rate of change in dividends paid over the indefinite life of the business entity (Ryan, 2007:374). According to PwC (2010:34), the approaches used to estimate market risk premium, which South Africa considers, are as follows:

Figure 2.8: Approaches used to estimate risk premiums



(PwC, 2010:31)

Build-up method

The mechanisms of a discount rate using the *build-up method* contain the risk-free rate that is the lowest rate of return investors would be willing to accept in an environment that is risk-free. The equity risk premium is the additional return received by regular equity investors in excess of the return on long-term capital securities and the size premium. There is more risk associated with small business entities than with a public trade business entity. Therefore, everything other being equal, investors in a small business entity will request a higher rate of return (Modica, 2010:195). The build-up model divides the risk premium into its main three subcomponents and estimates the cost of capital as a sum of the following:

- A risk-free rate
- A risk premium, including one or all of the following:
    - An equity risk premium
    - A size premium
    - A company-specific risk premium

Each subcomponent of the risk premium represents the reward to an investor for taking on a particular risk. The risk-free rate is the rate of return that is available on a risk-free security as at the date of the valuation. The equity risk premium is the reward for investing in the stock market. The size premium is the reward for investing in smaller business entities. The company specific risk premium is the reward for investing in a specific business entity or industry, or the reward for unsystematic risk. For the reason that the build-up model estimates the cost of capital as the sum of the risk-free rate and various risk premiums, the model is called an additive model and its components are referred to as building blocks (Pratt & Niculita, 2008:187). The formula for the build-up model is as follows (Modica, 2010:195):

$E(R_i) = R_f + RP_m + RP_s + RP_u$

Where: $E(R_i)$ = Required return on security

R_f = Risk-free rate

RP_m = Equity risk premium

RP_s = Size premium

RP_u = Unsystematic risk premium

This formula depends partially on a projection of the value of the subject business entity several periods into the future to estimate the value of the subject business entity today. It is common for the present value of the terminal value in this formula to account for more than half of the total present value. The matter of how the terminal value is estimated is an important part of the estimate of present value (Pratt & Niculita, 2008:220). If it is assumed that the business entity

will continue indefinitely as a possible going concern after the number of years for which separate projections were made, two procedures are commonly used to estimate the terminal value. The two procedures are the *capitalisation of going economic income* and an *estimated market multiple of economic income* projected for the last year of the separate projection period (Pratt, Reilly & Schweihs, 1998:242). The discounted economic income model can produce either a minority value or a control value, depending mainly on the model inputs concerning the valuation variables. If the involvements in the valuation model reveal changes that only a control owner would make, for example changed capital structure or reduced owner's compensation, the model would be anticipated to produce a control value. If the economic income projections simply reflect the perpetuation of current policies, the model would be anticipated to produce a minority value (Pratt, Reilly & Schweihs, 1998:242).

The argument is often proposed that, because discount rates typically are developed grounded on minority trades in publicly traded stocks, the discount rate is a minority interest discount rate, and therefore the value indicated by a discounted economic income model must be a minority value. According to Pratt, Reilly and Schweihs (1998:246), the difference between a control and a minority value in a discounted economic income model results from differences in the projected economic income which is also known as the numerator, and not from the differences in the discount rate. The cost of equity capital used in developing the *WACC* is based on the opportunity cost of equity capital (Pratt, Reilly & Schweihs, 1998:242). *Cost of equity capital* is estimated from trades of minority ownership interest. The capital structure, which is the percentage of debt versus equity of the subject business entity, is clearly influenced by the controlling stockholder, and the capital structure mix is at least as important as the cost of equity capital in the valuation of a business entity's overall WACC (Pratt & Niculita, 2008:229).

The discounted future economic income method can be used in combination with practically any mixture of standards of ownership and value characteristics as long as the forecasts underlying the valuation variable used in the calculation are constant with the description of value being required (Pratt & Niculita, 2008:231). Discounting future benefits to a present value is the most theoretically correct income method. It deals with expected irregular income streams, unusual lump sum payments, downturns in business, high near-term growth, and new product lines

(Gilbert, 1999:284). The critical element of this valuation method is that the present value discount rate used is an appropriate rate that is matched to the definition of the projected economic income. One of the errors in the presentation of the discounted future economic income method is using a present value discount rate that is not appropriate for the particular level of economic income used in the projection (Pratt, Reilly & Schweihs, 1998:242). This method is best applied in situations where something unusual is expected in the future of a business entity or when the income stream is expected to go both up and down in the near future (Gilbert, 1999:284). According to Nel (2009:117), a person may be tempted to argue that valuation methods other than the discounted future economic income method should be regarded as secondary valuation methods. However, there are circumstances when the availability of information may be limited, which may reduce a discounted future economic income method as inappropriate. In such instances, valuation methods such as multiples may be used as primary valuation methods.

2.3.4. Capitalised economic income method

The capitalised economic income method is used to transform an estimation of a single year's income expectation into a suggestion of value in *one* direct step, either by dividing the income estimation by a suitable rate or by multiplying the income estimation by an appropriate factor (Pratt, Reilly & Schweihs, 1998:255). This is also known as the *formula method* (Modica, 2010:195). According to Pratt & Niculita, (2008:238) and Pratt, Reilly and Schweihs (1998:255), in real estate terminology the capitalised economic income method is called direct capitalisation (Reilly, 2003:74). It is well known from what real estate valuators call yield capitalisation, which is comparable to the business valuator's discounted economic income. The capitalised economic income method is the application of one divisor or multiple to one economic income measure (Pratt, Reilly & Schweihs, 1998:255). There are two variations of the capitalised future economic income method that are widely used in business valuations, namely the *perpetual economic income stream model* and the *constant growth model*, also referred to as the *Gorden growth* model (Pratt & Niculita, 2008:238).

Similar to the *discounted future economic income method*, the essence of the capitalised income method is twofold (Van Vleet, 2004:74). Firstly, consisting of the projection of an expected

economic income stream, which is different to projecting the total and timing of each individual economic income flow the business entity is anticipated to produce for its owner. The capitalisation method needs to project a single, normalised amount of economic income that is also called the numerator. Secondly, capitalising expected economic income to produce a present value (Van Vleet, 2004:74). This includes dividing the anticipated economic income by a rate that replicates the risk or degree of certainty or uncertainty of getting an expected amount on a fixed basis. The present value discount rate is the starting point. The numerator replicates only a single time period of economic income, not any forthcoming changes. Therefore, if changes are anticipated, the present value discount rate must adjust by adding or subtracting the expected rate of growth or weakening in the economic income flow to change the present value discount rate into a direct capitalisation rate (Pratt, Reilly &Schweihs, 1998:255).

There are critical differences between the *discounting* and *capitalisation model* (Reilly, 2003:94). A *discount rate* converts the entire expected future returns of an investment into an indicated present value (Richardson, 2008:28). A *capitalisation rate* converts merely a *single* expected economic return amount to an indicated present value. A discount rate is a rate of return that is used to convert a financial amount, payable or receivable in the expected future, into a present value. A capitalisation rate is any divisor, typically expressed as a particular percentage, used to convert expected economic benefits of a single period into a value (Pratt & Niculita, 2008:238; Van Vleet, 2004:74). The capitalisation method is reasonably straightforward in methodology (Bakken, 1999:264) and is simply a shortened version of the discounted future economic income method. The perpetual economic income stream model's formula is as follows (Pratt & Niculita, 2008:239):

$NCP_1 / (k-g)$

Where: NCF1 = Net cash flow in year 1

k = Discount rate

g = Growth rate into perpetuity

The capitalisation economic income method uses simple mathematics (Bakken, 1999:264). Mathematically it shows that when the anticipated economic income is a constant in perpetuity, the above formula can simplify to the following:

$PV = E/_{k}$

Where ***PV*** is present value, ***E*** is an expected amount of economic income in every period ahead in perpetuity and ***k*** is the discount rate which is the cost of capital for that level of economic income. In a case where the expected economic income is a net level amount in perpetuity, the discount rate is equal to the capitalisation rate, which is demonstrated as follows:

$c = k$

Where ***c*** is the capitalisation rate and ***k*** is the discount rate, which is the cost of capital for that level of economic income (Pratt & Niculita, 2008:239; Bakken, 1999:264). Pratt, Reilly and Schweihs, (1998:256) call it the basic formula for valuing a business entity by the capitalisation of economic income method. This is a general method and analysts should be specific about the same points as in the discounted future economic income method. Discounting, for which a discount rate is used, is a procedure applied to one or a series of specific expected income amounts, as of a specific time or times in the future to convert those expected amounts to an estimate of present value. The discount rate is applied to all the expected future economic incomes, and therefore any expected future growth in returns is captured in the numerator of the discounted economic income formula (Pratt & Niculita, 2008:241). Capitalisation, for which a capitalisation rate is used, is a method that is applied to an amount demonstrating a measure of economic income for a single time period to convert that amount of economic income into an estimation of present value. Capitalisation procedures can be used with estimated present, historical, or stabilized measures of economic income. If there is growth expected from the base level of the economic income being capitalised, then the expected growth is revealed in the capitalisation rate (Bakken, 1999:264). For an investment with eternal life, the difference that exists between the discount rate and the capitalisation rate is the annually compounded percentage rate of growth or drop in perpetuity in the economic income variable that is being discounted or capitalised. If the level of economic income expected in the 12 months

immediately following the valuation date is expected to increase after that time at a constant average annually compounded rate in perpetuity, then it can be demonstrated mathematically that the basic discount economic formula can be simplified as follows (Pratt & Niculita, 2008:241; Bakken, 1999:264):

$PV = E_i / (1 + k)^I$ to $PV = E_1 / k - g$

Where: PV = Present value

E_i = Expected amount of economic income in the period immediately ahead

k = Discount rate

g = Expected average growth rate of E, annually compounded in perpetuity

In the above formula, $(k - g)$ represents the capitalisation rate, a relationship that can be expressed as a mathematical formula: as follows:

$c = k - g$

Where: c = Capitalisation rate

k = Discount rate

g = Annually compounded growth rate in the economic income variable being capitalised over the life of the investment.

This leads to the basic capitalisation formula that is as follows (Pratt & Niculita, 2008:242; Bakken, 1999:264):

$PV = E_1 / c$

Different from the discounted economic income model, the capitalisation model doesn't take the timing of future changes in expected economic income into consideration (Bakken, 1999:268). The bigger the differences in the expected changes over time, specifically in the first years, the more analysts are encouraged to use the discounted future economic income method instead of the capitalised income method. This leads to *four generalizations* about the comparative attractiveness of the two basic income approach valuation methods.

- The *first* one is that if the economic income flow is stable, growing, or declining at an even rate, the capitalised economic income method should achieve as accurate a value indication as the discounted future economic income method.
- The *second* one is that if there are reasons to believe that changes will be significant but predictable, the discounted economic income model should produce a more accurate valuation.
- *Thirdly*, if growth is anticipated to be high in the immediate future, the discounted future economic income method should produce a more accurate valuation.
- *Lastly*, changes that are irregular and unpredictable as to timing, the business entity's risk, and present value discount rates, increase (Pratt, Reilly & Schweihs, 1998:256).

The direct capitalisation model accepts that the base level of normalised economic income to be capitalised is the expected income in the period immediately following the effective valuation date (Pratt & Niculita, 2008:243). If the normalised economic income for the period immediately preceding the effective valuation date is measured as a reasonable base level from which to project sustainable growth, the *Gordon growth model* version of capitalised economic income method is appropriate. The Gordon growth model can be explained as follows:

2.3.5. Gordon growth model

Using the net cash flow as the economic income measure, the formula for the *Gordon growth model* is as follows:

$PV = E_0 (1 + g) / k - g$

Where: PV = Present value

E_0 = Amount of economic income in the period immediately past

k = Discount rate

g = Growth

The *Gordon growth model*, also called the *dividend* or *constant growth model* (Pratt & Niculita, 2008:243), version of the capitalised economic income method is often used to develop the terminal discounted future economic income method (Pratt, Reilly & Schweihs, 1998:260). The model assumes that growth is constant, that it is appropriate only where the required return is higher than the growth rate, and if growth exceeds the required rate of return, the model gives a negative valuation to the shares, which are limitations when using the *Gordon growth model* (Correia *et al.*, 2010:6-14). Since the model refers to a future period, it is described as an *ex-ante* model. The returns, the price at the end of the period, as well as the dividend receivable are all expected values (Ryan, 2007:374). According to CIMA (2011a:300), the dividend valuation model is grounded on the present value of future dividends being generated by the existing management.

The projections needed for the capitalised economic income method are twofold, consisting of the normalised expected base economic income and the expected long-term growth rate. These projections may be prepared by the business entity or by the valuation analyst (Pratt & Niculita, 2008:247; Pratt, Reilly & Schweihs, 1998:259). In order for the economic income method to produce an accurate value indication, the numerator should be a realistic normalised case of expected economic income. The expected economic income should be either steady or expected to change at a constant average rate over a long period. As with the discounted future economic income method, this method requires carrying out the adjusted income statement procedures. The number capitalised should represent expected future economic income. An average or weighted average of past operating results is not an acceptable procedure to develop this number. Historical average should be used only if the analyst is able to rationalise the notion that this past average is a reasonable alternative for future economic income expectations (Pratt & Niculita,

2008:247; Pratt, Reilly & Schweihs, 1998:259). The build-up CAPM procedure can also be used in the capitalised economic income valuation method, which requires a terminal value. The build-up CAPM procedure can be explained as follows:

2.3.6. Build-up CAPM

If the build-up or CAPM procedure is used to develop the present value discount rate from which the growth rate is to be withdrawn in order to develop a direct capitalisation rate, that discount rate should include the expected rate of inflation as part of the required rate of return. The implication is that the particular long-term growth rate should also reflect the impact of expected inflation on the economic income variable being capitalised. The capitalisation rate is a growth rate expected in perpetuity (Pratt & Niculita, 2008:248; Pratt, Reilly & Schweihs, 1998:260). The discounted future economic income method involves projecting cash flows for isolated times, followed by a terminal value as of the end of the isolated projection period. There are various ways to develop a terminal value and the most common methods are the capitalised economic income method with earnings before interest, taxes, and owner's compensation (EBITDA) (Evans, 2000:39; Bakken, 1999:264).

The *terminal value* is the expected value of the business entity as if of end of the separate projection period. If the economic income is expected to be constant following the separate projection period, the formula for the terminal value is as follows (Pratt & Niculita, 2008:252; Pratt, Reilly & Schweihs, 1998:262):

$PV = E_{(n + 1)} / c$

Where: PV = Present value

$E_{(n + 1)}$ = Expected economic income in the period directly after the end of the separate projection.

c = Direct capitalisation rate

In the above formulas used, the terminal value is discounted back to a present value at the present value discount rate for a certain number of years. Terminal value is the value at the start of a time directly following the separate projection period and is exactly the same point in time as the end of the separate projection period. The capitalised economic income method can create a control or minority value, primarily depending on the normalization adjustments made to the economic income flow being capitalised (Pratt, Reilly & Schweihs, 1998:262). If synergies or circumstances irregular to a particular investor were reflected in the economic income stream or in the direct capitalisation rate, the value indication would reflect those elements of investment value (Pratt & Niculita, 2008:252). In the income approach, capitalisation rates are resultant from discount rates and the capitalisation rate is the discount rate subtracted from the sustainable long-term growth rate (Modica, 2010:195; Hall, 2004:95).

In conclusion, there are *three* principal variables in the capitalised economic income method, namely the *projected base-level economic income flow*, the *present value discount rate*, and the *anticipated long-term growth rate* that modifies the present value discount rate to develop the direct capitalisation rate (Bakken, 1999:270).

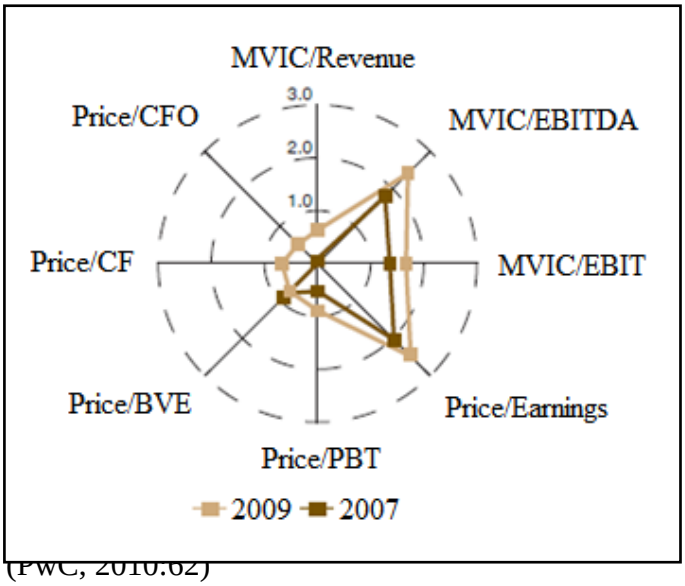
This method is a shortened version of the discounted future economic income method and the primary difference is the treatment of future changes in the expected economic income. The capitalised economic income method is a forward-looking exercise that uses averages of actual past economic income. It is important that the direct capitalisation rate be developed so that it is suitable for the description of the economic income flow being capitalised (Pratt & Niculita, 2008:257; Pratt, Reilly & Schweihs, 1998:267). Capitalisation consists of a single period valuation model that changes an income or benefit stream into value (Modica, 2010:194; Hall, 2004:95).

2.4. Market approach

The common theory behind the *market approach* is that business entities are considered to be the same in terms of revenue, cash flow, assets and functioning in similar industries, must respond in the same manner to market forces and have a strong correlation in business value (Gabehart & Brinkley, 2002:39). According to Sheeler (2004:50), the market approach is more objective than

the income and asset approach because it captures what actual investors pay for business entities in many industries. Within the market approach, the two most commonly used methods according to Van Vleet (2004:74) and Reilly (2003:94) are the *guideline publicly traded company method* as well as the *guideline merged and acquired company method*. PwC (2010:61) suggests that a number of valuation multiples or standards can be used in the demand of the market approach, and according to their survey, the most popular valuation multiples ranked as follows:

Figure 2.9: Valuation methods used



(PwC, 2010:62)

According to (Smith & Smith, 2005:18) the market approach uses indirect market multiples of financial statistics, for example revenue, free cash flow, and total assets, witnessed in public trading markets and publicly announced merger and acquisitions. These indirect market multiples are multiplied by the subject business entity's comparable economic statistics to offer indications of value. It is possible to use multiples like those which are adjusted for lack of marketability and controlling interest to value family business entities. Fodor and Mazza, (1992:171) make a statement that care must be taken in the selection of the comparable business entities, since many closely held business entities often are unique and no comparable public business entities really exist.

2.4.1. Guideline publicly traded company method

The practice of the *guideline publicly traded company method* to value the stock of closely held business entities has been considerably enhanced in the 1980s and 1990s by three important developments. The developments comprise an increased number of available actively traded public business entities for the analyst to select from, development of e*lectronic data gathering and retrieval* (*EDGAR*), used specifically in America, and the development of extensive new databases. The databases provide empirical guidance to assist in calculating the discount for lack of marketability that exists between a publicly traded security comparable value and an otherwise comparable closely held security value (Pratt, Reilly & Schweihs, 1998:270). The trademark of any market method is that it should be systematic and logical. There are two accepted styles in choosing guideline business entities. One is to go right for a sharpshooter approach, which is applicable when using guideline public business entities. A small, handpicked set of guideline public companies that closely match the subject business entity is chosen (Abrams, 2010:429).

The guideline publicly traded company method estimates the value of the subject business entity based on the application of a capitalisation rate or a market-derived pricing multiple extracted from empirical studies of stock prices and earnings fundamentals of publicly traded corporations (Van Vleet, 2004:74). The public capital markets re-price stocks daily, typically through transactions between economic buyers and sellers who are highly educated and have no special motivations or responsibilities to buy or sell. Business entities, which are already public, are ranked high on the list of possible acquirers for numerous private business entities. Valuations limitations of the possible acquirers' stock may affect the pricing of a possible acquiree (Pratt & Niculita, 2008:262; Pratt, Reilly & Schweihs, 1998:270).

Valuation multiples

The purpose of collecting guideline publicly traded business entity statistics is to develop valuation multiples grounded on the prices at which stocks of comparable business entities with similar characteristics trade in the public market (Miles, 1999:164). The valuation multiples established will be applied to the subject business entity's essential data and then correlated to

reach an estimation of a value for the subject business entity or its shares or other interest. A valuation multiple is a multiple calculated by dividing the price of guideline business entity's stock as of the date of the valuation by a particular applicable economic variable witnessed or calculated from the guideline business entity's financial statements. Security analysts may estimate some financial variables, such as projections of the following year's economic income (Pratt & Niculita, 2008:262; Pratt, Reilly & Schweihs, 1998:270). Income statement variables regularly used to develop *pricing* from guideline business entities are the following (Kirrane, 2009:3; Pratt & Niculita, 2008:262; Pratt, Reilly & Schweihs, 1998:270):

- Gross or net revenue
- Net income
- Gross cash flow which is the net income plus charges
- Net income before taxes
- Net income after taxes
- Operating cash flow, also known as earnings before the depreciation, other noncash charges, and taxes (EBDT)
- Dividends or dividend-paying capacity

In addition to business valuations there are multiples using simply the value of common stock to develop pricing multiple. Certain measures state the value of the invested capital as a whole. The numerator for the valuation multiple is regularly called adjusted market value of capital structure, market value of invested capital (MVIC), enterprise value , or aggregate market value of capital structure. The denominator used to calculate the pricing multiples must contain the returns obtainable to all classes of capital replicated in the numerator, for example, the preferred dividends and interest (Pratt & Niculita, 2008:265). Income statement variables commonly used to develop business valuation *multiples* for *MIVC* are the following (Pratt & Niculita, 2008:265):

- Gross or net revenue;
- Earnings before interest and taxes (EBIT);
- Earnings before depreciation, interest, and taxes (EBDIT);
- Earnings before depreciation, interest, and taxes and amortization (EBITDA);
- Operating cash flow which consists of net income, plus interest and noncash charges; and
- Debt-free income.

According to Pratt, Reilly and Schweihs (1998:280) the purpose of collecting data on guideline publicly traded business entities is to extract some pricing standards by which to value the subject privately owned business entity. In the process of collecting a complete list of guideline publicly traded business entities, not a single source that provides a complete list is available. In some industries it is easier to find respectable guideline business entities than in others. A comprehensive search needs creativity, originality, and experience. The starting point when accumulating a list of guideline business entities is to collect them according to the industry in which they operate. The starting point in an investigation for developing guideline publicly traded business entities which are similar is a search for the appropriate Standard Industrial Classification (SIC) (Sheeler, 2004:51) or North American Industry Classification System (NAICS) (McCarter & Aschwald, 1999:199) code that applies to the subject business entity (Pratt & Niculita, 2008:279). Usually, similar types of adjustments must be made to the financial statements of guideline business entities as are made to the financial statements of the subject business entity. The main classifications of adjustments are the following according to Pratt & Niculita (2008:289), Pratt, Reilly and Schweihs (1998:281) and McCarter and Aschwald (1999:208):

- Remove the nonrecurring objects and any required tax effects from the income statements;
- Where applicable, place guideline and subject business entities on a comparable accounting basis by adjusting any business entity accounting for inventory on the last in first out LIFO basis to the first in first out FIFO basis, and use constant depreciation methods;
- Adjust for non-operating items; and
- Adjust for discontinued operations.

For determinations of comparative performance as well as other ratios between the subject business entity and the guideline business entities, the comparisons will be more significant if the ratios are calculated after the adjustments have been made to the financial statements of the guideline business entities and the subject business entity. The comparative ratio analysis implementation is done simply for the most recent existing comparative year, or the last 12 months, even if valuation multiples are grounded on the average results of numerous years. If using the comparative ratio analysis to determine where the subject's value measures must be comparative to the guideline business entities' value measures, the analyst should be cautious to identify any irregularities in the year for which the ratios were calculated. Irregularities as such may cause the ratios to be deceptive for use in concluding the relevant value measure (Pratt, Reilly & Schweihs, 1998:279).

If the valuation multiples to be used are simply those that relate to the common equity, then all that is required is the price for every guideline business entity's stock as of the date of the valuation. If valuation multiples grounded on the MVIC are to be used, then the market value of every component of the invested capital needs to be projected. Certain guideline publicly traded business entities' high-ranking securities, for example, debt, or preferred stock cannot be publicly traded, and in that situation book value is used as a replacement for market value. The analyst may consider using fair value of financial instruments discovery in the appendixes for guideline business entities, where the business entity gives an approximation of the value of its short and long-term debt as of the economic year-end (Pratt & Niculita, 2008:290). Guideline business entity tables can be accessible on a direct equity basis or else on an invested capital

basis. They display the names of the guideline business entities, the market in which they are traded, for example New York Stock Exchange (NYSE), American Stock Exchange (ASE), and Johannesburg Stock Exchange (JSE), the per-share market price as of the date of the valuation, the financial fundamentals, for example, EBIT, EBITDA, the earnings, and the resulting valuation multiple, namely the price dividend multiple. For every valuation multiple that is presented, the table presents a high, low and mean, and median (Miles, 1999:169). The result of the guideline business entity analysis is a range of pricing multiples for each of the numerous valuation methods, and for each valuation multiple used, it is required to choose which pricing multiple for the subject business entity must be comparative to the observed multiples for the guideline business entities (Pratt & Niculita, 2008:291; Pratt, Reilly & Schweihs, 1998:283).

The similar common thought procedures and decision principles apply both to determining whether to depend on one specific value measure and to determining the relative weight to be allowed to each value measure that is eventually used. A study of actual pricing data can lead to better or reduced requirement on particular value measures than the analyst may have estimated prior to accumulating the pricing data. The following factors affect the impact of guideline publicly traded business entity data evaluation:

- Number of data points available;
- Comparability of data measurement;
- Comparability of data patterns; and
- Deceptive market reliance.

When it comes to the measures of fundamental trend, the median, referring to the number in the middle of the range, provides a better measure for ratios than the mean, which is the mathematical average. This is because one or more outliers, also known as extreme observations, can have more of a misleading effect on the mean than on the median (Miles, 1999:169; Stanton & Vinso, 1999:118). When using the mathematical average to summarise ratios that have a stock price or a MVIC in the numerator, like the P/E multiple, it weighs every guideline business entity in proportion to that business entity's ratio and it doesn't give equal weight to every guideline business entity (CIMA, 2011b:294; Pratt & Niculita, 2008:292). A simple but significant measure of risk is the range, which is the range between the highest and lowest the

observation. The tighter the collection of data points, the less room for judgemental error in deciding on the suitable multiple for the subject comparative to the guideline business entity. Differences between the subject and guideline business entities lead the analyst to determine that a multiple for the subject business entity must be outside the range for guideline business entities. The most accustomed measure of risk is the standard deviation, which is the square root of variance (Correia *et al.*, 2010:3-10).

Multiples of economic income variables, for example, P/E multiples, price/cash flow (P/CV) multiples, price to gross (P/G) multiple and price to book value (P/B) multiples are the reciprocals of the direct capitalisation rates applicable to those financial fundamental variables (Ryan, 2007:367). According to Leibowitz & Kogelman (1994:2), the P/E ratio measures the market's assessment of the business entity's future. A no-growth business entity will have a low base P/E that is simply the reciprocal of the equity capitalisation rate appropriate to the business entity's risk class, while high P/E results only when growth comes from new projects that provide sustainable above-market returns (Leibowitz, 2004:29). Therefore, the same elements that influence direct capitalisation rates influence pricing multiples (McCarter & Aschwald, 1999:205; Miles, 1999:174). The most important two of these influences are risk and expected growth in the financial fundamental variable being capitalised. In order to create an intellectual estimation of what pricing multiple is suitable for the subject business entity, relative to the pricing multiples observed for the guideline business entities, the analyst should make some judgements as to the relative risk and growth prospect of the subject business entity compared with the guideline business entities. The size factor is a significant indicator of risk (McCarter & Aschwald, 1999:201). The expected growth rate in perpetuity for an economic income variable, for example the earnings or cash flow, translates into the direct capitalisation rate appropriate for that variable. For that reason, if the subject business entity has long-term growth predictions above or below those of the guideline business entity, each percentage point of such differential should be subtracted from or added to the capitalisation rates observed for guideline business entities (Pratt & Niculita, 2008:293; Pratt, Reilly & Schweihs, 1998:285).

When the direct capitalisation of dividends method is used as a method in the valuation, it is by reference to dividend yields in guideline publicly traded business entities. An estimation of

dividend-paying capacity can be grounded, in part, on the typical pay-out ratios of publicly traded business entities in the subject business entity's industry. Valuation pricing multiples of revenue have a tendency to be highly correlated with the financial fundamental measure return on sales. The strength of this correlation varies significantly from one industry to another. When considering using a pricing multiple of revenue, it is useful for the analyst to determine whether the guideline business entities' multiples of revenue are well correlated with the guideline public business entities' return on sales. This valuation method tends to be more valuable for industries where such a correlation is higher than for those where it is lower. In a way, the capitalisation of revenues can be considered as a shortcut to the capitalisation of earnings, since there is an implied statement that a particular level of revenues must be able to produce a specific earnings level in a particular type of business entity. Valuations performed by the multiple of revenue method are vulnerable for risk because of differences in the capital structure between the subject business entity and the guideline publicly traded business entities. Therefore, the multiple of revenue pricing multiple is often removed on a market value of invested capital (MVIC) basis (Pratt & Niculita, 2008:296; Pratt, Reilly & Schweihs, 1998:286).

When analysts have calculated that the book value or the adjusted book value provides a valuable demonstration of a business entity's fundamental net asset value, the following procedure in this method is to interpret the book value and its implication for market value of the subject business entity's shares of stock or partnership interest. This procedure is performed by referring to the connection of the price of guideline business entities' stocks to their particular fundamental net asset value (NAV). The pricing multiple data for the guideline business entities may be grounded on the empirical prices of stocks traded on organized capital markets, transaction prices paid in merger and acquisition, or both (Pratt & Niculita, 2008:296). The data source used will rely on various factors, including the ownership percentage of the subject business entity's interest. It can be possible to calculate what the multiple of market price to book value is for a collection of guideline business entities that have stock publicly trading in the capital markets, and to apply a multiple someplace within the range of such market-derived multiples to the subject business entity's book value. If the book value of the subject business entity and guideline business entities was calculated on a comparable basis, and if the asset structure of the subject business entity and the guideline business entities is comparative, this

procedure may provide a reasonably accurate estimate of value of the subject business entity's interest. If accounting methods for the subject business entity and guideline business entities vary considerably, the analyst must make suitable adjustments before calculating the market price to book value multiples and then applying them to the valuation (Pratt, Reilly & Schweihs, 1998:288).

There can be additional important variances, such as in asset mix, that test the legitimacy of using one business entity's price to book value multiple in valuing another one's stock. The valuation multiples are calculated merely on tangible book value and may help to avoid risk, since certain business entities may have formed their own intangibles, and expensed them for accounting reasons, while others may have developed their own intangibles, and carry them on the balance sheet. If the subject business entity's return on equity is high in comparison to the guideline business entities', the suitable price to asset value multiple must be in the higher end of the significant range, and vice versa (Pratt & Niculita, 2008:296; Pratt, Reilly & Schweihs, 1998:288). For a limited number of industries, empirical data on the market values of fundamental net assets are obtainable. Where that is the situation, it is possible to extract multiples of the public business entity stock's prices to the adjusted NAV. When using multiples of market prices to adjusted NAV, it is essential to make similar kind of adjustments to the subject business entity as have been made to the NAV of guideline business entities. The procedures in the guideline publicly traded company method are as follows (Pratt & Niculita, 2008:305; Gabehart & Brinkley, 2002:46; Pratt, Reilly & Schweihs, 1998:294):

- Set standards for selection of guideline publicly traded business entities;
- Search for, and be aware of the business entities that fit the standards;
- Agree on the significant period for comparative analysis of the subject business entity and the guideline business entities;
- Find the guideline business entities' financial statements for the period decided on;
- Increase or narrow the standards, if required, to deliver the best collection of guideline business entities, adding or removing business entities according to the revised standards;
- Accumulate comparative financial ratios for the subject and guideline business entities;
- Decide which guideline business entity valuation multiples to use;
- Achieve the market price of each guideline business entity's stock as of the valuation date;
- Accumulate guideline business entity valuation multiple tables for the valuation multiples decided on;
- Grounded on the analysis of the valuation multiple tables in combination with the comparative financial analysis of the subject and guideline business entities, decide on the suitable multiple for the subject business entity for each valuation multiple to be used;
- Multiply each valuation multiple to be used by the appropriate financial variable for the subject business entity to get an indication of value according to each valuation multiple;
- Weigh or correlate the indications of value to influence an estimation of value as if publicly traded, which include a marketable, minority and ownership interest value; and
- Adjust this value, if suitable, for elements in the description of value, but not replicated in the value as if publicly traded, for example, the discount for lack of marketability and the premium for control. Furthermore, adjust every other element of value, if suitable, that were adjusted out of the guideline business entity analysis, such as non-operating assets.

Time periods

The above variables are calculated on an operating basis, with non-operating items treated individually. Any of the above financial variables can be measured for any or all of a diversity of *periods* to produce the denominator for a measure of value. Typical periods that are used are the (Pratt & Niculita, 2008:265; McCarter & Aschwald, 1999:212):

- Latest 12 months (one year);
- Latest economic year;
- Estimations for the upcoming year;
- Simple average of a certain number of past years; and
- Weighted average of a certain number of past years.

All of the above performances variables and periods can have numerous other variations, dependent on obtainability and significance of data. Value measures may also be developed grounded on balance sheet financial data. Measures typically are resultant from public stock prices as of the valuation date. The stock prices are divided by the balance sheet financial variables as of a date as near as possible prior to the date of valuation for which the guideline business entity and the subject business entity data are both available. Balance sheet variables generally used are book values, tangible book values, adjusted book values, and adjusted tangible book values.

As with valuation multiples grounded on operating data, valuation multiples grounded on assets value can also be performed on a total capital value basis, and in cases like that the market value of the senior equity as well as the interest-bearing liabilities normally is added into the numerator and the denominator in developing the valuation multiple (Pratt & Niculita, 2008:262; Pratt, Reilly & Schweihs, 1998:270). Different from operating variables, measured over one or more time periods, asset value variables usually are measured simply at the latest practical point of time. The actual measure that is applied to the subject business entity can be anywhere within the collection of value measures extracted from the capital market data.

The period used most frequently for analysis of operating data is three to five years. The conventional period shouldn't be automatically accepted. For a repetitive industry, a complete economic cycle for that specific industry is generally considered to be a respectable choice of time period from which to develop average functional results to be used as the foundation for valuation multiples. The same period that is used for collecting and giving data is used for income statements and balance sheet data. Valuation multiples grounded on income statement data are calculated by dividing the valuation date price by the averages of variables or income variables for one or more previous periods. Valuation multiples grounded on balance sheet

variables, for example, price/book (P/B) value, are calculated by dividing the valuation date price by the most current balance sheet variable. The purpose for gathering and presenting numerous years of balance sheet figures is to recognise and understand comparative tendencies among the guideline and the subject business entities, even though the previous years' balance sheet records are not used directly in the calculation of valuation multiples (Pratt & Niculita, 2008:271; McCarter & Aschwald, 1999:212).

Standard value used for the guideline publicly traded company method

The original value developed from the guideline publicly traded company method, before adjustments for shareholder-level elements such as the degree of marketability or the lack of it, is usually called the publicly traded equivalent value, or the freely traded value. This is the price at which the stock would be if anticipated to trade if it were traded publicly. This method may be used in combination with a valuation for every standard of value, most essentially for fair market value (Pratt & Niculita, 2008:267; Pratt, Reilly & Schweihs, 1998:274). While the guideline publicly traded company method may be used in combination with every standard of value, it commonly is most valuable when the standard of the value is fair market value. This valuation method is grounded on making comparisons concerning the subject stock and the active market transaction in guideline stocks. The fair market value is the standard of value in taxation-related valuations, for example, Revenue Ruling 59-60 references the public capital markets no fewer than seven times (McCarter & Aschwald, 1999:199; Pratt, Reilly & Schweihs, 1998:274).The fair market value is the standard of value for most employee stock ownership plan ESOP-related valuations as well. The fair market valuations are the standard for initial public offerings IPO's because the pricing of such transactions should be guided by what the market is willing to pay. The use of accounting information in combination with comparable business entity multiples is recommended for valuing IPO's. It has been found that the price-earnings P/E ratio, the market to book, and the price to sales multiples of comparable business entities have only uncertain analytical ability without additional adjustments (Kim & Ritter, 1999:409).

The guideline publicly traded company method typically would be a part of the investigation when fair value is the standard. The value of the investment is the standard of value that may advance the most from the value specified by a request of a guideline publicly traded company

method. The guideline publicly traded company method would be anticipated to indicate a value grounded on an agreement of market applicants, as demonstrated by their transactions. The value of the investment is the value to a specific buyer or seller, and therefore income approach valuation methods provide more opportunity for a particular party to project owner-specific economic income flows and use discount rates and capitalisation rates that are suitable to their specific individual investment criteria (McCarter & Aschwald, 1999:207). The analyst interested in the investment value can constantly adjust the economic variables on a pro forma basis. These adjustments would be made in order to reflect expected changes in the business entity, and use the guideline publicly traded company method to assess how sensitive the market value is to numerous possible changes in the financial variables.

Guideline publicly traded company transactions are non-controlling or minority ownership interest by definition, according to Pratt, Reilly and Schweihs (1998:275). They are directly relevant for valuation of other minority ownership interests. In applying the guideline publicly traded company method, quantitative and qualitative differences between the guideline business entities and the subject business entities are replicated in arriving at the publicly traded comparable value of the subject stock. These differences are commonly in the selection of pricing multiples applied to the subject business entity's financial fundamental data that are relative to the guideline business entities pricing multiples. When calculating a publicly traded equivalent value, there are adjustments that must be made for other factors, for example comparative excess assets, or shortages. Having calculated a publicly traded comparable value, the only unresolved adjustment required for a minority ownership interest value is the shareholder-level element of the lack of marketability (Pratt, Reilly & Schweihs, 1998:275). When valuing a controlling interest, it can be better to use the market approach by using simply guideline controlling interest transactions (Pratt & Niculita, 2008:268).

The guideline publicly traded company method is most appropriate when doing a valuation on marketable shares by direct comparison with other marketable shares. The most deceptive application of this valuation method is when pricing an IPO. According to Pratt & Niculita, (2008:268) and Pratt, Reilly and Schweihs (1998:275), the pricing of stocks in the public market is made on the assumption that they will continue as a going concern. Unless evidence is found

that states otherwise, the guideline publicly traded company method would be anticipated to create a value on the evidence that the subject business entity is anticipated to continue as a going concern business entity. As with several other valuation methods, the quantity and the quality of relevant data obtainable to implement will have a significant bearing on the practicality of the method. In analysing whether a certain publicly traded business entity may be considered a guideline business entity with respect to the subject business entity, there are certain factors that must be considered by analysts. These factors consist of the earnings, the products, dividend-paying capacity, markets management, the position of the business entity in its industry, book value, capital structure, depth of management, personnel experience, credit status, nature of the competition, and maturity of the business entity (Pratt & Niculita, 2008:271; McCarter & Aschwald, 1999:201; Pratt, Reilly & Schweihs, 1998:277). In revenue 59-60, the Internal Revenue Service makes the following comment: "Although the only preventive requirements as to comparable business entities indicated in the statute is that their lines of business be the same or similar, yet it is understandable that the most effective comparison possible will be obtained" (Pratt & Niculita, 2008:271; McCarter & Aschwald, 1999:199; Pratt, Reilly & Schweihs, 1998:277). When asking the question, "how many guideline public trade business entities should be analysed in the application of this particular valuation method?" the answer depends on the following factors (Pratt, Reilly & Schweihs, 1998:279).

- The more similar the guideline business entities, the fewer guideline business entities are needed for a substantial analysis.
- The more actively traded the guideline business entities are, the fewer guideline business entities are required for a substantial analysis.
- The broader the range of appropriate value measure data points, the higher number of guideline business entities is needed in order to recognise a pricing pattern appropriate to the subject business entity.

2.4.2. Guideline merged and acquired company method

The *guideline merged and acquired company method*, also known as the c*omparative transaction method* (Pratt, Reilly & Schweihs, 1998:310) estimates the value of the subject

business entity based on the application of market-derived pricing multiples extracted from empirical studies of transaction prices and earnings fundamentals of business entities involved in merger or acquisitions transactions. The guideline merged and acquired company method generates a controlling ownership interest value indication of the subject business entity. When using this method to value an equity ownership that lacks control, a valuation discount for lack of control is measured and applied. This discount is estimated by using empirical studies of acquisition price premiums paid for publicly traded business entities in control-event merger or acquisition transactions. The opposite of this acquisition price premium is considered a reasonable proxy for the valuation discount for lack of control. When this lack of control discount is properly estimated and applied, the analyst has fundamentally adjusted the merged and acquired business entity transaction pricing multiples to publicly traded business entity pricing multiples (Dellinger, 2010:62). These transaction pricing multiples, adjusted for lack of control, characteristically reflect the same income tax characteristics as publicly traded business entity investment rates of return (Van Vleet, 2004:76).

The merger and acquisition method is similar in theory to the guideline publicly traded company method, looking for valuation guidance from actual sale transactions in the market (Miles, 1999:163). Since the transactions data used are controlling interest, it is appropriate for valuing other controlling ownership interest, although it can be used for non-controlling interest valuations with suitable adjustments (McCarter & Aschwald, 1999:208). Merger and acquisition data come from numerous sources and are less dependable and less consistent than data on daily public stock market transactions. Occasionally, past transactions involving the subject business entity, are a decent source of valuation multiples. Since merger and acquisitions transaction dates vary from the subject business entity's actual valuation date, adjustments are required to reflect differences in the economic and industry conditions between the dates. Merger and acquisition prices reflect synergies and strategic advantages between the acquirer and target. A transaction may be more reflective of investment value, which is the value to that specific buyer, than fair market value, which is the value to a hypothetical buyer. For this reason, the conditions and details of merger and acquisition transactions must be thoroughly analysed, if available (Pratt & Niculita, 2008:323; Sheeler, 2004; Pratt, Reilly & Schweihs, 1998:325).

Standard value used in the guideline merged and acquired company method

The analyst can develop indications of *value* from data on the prices at which entire business entities or operating units of business entities have been sold, or from the prices at which substantial ownership interest in business entities changed hands. This market approach method highlights the economic standard of substitution (Miles, 1999:165), which means that a buyer would not pay more for something than for a substitute that delivers the same economic value (Pratt, Reilly & Schweihs, 1998:310). The criteria for selection of merged and acquired guideline business entity transactions are similar to those for selecting publicly traded stock guideline business entities, and in situations where limited data are available, the criteria may have to be extended (McCarter & Aschwald, 1999:201). The original value resultant from the guideline merged and acquired company method, before adjustments for elements like the size of the subject block and degree of marketability, is an indication of transaction prices of key ownership interests, which is usually controlling ownership interests. The characteristics of each transaction need to be thoroughly analysed to make conclusions as to what adjustments may be required in order to use the transaction pricing multiples as guidance in a specific valuation assignment.

Merger and acquisition transaction prices may be characteristic of fair market value, investment value (Miles, 1999:165), or in between. At one end of the spectrum, a sale to a pure financial buyer, which is a buyer who is buying severely for a return on investment from the business entity as a stand-alone entity, usually would be representative of fair market value. At the other end of the spectrum, the more unique the synergies between the acquirer and the acquiree, the more the transaction is representative of investment value rather than fair market value (Evans, 2000:37). This is because the pricing may reflect the synergy benefits to a specific buyer rather than the price a hypothetical buyer would pay. According to CIMA (2010:325), the *synergy* is where present value of the combined business entities is greater than the sum of the net present value of the individual business entity. The synergetic concept of "2+2=5", suggests that there is a possibility of gain in combination for business entities, which is not available if they act alone (Ryan, 2007:444).

When the comparative transactions include the assumption that the buyer will become an owner or operator, the regular cost of return for the operator of the business entity should be one of the

factors taken into consideration when examining the comparative transactions, except when the value measure used is the multiple of discretionary cash flow, which is before owners' compensation (Pratt & Niculita, 2008:311; Pratt, Reilly & Schweihs, 1998:313). Since merger and acquisitions characterise control transactions, they are applicable for valuation of other controlling ownerships interests. If valuing a non-controlling or minority ownership interest, it is required to apply a minority ownership interest discount to a value specified by merger and acquisition data. It may be suitable to apply an additional valuation discount for lack of marketability (Dellinger, 2010:62). The issue of adjustments for marketability, or the lack of marketability, relative to actual control transactions, is a subject of continuing discussion among business valuation professionals, according to Pratt, Reilly and Schweihs (1998:313). If merger and acquistition transaction data are used as guidance to estimate fair market value, which is a equivalent value as of a certain date, certain adjustments may be appropriate (Miles, 1999:166). The fundamental financial data of the guideline business entities used in this method are similar to the data used in the guideline publicly traded company method. The analyst develops value measures by comparing the price paid for an acquisition to the target business entity's income statement variables and balance sheets variables, such as the following (Pratt & Niculita, 2008:311; Pratt, Reilly & Schweihs, 1998:313l; Miles, 1999:180):

- Gross or net revenue;
- Earnings before interest and taxes (EBIT);
- Earnings before depreciation, interest, and taxes (EBDIT);
- Gross cash flow, which is the net income plus interest and non-cash charges available to invested capital;
- Debt-free net income, which is net income plus interest;
- Discretionary earnings;
- Book value;
- Tangible book value;
- Adjusted book value; and
- Adjusted tangible book value.

Elements of comparison

A number of elements of *comparison* should be considered, to the extent the information is available, when selecting and analysing each comparative transaction in the market approach valuation of a small business entity or professional practice. Potentially important elements of comparisons are as follows:

- The legal rights of business ownership or equity (McCarter & Aschwald, 1999:198).
- The occurrence of any special financing terms or arrangement between the buyer and the seller, with short-term or temporary employment agreements with the seller and earn-out provisions with regard to the payment of the purchase value (McCarter & Aschwald, 1999:215).
- Whether the fundamentals of arm's-length sale conditions occurred and whether the transaction was, in any way, a distress sale, and whether there were any transferability limitations related to the ownership interest that would indicate anything other than an arm's length independent sale (McCarter & Aschwald, 1999:198).
- The economic circumstances that occurred in the suitable secondary market at the time of the sale or merger transaction, which includes consideration of the local economic circumstances in the geographic area, mainly served by the business entity or practice, and of the economic conditions in the industry principally served by the business entity or practice (Miles, 1999:181).
- The degree of industry specialization of the comparative business entity and the specific industry in which the business entity specializes, for example, an industry on the incline or decline (McCarter & Aschwald, 1999:215).
- The physical characteristics of the comparative business entity, in terms of number of operating locations, offices, favourable versus unfavourable leases, short-term versus long-term leases, and new or modern offices versus old or out-dated operations (Kirrane, 2009:32).
- The functional characteristics of the comparative business entity in terms of product lines and specialisations (Pratt, Reilly & Schweihs, 1998:317).
- The human capital characteristics of the comparative business entity, such as numbers of significant managers, age and credentials of significant managers, business development effectiveness of owners, employment contracts with managers, age and qualification of

personnel, and annual turnovers at the manager and staff levels (McCarter & Aschwald, 1999:215).

- The economic characteristics of the comparative business entity, for example, average billing rates for each level of professional in a professional practice, strength of client relationship, and current backlog of client work (Kirrane, 2009:32).
- The attachment of other assets in the comparative business entity sale transaction that may contain the sale of a bundle or a portfolio of assets, which could contain owned real estate and non-compete agreements from the selling owners.
- The degree to which employment and non-compete arrangements were included in the guideline transaction (Pratt, Reilly & Schweihs, 1998:317).

Databases

A variety of reporting services, newsletters, and online databases develop information from disclosure filings, business entity announcements, the media, and business entity intermediaries to provide extensive and organised analysis of merger transactions as they progress. General business indexes and news databases can be useful in conducting merger research, but the following sources provide specific coverage of merger and acquisition activities (Pratt & Niculita, 2008:311; Sheeler, 2004:51):

- Mergerstat review;
- The merger yearbook;
- Mergers & Acquisitions magazine;
- Buyouts, published every week by Securities Data Publishing;
- Mergers & Acquisitions report;
- SCD Platinum; and
- Mergerstat/Shannon Pratt's Control Premium Study.

The databases dedicated to middle-market and small business entity controlling ownership interest transactions include Pratt's Stats, Done Deals, Bizcomps and IBA Market Database (Pratt & Niculita, 2008:311; Sheeler, 2004:51; Miles, 1999:174). Databases found and used primarily for South African business entities are the Bloomberg, Reuters, JSE South African

Reserve Bank and McGregor (PwC, 2010:31). The result of the comparative transaction analysis is a range of pricing multiples for each of various value measures. For each value measure used, it is required to select what the pricing multiple for the subject business entity must be, relative to the observed multiples for the comparative transaction business entities (McCarter & Aschwald, 1999:203). It is essential to ask the following two questions (Pratt & Niculita, 2008:320; Pratt, Reilly & Schweihs, 1998:323):

- Which measure should be used to reach an indication of value?
- What is the relative weight that should be allowed to each of the measures used?

The comparative weighting of valuation multiples is similar to that used in the guideline publicly traded company method (McCarter & Aschwald, 1999:1216). The exception is that multiples of an asset fundamental such as MVIC to tangible book value might get more weight in a valuation of a controlling ownership position, because the control owner has preference over the assets' use or disposal. Similar observations apply to non-operating assets, excess assets, and asset deficiencies. Since merger and acquisition transaction analysis focuses on market value of invested capital, the market value of the debt must be subtracted in order to estimate the market value of equity. If minority ownership interest is being valued, the minority ownership interest discount and the lack of marketability discount should be considered (Modica, 2010:197). In the case of a controlling ownership interest, it may be suitable to make modifications for lack of marketability or illiquidity relative to the values indicated from actual completed transactions (Pratt & Niculita, 2008:323; Pratt, Reilly & Schweihs, 1998:325).

2.5. Asset-based approach

The asset-based approach of valuation, also known as the *tangible asset* or *balance sheet* approach, values the intangible assets of a business entity (Richardson, 2008:28; Gabehart & Brinkley, 2002:36). If accurately applied, the asset-based approach valuation methods are, questionably, the most complex and difficult small business entity and professional practice valuation analyses (Pratt & Niculita, 2008:367). The asset-based approach is not commonly used to value a non-controlling equity ownership interest of a profitable going concern operating business entity (Van Vleet, 2004:76). Valuations of fixed assets to be shown in financial

statements are required for purposes such as annual account of business entities as specified in the *Companies Act 1967*, takeover bids, flotation, business entity borrowing, capital re-organisation, insurance, taxation, liquidation, bankruptcy, and receiverships (Butler & Richmond, 1990:209). Asset-based valuations are based on net asset value (NAV), which is calculated by deducting the market value of liabilities from the market value of assets. The NAV approach is used as a minimum value, in other words, the lowest price a share is worth (Fife, 1999:47), therefore, the NAV approach is not used as a primary valuation approach (Nel, 2009:123). The asset-based valuation approach looks at the fundamental value of a business entity's assets to specify value. The asset-based valuation approach is more appropriate when a significant percentage of assets can be liquidated voluntarily at well-determined market prices if so preferred (Kim & Ritter, 1999:409). This method of calculating the fair market value of assets has a respectable importance, but this approach fails to recognise that the best value measurement is the quality of income in the business entity (Hughes, 2003:10).

The asset-based approach is not used as much as the *income* and *market approach* because a business entity is worth a lot more than the value of its assets in liquidation (Dellinger, 2010:60). The difficulty in an asset valuation approach is establishing the assets to use, and values ought to be realistic. The amount attached to an individual asset may vary considerably depending on whether it is valued on a going concern or a break-up basis (CIMA, 2011b:292). According to Ratner, Stein & Weithauer (2009:27), the asset-based approach should not be used by business entities with limited assets and significant intangible assets, such as service or technology business entities. There are *two* alternatives in the application of the asset-based approach to business valuation (Pratt & Niculita, 2008:352):

- The combined revaluation of all of the business entity's assets and liabilities. This analysis is commonly used together with the application of the capitalised *excess earnings method.*
- The individual adjustment of all the business entity's assets and liabilities, also known as the *asset accumulation method.*

2.5.1. Capitalised excess earnings method

The capitalised excess earnings method, often called the formula approach or treasury method, is perhaps the most commonly used business valuation method (Summers, 1999:222; Pratt, Reilly and Schweihs, 1998:422; Pratt & Niculita, 2008:346). The excess earnings method was created in the 1920s with the publication of appeals and review memorandum 34 (ARM 34) by the U.S department of the treasury. The excess earnings method was accepted in order to assess the intangible value of goodwill that distilleries and breweries lost due to the legal obligation of prohibition in the U.S treasury department regulations. From then, both the taxpayer and the internal revenue service used this valuation method extensively in association with business valuations for gift tax, estate tax, and other taxation purposes. In 1968, the internal revenue service updated the method in Revenue Ruling 68-609. It is still in effect today (Pratt, Reilly and Schweihs, 1998:402). In the Revenue Ruling 68-609, it states that the formula for the excess earnings approach can be used in calculating the fair market value of intangible assets of a business entity simply if there is not an existing base which is better for making the determination (Pratt & Niculita, 2008:333; Summers, 1999:222; Pratt, Reilly & Schweihs, 1998:402). The capitalisation of excess earnings method is a combination of the *income* and *asset approaches*. A number of specialists allocate this method as asset approach, while others allocate it to the income approach, according to Kalajian (2003:5).

Tangible and intangible assets

The most suitable application of the capitalised excess earnings method is for assigning total value between tangible and intangible assets, as in the following examples (Pratt & Niculita, 2008:334; Pratt, Reilly & Schweihs, 1998:402):

- Marital termination cases in jurisdictions where private goodwill value is considered a private rather than a marital asset and requires being individually valued, separate from the rest of the business entity.
- Important domain cases, where the tangible and intangible values need to be recognised individually.
- Property tax cases where a business entity's tangible assets are subject to property taxation but the intangible assets are not.
- Economic impairment or deficiency cases, such as a violation of a patent or trademark or breach of a contract.

Intangible assets produce the straightforward assumption underlying the excess earnings method, which is business revenue in excess of a regular rate of return on tangible assets. According to CIMA (2011b:312), intangible assets are recognisable non-monetary assets without physical material which must be controlled by the business entity as the result of previous events and from which the business entity expects a flow of future economic benefits. These excess earnings, according to Summers (1999:223) can be capitalised into intangible value or goodwill. The typical procedures in the excess earnings method are summarized as follows (Pratt & Niculita, 2008:334; Pratt, Reilly & Schweihs, 1998:402):

- Decide on the value of tangible operating assets and liabilities (net tangible assets) for the business entity.
- Decide on the standardised level of economic earnings/operating profits.
- Decide on the required rates of return for the tangible operational assets. These rates are used to determine a return on tangible assets factor, which is deducted from the characteristic operating profit to develop excess earnings.
- Decide on the required rate of return. This particular rate is used to estimate intangible asset value, or goodwill.
- Capitalize the excess economic earnings at the estimated direct capitalisation rate calculated.
- Add the values from the net tangible asset values and the intangible value in the nature of goodwill.

The capitalised excess earnings method is categorised as an asset-based valuation approach method (Van Vleet, 2004:76). In strict use of this method, all of the subject business entity's assets, both the tangible and intangible assets, are valued. However, the capitalisation of excess financial procedure itself values simply one asset, which is the business entity's intangible value in the nature of goodwill. This particular intangible value is the value of the business entity's economic income over and above a rational rate of return on the value of the business entity's net tangible assets. When the subject business entity's economic income is less than a reasonable rate of return on the net tangible asset, the result is called a *negative goodwill.* Negative goodwill shows that the shared going-concern value of the entire subject business entity is less than the amount of the separate values of the business entity's entire tangible assets. In such circumstances, the subject business entity's economic income is inadequate to validate buying the business entity based on the collective value of its individual tangible and intangible assets, with the intangible asset consisting of goodwill, patents, and copyrights (Modica, 2010:196). In such an example, the combined value of the business entity's assets, containing tangible and intangible assets, would be reduced to the level of financial value specified by the business entity's overall direct capitalisation rate. If the adjusted net asset value specified by the application of the business entity's *negative goodwill* drops below the liquidation value of the business entity's net assets, an analyst or practitioner can determine that the business entity

would be more worth on a liquidation basis than on a going concern basis. A liquidation of the subject business entity would be a sensible economic decision (Pratt & Niculita, 2008:340). In determining what the business entity is worth, goodwill should not be ignored as a possible source and factor of enterprise value. The existence of goodwill having economic value is demonstrated by the existence of a competitive advantage and excess earnings that are maintainable and transferable (Gomes, 1988:30).

Required adjustments when using the capitalised excess earnings method

To start this analysis, it is necessary to know what the business entity's balance sheet at the date of the valuation is. The different account balances will reflect the book value of the accounts. In determining the value of tangible assets and liabilities, adjustments to book values will take two general forms. The *first* is the adjustments required to restate the account balances from book value to actual economic value. The *second* is the adjustments required to reflect the value of assets and liabilities that are not included on the balance sheet. It will be required to separate operating and non-operating items. Non-operating assets and liabilities should be removed from the balance sheet and valued separately (Summers, 1999:223). The following adjustments are required:

- Cash and equivalents need no adjustment.
- Marketable securities must adjust to market value.

Accounts receivable should if possible, have their aging value observed to estimate the net realizable value of the accounts. Accounts receivable will not appear on cash basis statements and should be involved in this analysis. A physical inventory of stock should be taken with values grounded on the lower of current replacement cost or net realizable value. If it is impossible, this adjustment must be estimated. If LIFO accounting is used, additional consideration must be given. If prepayments will benefit future periods, no adjustments are needed, but if they are not for genuine business purposes or not transferable, the account from operating assets should be removed. Expenses that have been prepaid but not recorded as assets should be included, and compatible adjustments should be made to the statement of income and expenses.

Numerous definitions can be given to the value of furniture, fixtures, and equipment. Liquidation value, replacement value, book value, value in use and others are examples. It is the most appropriate to use the depreciated replacement cost of each asset unless specific information on the market value of comparable used equipment is available. Leasehold improvement should be valued in the same way as furniture, fixtures, and equipment, unless the lease is not expected to be renewed before the end of the useful lives. In that case, their value can be estimated through straight-line depreciation of the original cost over the period between the purchase date and expiration of the lease. Real estate should be treated like non-operating assets and removed from the balance sheet. Debt secured by real estate should also be removed. It is also essential to replace all of the expenses relating to real estate on the income statement, with an allowance for fair rent as an adjustment. The book value of intangible assets should be removed in this analysis since the purpose of the excess earnings method is to estimate intangible value. However, certain intangible assets with voluntarily ascertainable market values that are independent of the business entity, for example liquor licenses or franchise agreements can be included. No adjustments need to be made with liabilities except if there is different information. Certain liabilities, including notes payable to owners, deferred taxes, and obligations under leases may require adjustments, depending on the specific circumstance (CIMA, 2011a:293; Summers, 1999:223).

Standard value used in the capitalised excess earnings method

The first process in the capitalised excess earnings method is to estimate the net tangible asset value for the subject business entity. According to Pratt & Niculita, (2008:336), the Revenue Ruling 68-609 offers minimum technical guidance to the analysts with reference to the suitable standard of value or the suitable evidence of value that must be used when the net tangible asset value is estimated. As with the request of other business valuation methods, the question of standard of value and evidence of value with respect to applying the capitalised excess earnings method may only be answered after careful consideration of the following (Pratt & Niculita, 2008:334; Pratt, Reilly & Schweihs, 1998:402):

- The tenacity and objective of the specific valuation;
- The quality and quantity of available data; and
- The best use of the subject business interest.

There is a common arrangement between analysts that the most general description of net tangible asset value is the fair market value standard as well as the value in continuous use evidence. This particular standard of value and evidence of value would be measured by using one or more of the commonly accepted asset valuation approaches. The private letter ruling 79-05013 of the IRS takes the position that the suitable standard of value for the net tangible assets must be fair market value and Revenue Ruling 68-609 reports the determination of fair market value of intangible assets by the formula approach. The private letter ruling and Revenue Ruling are used in the USA as groundwork for valuations. For this reason, it is appropriate that every term used in the formula is constant (Summers, 1999:230). The formula uses value in relations to fair market value. The term 'value of tangible assets that is used in business entities' in the formula, must be in terms of fair market values, as it is defined in Revenue Ruling 59-60 (Pratt & Niculita, 2008:337; Pratt, Reilly & Schweihs, 1998:409).

The objective of the analyst is to approximate the value of the subject net tangible assets on a continued use basis on which a realistic rate of return must be earned. Therefore, the analyst does not make several adjustments to identify the income tax effect of unrealized or built-in gains or losses. Analysts must not just disregard income tax considerations. There could be, for example, cases like a large inventory report where a tax payment on the sale of inventory is forthcoming, where an income tax adjustment can be suitable (Pratt, Reilly & Schweihs, 1998:409).

As the expression 'net tangible asset value' suggests, intangible asset values must be removed from the subject business entity's balance sheet before carrying out the capitalised excess earnings analysis. On the other hand, certain analysts leave those intangible assets that are already capitalised on the subject business entity's financial statements on the balance sheet. Some examples of intangible assets that may previously be recognised on the business entity's financial statements would include purchased computer software, purchased goodwill, as well as computer software internally developed in expectation of resale (Pratt & Niculita, 2008:337). Goodwill can frequently be a significant asset and in certain circumstances, it can represent the

key part of the price paid for a business entity (Gomes, 1988:23). There is a common agreement between analysts that it is better to eliminate non-operating and excess assets from the balance sheet, as well as the associated economic income from the income statement, and to deal with such items individually in the capitalised excess earnings method. In the valuation of those small business entities or professional practices where the business entity does not own real estate, valuation experts eliminate the owned real estate from the business entity's balance sheet and credit a fair market rental expense on the business entity's income statement. The objective of this adjustment is to examine what the business entity would look like if it were sold with the real estate, likely being sold separately from the business entity (Pratt & Niculita, 2008:339; Pratt, Reilly & Schweihs, 1998:410).

There is not a generally accepted conclusion as to what accounts must be "netted out" in the valuation of net tangible asset value. For instance, numerous analysts have interpreted net tangible assets to have the meaning of any one of the following:

- Gross assets net of accumulated depreciation, for example, the present market value of the tangible assets net of economic depreciation;
- Net present value of the economic assets and tangible assets minus current liabilities; and
- Net present value of the economic assets and tangible assets less all the liabilities.

The most common understanding of the phrase "net tangible asset value" is net present value of economic assets, and the tangible assets minus current liabilities only (CIMA, 2011b:291). However, if correctly applied, different interpretations such as the average of net tangible assets involved during the year can be just as appropriate (Pratt & Niculita, 2008:338). If payment at face value is forthcoming, for example, if a payment is activated by the transaction for which the valuation is being conducted, then it is suitable to value the subject business entity debt at face value. If debt can remain unsettled for a period, practitioners would value the subject business entity debt as its fair market value (Pratt, Reilly & Schweihs, 1998:410).

The estimation of a normalised level of earnings is called a normalised level of economic income in the capitalised excess earnings method as well. This more general description is suitable because Revenue Ruling 68-609 does not precisely describe the term 'earnings' (Pratt &

Niculita, 2008:338). However, it makes the important statement that the earnings must reflect the possible future earnings fairly. When estimating a normalised level of earnings, the following aspects must be taken into consideration:

- Consistent with the elimination of non-operating assets from the net tangible asset base, associated non-operating income must be eliminated from the earning base (Summers, 1999:225).
- Revenue Ruling 68-609 reports that the business entity is an individual proprietorship. From the earnings of the business entity a practical amount for service performed by the partners or owner involved in the business entity must be removed. Analysts normally agree that owner and employee's *abnormal payment* must be adjusted to a normal level of payment in the valuation of a closely held business entity (Summers, 1999:230).
- The measure of earnings, or financial income to be capitalised, must generally be net of federal and state income taxes that are paid by the subject business entity. The measure of earnings, or financial income that is carefully chosen, whether it is net income, net cash flow, or operating cash flow, and whether it is before or after tax, must be consistent with the measure of the fair rate of return and the measure of the direct capitalisation (Reilly, 2003:94).

There is a difference in judgement between analysts about whether net cash flow or operating cash flow are the best measure of economic income. According to Pratt & Niculita (2008:339), the trend among analyst is to favour net cash flow because that measure of income is the sum that the stakeholders can take out of the business entity without distracting operations. Numerous alternative procedures can be used to measure the suitable *rate of return* on the subject business entity's net tangible assets. Several practitioners agree that the required return is reliant mainly on the asset combination. The more risk the assets have, the higher the rate of return required to support them. A single general process is to use a weighted average of the business entity's cost of debt and cost of equity, with the weighting grounded on the quantities of the numerous asset classes that can be financed by debt (Pratt, Reilly & Schweihs, 1998:412). Some practitioners and analysts use historical industry average rates of return, and what makes this problematic is that the required rates of return, by description, are grounded on the future

anticipations and substitute opportunity cost of the investor. The historical industry rate of return may not be characteristic of future anticipations (Pratt & Niculita, 2008:340). Since the business entity's debt rate and the safest part of the business entity's equity rate are usually used in the approximation of the rate of return for the net tangible assets, the direct capitalisation rate appropriate to the excess earnings typically would have to be higher than the business entity's required rate (Pratt & Niculita, 2008:340). Most practitioners agree that the most significant force driving the capitalisation rate for excess earnings is the professed perseverance of the excess earnings. The longer the period, and the higher the certainty of the anticipation of receiving the excess earnings, the lower the applicable capitalisation rate will be. The rate most commonly encountered in the market is 33.33%, which is the equivalent of paying for three years of excess earnings. It should be clear that the selection of an excess earnings capitalisation rate by these typical concerns is one of the most subjective judgements that must be made within the several business valuation methods. However, the weighted average of the capitalisation rates for the tangible assets and excess earnings should be similar to the business entity's overall capitalisation rate (Pratt, Reilly & Schweihs, 1998:413).

2.5.2. Asset accumulation method

In the literature of valuations, there are numerous names for very similar asset-based valuation methods. These methods are interchangeably mentioned as the *adjusted net worth method*, the *net asset value method*, the *asset build-up method*, the *adjusted book value method*, or the *asset accumulation method*. These names are all different, but used for the similar method within the asset-based valuation approach (Pratt, Reilly & Schweihs, 1998:368). For the purpose of this research study, the method will be referred to as the *asset accumulation method*. The asset accumulation method is a balance sheet oriented valuation method, and the business entity's balance sheet is restated to current value. This usually involves the identification and valuation of otherwise unrecorded tangible, as well as intangible asset and liabilities already recorded on the balance sheet. The asset valuation approach values each element of a business entity individually. The fair market values of the assets are totalled and the fair market values of the liabilities are deducted for a total business entity value, according to Hughes (2003:10). In the

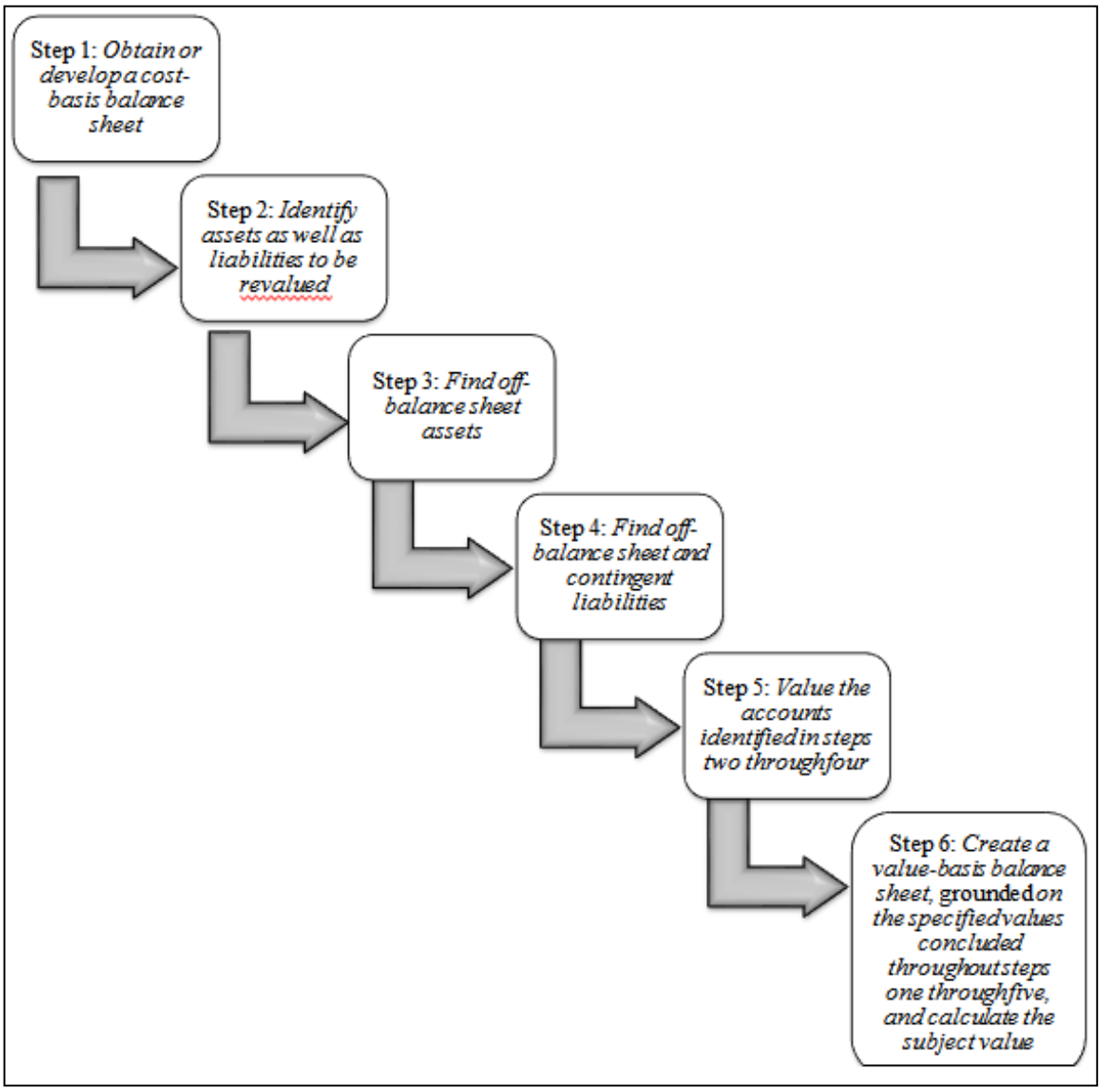
asset accumulation valuation method, all the subject's individual asset and liability account categories are evaluated and valued individually (Reilly, 2003:94; Modica, 2010:195).

In the asset accumulation valuation method, the value of the different assets, both the tangible assets and the intangible assets, minus the value of all the liabilities, both the recorded liabilities and the contingent liabilities, signifies the subject business entity value. Academically, the business entity value recognised under the combined revaluation method, namely the *capitalised excess earnings method*, must equal the business entity value under the separable revaluation method, namely the as*set accumulation method*. Under the asset accumulation method, the market values of all individual assets and liabilities are determined first. The book values of the assets and liabilities are adjusted to market values. Thereafter, the adjusted liabilities are deducted from adjusted assets to determine equity value (Telling, 1999:312).

Performing the asset accumulation method

Six steps should carefully be followed when doing a valuation grounded on the asset accumulation method. It is briefly discussed as follows:

Figure 2.10: Steps used in the asset accumulation method



(Adapted from: CIMA, 2011a:293)

Obtain or develop a cost-basis balance sheet: Preferably, the cost-basis balance sheet will be arranged in agreement with GAAP; furthermore, this balance sheet will be arranged as of the date of the valuation. If a cost-basis balance sheet is not obtainable because the valuation is directed as of an interim date, then the analyst has three options that are the following:

The customer, or an accountant employed by the customer, can prepare a cost-basis balance sheet as of the date of the valuation and provide it to the analyst:

- The analyst can prepare a cost-basis balance sheet as of the date of the valuation from the business entity's trial balance or general ledger, supposing that the analyst has the necessary basic accounting knowledge to prepare such a financial statement; or
- The analyst can depend on the most current cost-basis balance sheet prepared at the financial year-end prior to the date of the valuation. Normally, a recent financial year-end balance sheet is usually better than not containing a balance sheet to start with at all.

Identify assets as well as liabilities to be revalued: The analyst will cautiously analyse and comprehend each physical asset and liability account documented on the subject business entity's financial statements. The objective of this examination is to decide which of the documented assets and liabilities will be required to be revalued, grounded on materiality and the particular standard of value suitable for the subject business entity valuation.

Find off-balance sheet assets: The analyst will find which of the unrecorded assets need to be accepted on the value-basis balance sheet; for instance, intangible assets are not usually documented on financial statements which are prepared under GAAP. However, they regularly represent the biggest element of the complete business entity value in numerous industries. Typically, intangible assets are simply documented on the balance sheet if they are developed in a purchase. Certain tangible assets may have been anticipated rather than capitalised when they were developed, while other tangible assets can be completely depreciated and written off on the financial statements, even though they may still have a residual useful life and a significant economic value (e.g., tools and dies). For these causes, the analyst must look for unrecorded tangible assets and unrecorded intangible assets (Pratt & Niculita, 2008:356; Pratt, Reilly & Schweihs, 1998:374).

Find off-balance sheet and contingent liabilities: Analysts will find which unrecorded material contingent liabilities, if there are any, must be documented on the value-based balance sheet. If possibly environmental liabilities exist, a professional opinion may be required. Under current GAAP accounting, contingent liabilities are normally not documented on a cost-basis balance

sheet. However, in reviewed and audited financial statements, material contingent liabilities are commonly discussed in the descriptive footnotes to the financial statements. For business entities that have material awaiting litigation against them, property or income tax claims against them, and environmental dues against them, these contingent liabilities have an important impact on the risk of the business entity, and for those reasons, these material contingent liabilities can have an important impact on the business entity value.

***Value the accounts identified in steps two through four**:* Analysts will start the quantitative procedure of revaluing every one of the asset accounts, and if required, every one of the liability accounts. The typical categories of assets for the purpose of applying the asset accumulation valuation method are as follows (Pratt & Niculita, 2008:356; Pratt, Reilly & Schweihs, 1998:374):

- Economic assets;
- Tangible private property;
- Real estate;
- Intangible real property; and
- Intangible private property.

Create a value-basis balance sheet, grounded on the specified values concluded throughout steps one through five, and calculate the subject value: Analysts will create a value-basis balance sheet, as of the date of the valuation. From this particular value-basis balance sheet, it is a simple process to deduct the value of the business entity's liabilities from the value of the business entity's assets. The rest of this deduction process is the value of 100% interest in the ownership level of value. Additionally, if the subject valuation project relates to something less than the total business entity value, for example to a specific class of securities or to non-marketable or non-controlling ownership interest levels of value), then supplementary valuation discount analyses may be necessary (Pratt & Niculita, 2008:356; Pratt, Reilly & Schweihs, 1998:374).

According to Reilly and Schweihs (1998:397), the asset accumulation valuation method is a typical asset-based approach valuation method. The value of the business entity is the value of the business entity's assets, consisting of tangible and intangible assets, minus the value of the

business entities liabilities, both recorded and contingent. Valuing assets are used to determine the minimum value of the business entity (Fife, 2008:47), or the "floor" value as it is called by Modica, (2010:196).

2.6. Summary

The purpose of this chapter was to consider the fundamental principles of the various approaches and methods of valuations used by different theorists and practitioners. This was achieved by gaining an understanding into the valuation procedures. References and published academic research nationally and internationally were obtained. It was found that there are three key valuation approaches, namely the income, market, and asset-based approach, each comprising several detailed or specific methods. Two popular methods under each of the approaches were then evaluated, making it a total of six popular business valuation methods used by different theorist and practitioners. Two popular methods used in the income based approach that was assed were the discounted future economic income method and direct capitalisation method, which basically revolve around calculating a discount or a capitalisation rate and discounting the cash flow for business entity back to a single value. The guideline publicly traded company method and the guideline merger and acquired company method was two most popular methods that were assessed in the market based approach, which basically revolves around comparing the ratios of different business entities in the same industries with each other. The asset based valuation approach classifies the capitalised excess earnings method and the asset accumulation method as two popular methods, and were assed as well, which basically revolves around calculating the net asset value of a business entity and making adjustments to the assets as well as the liabilities. The asset based valuation approach with its two methods normally gives a minimum value.

In the following chapter of this research study, the history and background of franchises and restaurants will be looked at, explain how they work, why they are used, and will provide acceptable information of understanding them. The background and history about Spur Steak Ranches, and more specific the Tampa Bay Spur Steak Ranch will be provided. In addition, the

two most popular methods used by theorist and practitioners to value a restaurant in particular will be identified and evaluated.

CHAPTER 3

3. FRANCHISING IN THE FOODSERVICE INDUSTRY

The purpose of this chapter is to give the history and background of *franchises* and *restaurants*, explaining how they work, why they are used, and to provide acceptable information towards understanding them. The background and history will be provided about Spur Steak Ranches, and more specific the *Tampa Bay Spur Steak Ranch*. In respect of the valuation of these types of business entities, the two most popular methods used by theorists and practitioners to value a restaurants in particular will be identified and evaluated.

3.1. Background

Franchising has been established over time as an effective method to do business. There existed visions of franchising in Europe many centuries ago. The origin of the term '*franchise*' goes back to the Anglo-French, meaning liberty and freedom (Daszkowski, 2011b). The term '*franchising*', resultant from ancient French, is described as holding a certain right or privilege. In the middle ages, the local leaders would label privileges to residents. Several of these rights included conducting fairs, operating ferries and operating markets. The franchising concept carried forward to the practice of Kings yielding rights to conduct events like road building and beer brewing. Moreover the development of the church is acknowledged as a method of franchising (Daszkowski, 2011b).

The practice of franchising is extensive in most Western economics, mainly in the hotel and restaurant industry (Hing, 1999:502). *McDonalds*, *Wimpy*, *KFC* and *Spur* are examples of today's popular franchises in South Africa. There are several different kinds of franchises. Numerous people simply associate fast food business entities with franchising. More than one hundred and twenty different kinds of franchises are available today, including financial services, health and fitness, automotive, cleaning, and maintenance franchises. Franchising has become a dominant power in the distribution of merchandises and services in many parts of the world. It is expected that it will become the primary method of doing business and expanding

worldwide. Franchising in the global market is growing rapidly; especially restaurant franchises have seen a remarkable increase in recent years (Khan, 2005:188).

Many economic studies have examined the franchise phenomenon. Most of these focus on the franchiser's motivations which are to create a rapid market presence, to get off balance sheet financing and to increase and exploit their trademark and goodwill. With franchising such a universal force in the economy, sooner or later the valuation experts can expect to come across situations involving franchises. These may occur in agreements to buy and sell, to set and justify an asking price for possible buyers, and in more argumentative areas like the computation of damages in franchise litigation, arbitration or in marital disputes. However, there is very little information available about franchise valuations, for example, the National Association of Certified Valuation Analyst (NACVA) database has no valuations that are franchise specific and the Canadian income tax book and software publisher's (CCH) business valuation guide does not even contain the word '*franchise'* in its index and has nothing on valuing franchises in its tens of thousands pages (Schaeffer & Ogulnick, 2008:37).

3.2. Early development of franchising

During the 1840s, numerous German ale brewers allowed rights to certain taverns to market their ale. This was the start of the franchising nature that became familiar to the people in the twentieth century. Franchising progressed from European brewers into the US. There was no method of chain operations before franchising. Traders in the primary American history who were selling objects from town to town, were considered a method of franchising as well. General stores at military bases were provided with licences (Daszkowski, 2011b).

People believe that *Isaac Singer* (1811 – 1875), the inventor of the Singer sewing machine, was the creator of modern franchising (Allen & Albala, 2007:198). He was essentially the first person acknowledged by most people as being related with franchising in 1851. Isaac Singer came on the scene with his popular Singer sewing machine business entity. He used franchising to distribute his sewing machines over an extensive geographical area. Isaac Singer is the first name known as an early franchiser, and he was also the first to formulate franchise contracts.

The contracts formulated by Isaac Singer became the foundation for the modern versions of franchise agreements.

In the late 1800s as well as the early 1900s several other methods of franchising took place. Street car business entities and monopolized franchises are some examples. As oil refineries and auto manufactures found that they could sell their merchandise over a bigger geographical area, they began to franchise. Transport and increasingly travelling Americans were the foundation for the institution of restaurant and retail franchises.

3.3. Franchising as a business model

According to the Chartered Institute of Management Accountants (CIMA, 2011b:197), franchising is a method of expanding a business entity on less capital than would otherwise be possible. The franchisee pays a capital lump sum to enter the franchise and also accepts some of the running costs of its outlet. The franchise offers the franchisee the use of the franchise name and any goodwill associated with it, the use of its business systems and support services, its product and service to sell, and management and staff training programmes. In return the franchisee pays the franchisers for being granted these rights. The franchisee has the responsibility for day to day running and for the ultimate profitability of his franchise. The franchisee supplies capital, personal involvement and local market knowledge (Luangsuvimol & Kleiner, 2004:63). For the reason that the franchiser receives royalties on the franchisee's gross sales, they attempt to maximize system-wide sales, whereas franchisees pursue to maximize the net profits of their individually owned business entities (Nair *et al.*, 2009:207).

A franchise is a right granted to an individual or group to market a company's products or services within a certain territory or location (Weaven & Frazer, 2006:225; Gonzalez *et al.*, 2010:1568; Daszkowski, 2011a). The use of franchising can be considered a source of competitive advantage because it allows business entities to beat somebody to decent locations. The higher the number of locations which the franchiser accumulates, the higher its territorial coverage, and the broader its customer base (Polo-Redondo, Juste & Palacios, 2011:172).

The current leading method of franchising, identified as a business format of franchising, became popular after World War II. At that time, the people who had been serving in the war returned back home and had a need and/or desire for various services and products. Consequently, the *baby boomers* became the front-runners of the economy and are anticipated to continue as the dynamic force for some time. As franchising developed quickly in the 1960s and 1970s, a vast number of unfair activities came with it. There were numerous business entities that were poorly managed and under-funded, therefore going insolvent leaving several franchises in financial distress. More disappointing were the dishonest business entities who literally took the people's money for nothing (Daszkowski, 2011a).

These unfortunate proceedings led to the development of the IFA (International Franchise Association) in order to control the franchising industry. The IFA constantly works in combination with the US Congress as well as with the FTC (Federal Trade Commission) on improving the industry's relationships with franchisees. In the year 1978, the FTC formed the UFOC (Uniform Offering Circular) requiring franchise business entities to provide thorough information to potential franchisees. This document was updated in 2007 and renamed the FDD (Franchise Disclosure Document). Franchising business entities continues to be an extremely structured industry in an effort to encourage strong growth of the economy (Daszkowski, 2011a).

3.4. Franchising foodservice

The first franchisers of food were *A&W Root Beer* located in Lodi, California, and the *Pig Stand* in Dallas, Texas. Both franchised their business entities in 1924 (Allen & Albala, 2007:198). As time went on, a number of institutions began to franchise, including the well-known *KFC* (Kentucky Fried Chicken) in the 1930s, *Dunkin Donuts* in 1950, *Burger King* in 1954 and *McDonalds* in 1955. A man named Ray Kroc (1902 – 1984) who worked as a milkshake mixer salesman and discovered the two McDonald brothers, Richard and Maurice McDonald's small San Bernardino, Californian hamburger stand in the year 1954, is credited with releasing the development of franchising as it is known today (Allen & Albala, 2007:198). He found that the two brothers were buying so much of his mixers because they had established a high capacity production system which allowed them to deliver fast service with constant results and low cost.

Ray Kroc became their licensing agent and enlisted franchisees, beginning in the Chicago area. In 1961 Ray Kroc bought out the McDonald brothers' interest and was titled senior chairman. By the year 1988, *McDonald's* had opened its ten thousandth restaurant. Today there are over thirty thousand worldwide (Webster, 1996).

Franchising was presented in the *restaurant* sector in the 1930s by *Howard Johnson* to increase his North American operation to more than 100 restaurants by the 1940s. In the mid 1940s, Dairy Queen, presently one of the best franchise structures in the USA, was established, while the 1950s and 1960s witnessed the creation and proliferation of McDonald's, Pizza Hut and Kentucky Fried Chicken (Hing, 1999:502)**.**

3.5. Restaurants as franchises

3.5.1. Background

During the course of recorded history, eating away from a person's home and in public places has been experienced as a liability rather than a pleasure. Going to restaurants as a pleasant, leisure time activity, and differentiating restaurants from cafés, inns, taverns, or brothels, is a recent development. In the West, restaurant philosophy goes back no more than 250 years. In several other areas it is much younger. In south-eastern China, restaurants were part of urban culture before the thirteenth century. The extravagant eating institutions found in Hangzhou, where local cuisines like '*Szechwan*' and '*Honan*' were readily available, astonished Marco Polo. While certain cultures have a centuries-long history of public, marketable cooking, several others do not. In numerous parts of the world, business entities clearly classifiable as restaurants have only developed in the past fifty years. Those restaurants are the products of the post-1945 developments in trade and travel, like the appearance of international tourism and the spread of global corporations (Katz, 2003:179).

According to Allen & Albala (2007:323), any facility that cooks individual meals for eating on or off the premises falls under the title *"restaurant"*. Restaurants range from "*formal temples*" of gourmet food, where extremely well-trained chefs in multimillion-dollar kitchens treat the appetites of wealthy food lovers to exotic delicacies, to temporary, open-air cook stands, where

inexpensive, enthusiastic meals or quick snacks are prepared on basic cooking equipment with simple ingredients.

3.5.2. Development of the restaurant concept

While public restaurants existed in the Sung Dynasty China and Ancient Rome, restaurants as known today, are normally credited to 18th century France. The word *restaurant* is resultant from the French word '*resaurer*', meaning *'to restore'*. The first French restaurants were extremely controlled establishments that sold meat based broths intended to restore a person's strength to individuals not feeling well. The first cafés, commonly defined as places selling beverages and snacks, were established in 1550 in Constantinople. The first café was a coffee café. Cafés were places where educated individuals went to share philosophies and new discoveries. Clients spent numerous hours in these places in a single sitting. This development caught on in Europe in the 17th century. When cafés were opened in France, they sold sweetened wines, brandy, and liqueurs in addition to coffee. The first kind of contemporary café was the *Café Procope*, which opened in 1669 (Montagne, 1999). It was the French Revolution that launched the modern restaurant industry. It relaxed the legitimate rights of business entities that were licensed by the king to control particular foods and generated a hungry, middle class client base that enjoyed the principles of social equality. Innovative French chefs were fast to capitalize on this market. Menus, consisting of dishes individually prepared, portioned, and priced were presented to the public for the first time.

Researchers agree that the leading self-styled restaurant opened for business in Paris in the course of the 1760's, but there are contradicting opinions as to the importance of these establishments. For several years, a man called *Boulanger* has been accredited with having been the first person to have sold a wide range of excellent dishes and to have served them at little, oilcloth covered tables in his shop located on the *rue des Poulies* (Katz, 2003:181). Ever since the early nineteenth century, it has been customary to refer to the tale of *Boulanger's* argument with the city of Paris's society of cook-caterers over the exact status of his signature dish, which was sheep's feet in sauce. According to Katz, (2003:181), in the year 1765 the cook-caterers tried to close down *Boulanger's* shop because that specific dish invaded their legal monopoly on the sale of every ragout, which refers to dishes that are cooked in a sauce.

As the 19th century developed, restaurants appeared to serve a variety of clients. Urban labourers, new immigrants, and adventurous Americans flocked to cheaper restaurants, especially those presenting ethnic cuisines from the home country of the customer. Unlike the *haute cuisine* dining palaces, these restaurants used smaller staffs and menus, less expensive ingredients, and informal table accoutrements. Their profit depended on multiple seating over the course of a meal period. By the late 19th century, different restaurants served working, middle, and upper class diners with different needs and social agendas. Prohibition and the Great Depression interrupted American fine dining by eliminating the profitable alcohol sales that often made the difference between profit and loss. The problem was aggravated when diners chose to eat and drink at home, rather than dine out in a *"dry"* establishment. The termination of Prohibition in 1933 came too late, as the stock market crash of 1929 had ended the freely spending overindulgences of the Gilded Age. High-end restaurant dining would re-emerge as a major social activity only after World War II. By contrast, lower-end and middle-market restaurants succeeded during the 1920s, 1930s, and 1940s. This period saw the beginning of fast food, particularly the *White Castle* and *McDonald's* franchises, and family-style restaurants, such as the now nearly outdated *Howard Johnson's*. These enterprises relied on limited menus and centralized commissaries to reduce food costs and the need for skilled kitchen staffs. Volume, rather than price, made these establishments profitable (Allen & Albala, 2007:324).

Before World War II, chain restaurants were reasonably original, accounting for merely 15 percent of all restaurant business entities, which in contrast to chain grocery stores in the 1930s were already accountable for approximately half of all grocery sales. *Howard Johnson's*, originally a New England ice cream chain, expanded alongside the highways of the 1930s and 1940s, much as Harvey House did alongside the railroads. In the late twentieth century, franchised business entities have accounted for a considerable amount of the U.S. restaurant industry's development. In the year 1994, approximately 60 percent of the total 406,000 U.S. restaurants were chain units and 200,720 restaurants were owned by chains that contained more than 200 units. Several of these were fast-food institutions like *McDonald's, Burger King*, or *KFC*, but several others were full-service restaurants like the *Olive Garden*, the *Outback Steakhouse, Denny's* , and *Bennigan's*. The achievement of these chains suggests that customers value familiarity (Katz, 2003:184). Ever since Ray Kroc purchased the rights to use the

McDonald brothers' idea of serving fast-cooked, low-cost hamburgers, French fries, and chocolate shakes to customers in 1955, the restaurant industry has never been the same (Pitts & Lei, 2002:4).

3.6. Spur Steak Ranch

3.6.1. Background

According to food historians, *steakhouses/ranches* originated in New York City because the people of New York could afford to spend the highest amount of money and demanded the top cuts of beef. Americans had developed a big appetite for meat by the turn of the century. After G. H. Hammond, a Detroit meat-packer, brought out the refrigerated railway car in the year 1871, ice-cold carcasses became readily obtainable in the East; however fresh meat was still not common in the outside reaches of the western border. By the 1880s meat was being transported even to England, and steakhouses were amongst the most popular restaurants in big American cities (Mariani, 1999).

Spur Steak Ranches have been in South Africa for more than 40 years. Allen Ambor, the founder and executive chairman of Spur (Hassenfuss, 2008a:31), is the person who started it all in 1967 (Coulson, 2007a:45) when he invested an amount of R4,000 to open the *Golden Spur* located in Newlands, Cape Town. It got popular for its delicious, healthy, value for money meals and selling a famous Spur burger at just 40 cents in the 1960s. The Spur has a reputation for having a warm, friendly and relaxed, family friendly atmosphere. Today, the Spur is very popular for having play areas for children, thus entertaining the whole family and making Spur a very popular fully licensed franchised restaurant.

The Spur group listed on the JSE in the year 1986 (Coulson, 2007a:45). At that time it had 43 franchised Spur Steak Ranches. Spur Corporation was born from that movement, and has been forging ahead, taking Spur Steak Ranches as well as its related brands to new heights. Spur Corporation is South Africa's foremost family casual style sit down restaurant group (Coulson, 2007a:45). Its value based excellent family offerings across Spur Steak Ranches, John Dory's

Fish and Grill, and Panarottis Pizza and Pasta have capitalised on the improved spending ability of the fast growing middle class in South Africa (Coulson, 2007b:38).

Spur has developed into an globally recognised brand with 245 local and 32 international restaurants, including countries like Australia (Hassenfuss, 2008b:33), Ireland, Mauritius, Zimbabwe and the United Kingdom (Van Tonder, 2010). In the year 1990 the first *Panarottis pizza and pasta restaurant* was opened. It was located in Tygervalley, Cape Town. Within a period of ten years, over 40 additional outlets were opened, making the Panarottis brand the little brother of the *Spur Steak Ranches*. In the year 2004 the group acquired 60% of *John Dory's fish and grill*. This shareholding has grown to 65% in 2007. Spur Steak Ranches, John Dory's Fish and Grill and Panarottis Pizza and Pasta restaurants are all operated based on a franchise.

3.6.2. Business model

The Spur has a very simple *vision* and *mission*. Their vision is to be the top family style sit down restaurant in the markets in which they do business. Their mission is to be devoted at all times to their customers as well as to their employees, to deliver like their logo says, "a taste for life" for their customers and to be an excellent working place for their employees (Van Tonder, 2010).

The Spur has a *strategy* towards which it works. They plan to continue their restaurant expansion through *Spur Steak Ranches, John Dory's Fish and Grill* and *Panarottis Pizza and Pasta* in South Africa (Makholwa, 2010:14), while developing their international operations on a continued basis as they enter several new and unchartered markets.

Spur Corporation supports franchisees in numerous ways, both *before opening* as well as *after opening*. Initial support contains the accumulating of a business plan and cash flow forecast, assistance in selecting a location and negotiating a lease, and as operational assistance with the opening and primary operating of the restaurant. The well qualified, experienced and motivated operations team offers constant support, backup and assistance to franchisees. The team is accountable for maintaining the high quality of the brand as well as its products. The must also support the franchisee in every part of building and maintaining an effective business entity. In addition, support is provided by way of the assessment and training of the workers, combined

information systems as well as the Spur Corporation marketing plan. Consistent restaurant appointments guarantee that their high operational standards, safety regulations, external health, and their customers' demands for service and quality are met and maintained (Van Tonder, 2010).

Being a *marketing* type of business entity, Spur is passionate about building the Spur, Panarottis and John Dory's brands (Makholwa, 2010:14). Their business concept is to be a customer focused service department collaborating with multiple commercial partners. They interrogate market and business intelligence to guide the creation of compelling communication that broadens their consumer base and builds profitable, iconic brands.

The procurement and manufacturing divisions consist of the Cape Town and Midrand manufacturing facilities and are responsible for improvement, retail sauces, testing of products, and numerous extra procurement opportunities that contain the potential to improve profitability.

Training and *preparation* are crucial factors to provide quality products and service to their customers. For that reason, the *Spur* has a devoted team of trainers whose job it is to guarantee that their franchisees, employees, and head office employees are given the required skills to perform their tasks to the best of their abilities. The head office is located in Century City, Cape Town.

Spur have declared themselves the official South African family restaurant (Van Tonder, 2010). They are one of the very few restaurants that cater specially for children. Most, if not all, of the Spur Steak Ranches have an enclosed play area for children and will provide crayons and pictures for colouring in for kids. There are also children's menus available and the décor is likely to provide the children with some amusement as well. In spite of its South African origin, *Spur Steak Ranches* use *Native American* themes expansively, in their marketing as well as décor. From the restaurant names, for example, "Apache", "Silver eagle", "Flaming arrow", and" "Big Creek", to the décor, which consists of adobe style walls, cowhide print leatherette banquettes, vaguely Aztec themed light accessories, to the logo, which is a native American man in feathered headdress, to the menu that is Texan and Mexican (Tex-Mex). All of the above mentioned has a Native American angle.

3.6.3. Tampa Bay Spur Steak Ranch

The *Tampa Bay Spur Steak Ranch*, used as the research case study, is a family oriented franchised restaurant, grounded on the widely known *Spur* concepts. The firm Lungisa Financial Administrators owns the restaurant. The restaurant is located in the Time Square Building, Dias road, Jeffrey's Bay, occupies an area that is approximately 550 m^2, and up to 180 customers can be accommodated. Presently, the *Tampa Bay Spur* employs 25 kitchen personnel. There are four floor managers, consisting of two *front of house* and two *back of house* managers. There is one *operating manager* working above the four managers. At present, there are 17 waiters working different shifts that consist of seven hours. Transport is prearranged for staff members who are situated far from the restaurant. The restaurant has been open for nine years and is well-known in the area. Jeffrey's Bay is known for the Billabong surfing contest that takes place there twice a year. It attracts many foreigners, including from the USA, Australia, New Zealand and England. Excluding the surfing contests, Jeffrey's Bay also attracts South Africans with its cultural festivals, such as the '*skulpie*, *naartjie*, and *biltong*' festival. The restaurant was taken over by a new owner on the first of March 2011 and its revamp was completed at the end of December 2010.

3.7. Restaurant valuations

3.7.1. Background

Accurately valuing a restaurant is challenging. However, it does not have to be an overwhelming task. The buyer must constantly keep in mind that the asking price is not the buying price. Sellers are emotionally involved in their business entities. They factor years' worth of hard work into their calculation that does not have any value in the valuation equation. The ways to calculate the value of a restaurant is *asset valuation, liquidation value, income capitalisation, income multiple* and *rules of thumb* (Parker, 2009). According to Harris & Mongiello (2007:240), all restaurants are different, and by producing meal experiences with unique characteristics, restaurants cater for the needs and desires of specific customer categories. A

restaurant business entity is as much an economic unit as any other business entity. The most important elements in profitability are economy and productivity (Harris & Mongiello, 2007:23).

There is no formula for determining the fair market value of a restaurant. Each business entity must be considered on individual merits (Perkins, 1999:330). Rules of thumb may have credibility for a franchise, where the performance of a business entity is closely monitored by the parent business entity and a certain level of sales generally results in a corresponding level of earnings. This is not the case for privately owned restaurants, as owners may not have the training or experience to develop the business entity to its full potential, and there is no responsibility for maintaining accurate books and records. The following four factors should be considered in determining restaurant values (Perkins, 1999:330):

- Sales;
- Cash flow;
- Condition of improvements; and
- Terms of the lease.

According to Holten and Bates (2009:132), critical factors for valuing a restaurant are the location, rent, conversion potential, condition of equipment, asking price , lease term agreement, liquor licence and occupancy cost. When valuing a restaurant, the documents needed are the tax returns of three years, three years' worth of financial statements, monthly sales figure for three years, copy of the current menu, copies of any press release, copy of the restaurant lease, copies of floor plan and site plan, equipment list, latest health inspector's report, most recent work schedule, copies of all licences and permits, and updated list of payables. When performing a valuation on a restaurant, the *multiple method*, also called the discretionary cash flow method is the one most used by practitioners (Parker, 2008; Perkins, 1999:332).

3.7.2. Restaurant valuation methods

Rule of thumb valuation method

The *Rule of thumb method* of valuing a business entity provides general guidance on categories of business entities and gives buyers and sellers a ballpark figure on what average a business entity in a certain industry is worth (Holten & Bates, 2009:132). Rules of thumb are formulas which result in varieties of value for particular types of business entities. According to Thomas (1999:160), when following the Rule of thumb method of valuing a restaurant, the following is the way to do it (Moran, 2010, 11):

- *Casual style restaurant* – 33 % of annual sales;
- *Fine dining restaurant* – 20% – 30% of annual sales;
- Restaurant not serving alcohol – 44% of annual gross sales;
- *Fast food restaurant* – 35% – 45 % of annual gross sales;
- *Italian restaurant* – 30 % of annual gross sales;
- *Mexican restaurant* – 30 % of annual gross sales;
- *Chicken restaurant* – 37% - 40% of annual gross sales;
- *Chinese take-out restaurant*- 35% - 45% of annual sales; and
- *Franchised restaurant* – 40% - 50% of annual sales.

According to Holten and Bates (2009:132), a full service restaurant's rule of thumb method is as follows:

- 30% to 35% of yearly sales plus the inventory;
- 2 to 2.5 times sellers' discretionary earnings plus the inventory;
- 2 to 3 times EBIT; and
- 2.5 to 4 times earnings before interest, taxes, depreciation and amortization (EBITDA).

Although a widely used industry rule of thumb should not be ignored, such rules generally should not be used as the only method of valuing a business entity or restaurant (Pratt, 2003:88). Most rules of thumb valuations of restaurants do not apply across the board and each one is very

different except if the restaurant is a franchise, according to Holten and Bates (2009:132). The rule of thumb method of valuing a business entity is too general and it is hard to find any two business entities that are exactly the same (Parker, 2008). Different rules of thumb for similar kind of business entities frequently lead to wide varieties of value. Occasionally value ranges grounded upon the application of rule of thumb are so wide-ranging that they are not valuable for actual transaction purposes. There are more economical and better alternatives than the rule of thumb valuation method for determining a variety of value for business entities (Sliwoski, 1999:8).

Multiple of discretionary cash flow method

Possibly better than every other valuation method, the *multiple of discretionary cash flow* attempts to measure the economic as well as the lifestyle characteristics perceived by the people who buy and serve of small to midsize business entities (Jones, 1999:232). The formula for this method can be expressed as follows (Jones, 1999:232):

BV = de x m (la – cl)

Where: de = discretionary earnings

m = selected multiplier

la = liquid assets

cl = current liabilities

While the formula is simple, obtaining a valid indication of value that can be supported by other income approach methods is highly dependent upon accurately determining the level of earnings and selecting the appropriate multiplier. Historical earnings for up to five year periods are analysed, normalised, and weighted in some form to serve as the substitute for future earnings (Perkins, 1999:337). The range of multipliers appropriate to discretionary earnings that will produce creditable indications of value must represent the investment risks associated with receiving a reasonable salary, asset replacement, assets replacement risks associated with

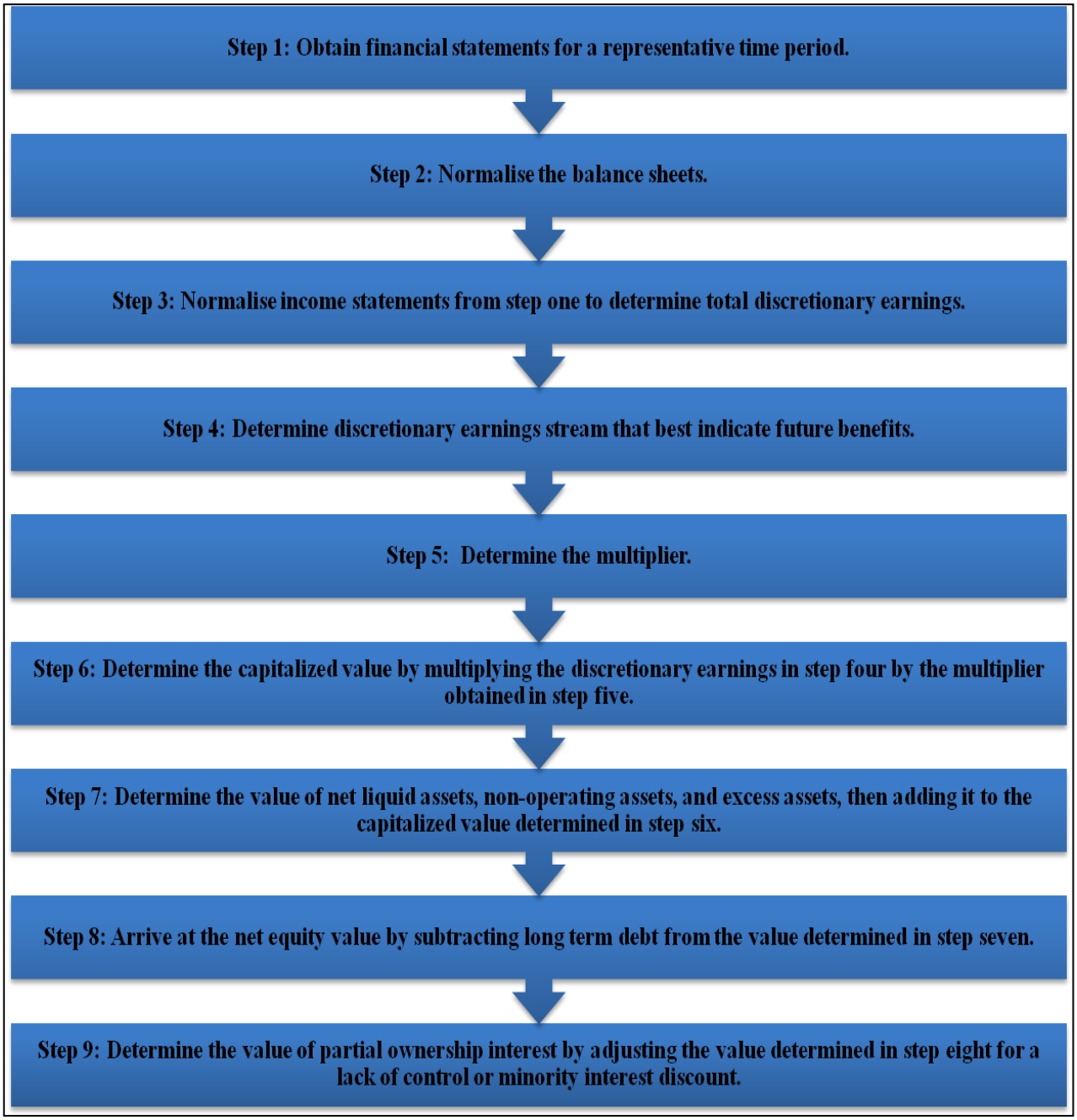
receiving a reasonable salary return on investment, and lifestyle considerations (Jones, 1999:234).

The multiple of discretionary valuation method has developed over the years from its 'rule of thumb' origin of 'one times the owner's cash flow, plus the market value of the tangible assets'. Like the most rules of thumb, this original procedure for determining value has a number of weaknesses, which include the following:

- No common agreement as to what constitutes owner's cash flow;
- Use of a singular multiple that does not provide a sufficient range to cover the spectrum of investment risk associated with business investments;
- A tendency to favour assets over earnings; and
- No standard for defining which assets are to be included or excluded (Perkins, 1999:337).

The multiple of discretionary cash flow method overcomes the weaknesses of the rule of thumb. This particular method has a realism that buyers and sellers of business entities can understand. This method attempts to eliminate as many variables as possible. It develops a level of earnings that includes all the discretionary expenses of an owner, operator, or manager substituting for an owner, and converts this level of earnings into an indication of value using multipliers representing investment risk characteristics based on lifestyle considerations. The procedure for carrying out the multiple of discretionary cash flow method is carried out in the following nine steps:

Figure 3.1: Steps in carrying out the multiple of discretionary cash flow method



- ***Step one: Obtain financial statements for a representative time period.*** When beginning a valuation arrangement, the analyst should obtain copies of a business entity's prior years' tax returns and financial statements (Holten & Bates, 2009:112). A spread sheet

should be prepared, showing a comparison of the balance sheets and the income and expenses for the periods under review (Jones, 1999:241).

- ***Step two: Normalise balance sheets.*** From the tax returns and financial statements obtained, the balance sheets may need to be adjusted to reflect results of operations that are realistic and representative of future operations (Jones, 1999:241). Some of the adjustments that may be required include:
    - Non-operating assets should be valued independently of the business entity, and either added to the total business entity value or excluded if they are not to be included in the final opinion of value;
    - Excess assets or assets shortages must be reflected, and if appropriate, adjustments must be made to the final opinion of value to account for their impact;
    - The market value of the operating assets, including the machinery and equipment and normalised level of inventory, needs to be determined; and
    - Current liabilities and long term debt should be normalised if included in the final opinion of value, or excluded if not included.
- ***Step three: Normalise income statements from step one to determine total discretionary earnings.*** The tax returns and income statements may need to be adjusted to generate results of operations that are realistic and representative of future operations. Discretionary earnings are a pre-tax concept from which adjustments to income and expenses are added or subtracted (Jones, 1999:242). Typical adjustments include the following:
    - Subtract non-operating sources of income and expenses if included in reported pre-tax earnings;
    - Add or subtract operating expenses for items that are extraordinary, nonrecurring events, or missing for a certain period;
    - Add back interest expenses associated with short and long term debt;
    - The expenses for depreciation and amortization should be added back to reported pre-tax earnings, making this adjustment unique to the multiple of discretionary earnings method; and

- The owner's total return for one owner/operator, after adjusting the total return of all other owners to market value, should be added back to reported pre-tax earnings (Perkins, 1999:333).

- ***Step four: Determine the discretionary earnings stream that best indicates future benefits.*** The multiple of discretionary earnings method is a single period method, which means that a single period of earnings is used to determine value, as opposed to the discounted economic income method, which develops value using multiple earnings periods (Dunse & Hutchison, 2004:251). Numerous procedures can be used to select the replacement for future discretionary earnings. A common error is to arbitrarily select the past year's earnings. The analyst should evaluate the historical discretionary earnings for trends (Jones, 1999:245).
- ***Step five: Determine the multiplier.*** A multiplier is a mathematical factor used to convert a single period benefit stream into an indication of value. While either a capitalisation rate or multiplier can be used with the multiple of discretionary earnings method, the use of multipliers is more general because capitalisation rates are usually associated with other levels of benefit streams, such as pre-tax earnings or after tax earnings (Perkins, 1999:335). Value is a range concept, with lower and upper ends of the range being defined by economic constraints and investment risk characteristics. The significance of these characteristics and the weight given to them by the "willing buyer" critically influence the final opinion of value. The multiple of discretionary earnings method uses multipliers to measure risks (Jones, 1999:245). These multipliers must include a reasonable amount of salary to support an owner/manager, the capital expense of replacing assets when due and a market rate of return on investment given specified business risk characteristics. The range of multipliers appropriate to discretionary earnings is zero to three. While multipliers of less than one can be allowed to any specific investment risk characteristic, owners will seldom sell their business entities for less than one year's discretionary earnings. Selecting a multiplier is unquestionably the most difficult step in applying the multiple of discretionary earnings method. The two most common procedures for developing multipliers appropriate to discretionary earnings are grounded on the following concepts of obtaining multipliers directly from guideline business entity transactions and assigned it to the investment risk characteristics. When

using guideline business entity data, it is important to use multipliers resultant from business entities that are similar in size and have similar investment risk characteristics to the business entity being valued. Sources that maintain databases of actual transactions include the Institute of Business Appraisers and BIZCOMPS (Perkins, 1999:332), and Pratt Stats (Pratt & Niculita, 2008:311; Sheeler, 2004:51; Miles, 1999:174). Analysing investment risk characteristics and weighting their importance is a common procedure for developing a multiplier appropriate to discretionary earnings. This procedure is more subjective than developing multipliers from actual transactions, but is grounded on an analysis of risk characteristics that drive value considerations. When these risks are accurately measured, multipliers can be developed that will produce a value similar to other income approaches (Perkins, 1999:338)

- Step six: Determine the capitalised value by multiplying the discretionary earnings in step four by the multiplier obtained in step five. The indication of value in this step represents the capitalised value of a business entity, which includes the tangible and intangible operating assets necessary to generate the discretionary earnings. This value includes the machinery, equipment, supplies, leaseholds improvements, normalised inventory, and intangible assets (Jones, 1999:256).
- Step seven: Determine value of net liquid assets, non-operating assets, and excess assets, then adding it to the capitalised value determined in step six. When the assignment calls for the valuation of the total business entity, the value determined in step five will need to be adjusted for net liquid assets and non-operating assets (Pratt & Niculita, 2008:265; McCarter & Aschwald, 1999:212). For the purpose of conducting the multiple of discretionary earnings method, net liquid assets are defined as current assets less current liabilities (Jones, 1999:256).
- Step eight: Arrive at net equity value by subtracting long term debt from the value determined in step seven.
- Step nine: Determine value of partial ownership interest by adjusting the value determined in step eight for a lack of control or minority interest discount.

In conclusion, the multiple of discretionary earnings method is an income based approach that develops indications of value by applying a multiplier to a single period of discretionary

earnings. The range of appropriate multipliers must include the need for owner's return, asset replacement, and return on investment given risk characteristics associated with a specific business entity. The discretionary earnings must represent the expectation of near term future benefits. The multiple of discretionary earnings method is capable of producing valid indications of value given an unemotional analysis of the investment risks characteristics combined with correctly applied valuation methodology, and strengthened with sound judgement (Jones, 1999:263).

3.8. Summary

The purpose of this chapter was to provide the historic overview and background of franchises and restaurants, giving an explanation on how they operate, why they are used, and to provide acceptable information for understanding them. Background and history about *Spur Steak* Ranches was provided, and more specifically the *Tampa Bay Spur Steak Ranch*. In addition, the two most popular methods used by theorists and practitioners on doing restaurant valuations were identified and evaluated. The conclusion was drawn that the rule of thumb and multiple of discretionary cash flow method are the most popular methods used to value a restaurant.

In the following chapter it will be described how the data of the literature review were obtained. There will also be described where the data for the empirical study came from and the use of these in the research study.

CHAPTER 4

4. RESEARCH METHODOLOGY

There are two purposes of doing this chapter. Firstly, to describe how the data of the literature review was obtained, and secondly to describe where the data for the empirical study came from and the use for it in the research study.

4.1. Background

Research is a scientific search for relevant information on a specific topic, is an art of scientific investigation, finding facts, and refers to a search for knowledge (Ramadass & Aruni, 2009:4). According to Gillham (2000:2), research is developing new knowledge, and the raw material of research is proof, which then has to be made logical. Evidence, according to Reinhardt (2010:36), refers to research results that link a specific kind of treatment to a specific outcome for a specific population, demonstrating that a treatment "works." Based on the data that were provided in chapter two and three of this research study, the assumption was made that an empirical case study was required. The reason for carrying out the empirical case study is because it was found that there are various ways of performing a valuation, according to various theorist and practitioners (Scarlata, 1999:80; Smith & Smith, 2005, 18). Therefore, it is essential to examine the different valuation approaches and methods used by different theorist and practitioners in different industries.

4.2. Research design, methods and methodology

Research design is a common term that covers a big amount of isolated but connected issues associated with research. It consists of the goals of the research, the ultimate selection of the suitable methodology, the data collection techniques for intended use, the selected methods of data analysis, as well as the interpretation of the research (White, 2002:26.) The term 'research design' is frequently used to refer to the practical aspects of the manner in which the research was conducted (Oliver, 2009:106). Knowledge of existing literature forms the initial research

design (Green, Kao & Larsen, 2010:117). Research design is a tactical framework specifying plans of action as well as providing a connection between the research problem and the implementation or execution of the research (Durrheim, 2006: 34). Research design can create the design for the measurement, collection, and analysis of the appropriate information, which relies on careful forward planning as well (Mouton, 2009:54; Blumberg, 2008:68; Cooper & Schlinder, 2008:141; White, 2002:21). The main difference between the research design and the research methodology, according to Mouton (2009:55), is that the research design concentrates on the final product, while the research methodology concentrates on the procedures, techniques and processes that are used to research the final product.

Research methods and *research methodology* are different concepts, according to Winstanley (2009:223), because the research of data establishes the methods, while the methodologies are the broader issues surrounding the research study. The particular approach that a researcher uses to explore a subject is called the '*methodology*', which refers to the theoretical basis on which the research is originated. The specific methods used to gather data and information are called '*methods*' (White, 2002:21). At the core of all the research lies what the ancient Greeks called '*methodos'*, meaning 'the path towards knowledge' or 'reflections on the quest for knowledge-gathering'. Research methods can basically be seen as the methods or procedures used to collect and analyse data (Grix, 2004:30). It may be understood as all those methods or techniques that are used for conducting research, and will refer to the methods the researcher uses in performing research operations (Ramadass & Aruni, 2009:3). According to Grix (2004:32), research methodology is concerned with the rationality of scientific investigation, specifically with exploring the potentialities and restrictions of certain methods or procedures. Henning, Smith & Van Rensburg (2009:35) refer to research methodology as a rational combination of methods assisting each other in order to provide the information and findings that reveal the research problem and support the purpose of the research. Research methodology, according to Mouton (2009:49), includes issues such as literature review or selection of cases, data collection, measurements, data analysis, and interpretation. Research methodology, according to Ramadass & Aruni, (2009:3), is a way to systematically solve the research problem, and concentrates on the process, methods and procedures that are used to perform the research (Babbie & Mouton,

2001:76). Research methodology is the common method the researchers apply in order to carry out the research project (Leedy & Ormrod, 2005:13).

4.3. Quantitative and qualitative research

The *quantitative* versus *qualitative* approach to the classification of the research activities categorises all research studies into one of six categories, which, according to Ramadass & Aruni, (2009,25), is as follows. The quantitative approach consists of *descriptive research*, *correlational research*, *casual-comparative research* and *experimental research*, where the qualitative approach includes *historical research* as well as *qualitative research*. A big difference in research studies is between qualitative and quantitative studies (Blumberg, 2008:192) and it discusses the various types of data researchers ground their conclusion(s) on. All research is grounded on observational data (Wolcott, 2001:85). Qualitative and quantitative research are not contradictory and can support each other in the research procedure. Nicholls (2009:586) argues that quantitative research is commonly *deductive*, where theory is tested, while qualitative research follows a process of *inductive* reasoning, where theory is developed.

4.3.1. Quantitative research

Quantitative research, occasionally called '*positivist'*, is a scientific method which intends to be objective, and gathers and uses numerical information (White, 2002:25). According to Ramadass and Aruni (2009:27), quantitative research is the regular scientific examination of quantitative properties and singularities and their relationships. A research study which is quantitative is generally used to reply to questions surrounding the relationship between measured variables with the tenacity of explaining, calculating and monitoring the events, and generally ends with an approval or disapproval of the theory that was tested (Leedy & Ormrod, 2005:94). According to Grix (2004:117), quantitative research is categorised by three simple phases, namely, finding variables for models, operationalizing the variables in the study, as well as measuring them. The focus in quantitative studies will be to control the actions and presentations of the participants (Henning, Van Rensburg & Smith, 2009:4; Ramadass & Aruni, 2009:29). According to Winstanley (2009:223) and Sayer (2000:83), the quantitative research method makes use of statistical implements to gather and calculate numerical information and it frequently includes

large-scale participants to calculate the regularity of occurrence and difficult text scores, and involves counting and measuring (White, 2002:25; Gillham, 2000:9).

4.3.2. Qualitative research

Qualitative research, sometimes called '*relativist',* is considered to be very difficult for researchers to be objective about, since they are actually part of the procedure being researched (White, 2002:25). Qualitative research usually involves in-depth investigation of knowledge (Grix. 2004:30). In qualitative studies, the variables are generally not manageable, and this method provides the gathering of information that cannot be calculated (Henning *et al.*, 2009:3). The qualitative research method is research of peoples' lives, lived experiences, emotions, behaviours, and feelings about managerial efficiency, cultural phenomena, social activities, as well as interactions (White, 2002:26). A qualitative research study depends on the process of collecting and analysing data in phases, and progressively developing a theory inductively, which is based on or grounded in the data (Oliver, 2009:111). According to Saunders, Lewis & Thornhill (2009:284), the qualitative method has the capability to reply to the questions of "*what*", "*why*", and "*how*". Qualitative research is essentially descriptive and focuses primarily on the kind of evidence to help people understand what is going on (Gillham, 2000:9). When comparing quantitative and qualitative analysis, the researcher should always remain objective, according to Oliver (2009:114). Considering the above, the primary research method used in this study is quantitative research, because it uses numerical data, consisting of financial statements and statistics.

4.4. Research method

4.4.1. Background

In this research study, a *case study* method was chosen because it is associated with the purpose of the study. The phrase '*case study*' generally implies that research is limited to a single component of analysis, which might be an individual department, business entity, industry or country (Smith, 2003:134). Case studies, according to White (2002:40), are studies of a single situation, like an individual, family or business entity. Conducting an in-depth case study can

result in understanding of the essential characteristics of a new or persistently problematical research area (Grix, 2004:52). A case study is an object of importance in its individual right with the researcher aiming to deliver an explanation of the research area (Bryman & Bell, 2007:63). Since a case looks at a particular person or particular situation, it often involves using a range of methods such as questionnaires or sampling and observation for collecting empirical data (Winstanley, 2009:223). According to Lindegger (2006:461), a case study is a research technique that examines individuals as individuals, rather than examining them as members of a population. The word 'case' in 'case study', is according to Gillham (2000:1), an element of human activity rooted in the real world, which can simply be examined or understood in context, which occurs in the *now* and *here*, that joins in with its context so that exact limitations are hard to draw. A case study may involve interviews, observations, experiments and tests (Ramadass & Aruni, 2009:51; Gillham, 2000:13). Relying on the condition, a case study may be conducted by itself or it can be combined with approaches like doing surveys, planning and conducting experiments, using quantitative models as well as doing qualitative research (Yin, 2003:52). Case studies are very popular as a way of structuring projects, and are a restriction or narrowing of focus to one or more towns, individuals, and business entities, which are studied in great detail. A variety of quantitative and qualitative research methods are used (Grix, 2004:162). Case study is a *key* method, and within it several sub-methods are used (Gillham, 2000:13). According to Betkerur (2008:690) decent analysis leads to respectable results. Many researchers often base case study research on the research problem as well as the research question being asked. According to Merriam (2009:105) all case studies are inductive because they report on the specific and particular, and then try to relate it to the overall picture. Case studies can be used either to create theory and concepts about a particular topic, or to examine a theory to see if it happens in and applies to real life circumstances. According to White (2002:40), there are different types of case studies, which can be described as i) where the business entity is as *typical* as possible, ii) where the business entity is *atypical* or *unusual* and out of the ordinary, iii) with large research projects case studies are sometimes used at the start and act as *precursors* to identify the issue involved before the research is planned in detail; and iv) using *multiple case studies* that allows for a comparative behaviour and, as a result, assists building and confirming accepted theory.

4.4.2. Advantages of a case study

The advantages of case studies are more than the disadvantages of case studies and provide insight into people's real-life practices and experiences (Merriam, 2009:105). Case study information is grounded on real-life circumstances, making the information more believable and more manageable (Cohen, Kahn & Steeves, 2000:184). According to Gibbert, Ruigrok and Wicki (2008:1465), a researcher uses case studies as an instrument to create and test different theories in order to create appropriate managerial knowledge. Case study research has various potential parts to play, even though the fundamental role is that of examination (Otley & Berry, 1998:S106). Some advantages of a case study is that it can be performed by a single researcher, is fairly cheap and not reliant on expensive technology, will constantly produce empirical data information to be independent of previously published work, takes place in an ordinary situation within an actual business entity, and looks at the complete situation (White, 2002:42).

4.4.3. Disadvantages of a case study

In spite of all the advantages of case study research, there are several concerns about the diligence of the approaches used in relations of dependability and strength, according to Gibbert, Ruigrok and Wicki (2008:1466). Blaxter, Hughes and Tight (2006:74) state that in the course of a case study, researchers become aware of the links between various events, variables as well as conclusions, but must be wary not to lose sight of the entire picture, making this a complication of the case study because it can make an analysis challenging. Case study research is restricted by the reliability and understanding of the investigator because the researcher is the key instrument in the gathering and analysis of the information (Merriam, 2009:105). In a case study research with a single unusual case study it is often hard to distinguish what is exclusive to the business entity involved and what is general to comparable business entities. Case study research tends to be individual, and because it can generate a lot of data, the interpretation and analysis must be handled sensibly and in a rational, systematic manner (White, 2002:43).

4.5. Research ethics

Ethics is defined in the Longman business English Dictionary (2001:161) as the ethical rules or principles of behaviour that must guide professional participants or business entities. According to Tseng, Duna, Tung and Kung, (2010:587), ethics can be described as the examination and philosophy of human behaviour, emphasising the capability to differentiate between what is right and what is wrong. Therefore, it can be determined that ethics comprises human morality or behaviour that must guide a practitioner of a profession. The ethics of science concerns what is incorrect and what is correct in the behaviour of research, and because scientific research is a type of human behaviour, it follows that such behaviour has to adapt to commonly accepted norms and values. In any sphere of human life, several kinds of behaviour are normally acceptable, whereas others are not (Mouton, 2009:238). As the data collection technique is developed, it must be considered whether the research procedures are expected to cause any emotional or physical distress, such as, violating informants' rights to confidentiality by posing sensitive questions, witnessing the behaviour of informants without their being aware of it, allowing private information which informants would rather want to be kept private to be made publicly available, and failing to witness and respect specific cultural values, traditions or taboos valued by informants (Ramadass & Aruni, 2009:51; Gillham, 2000:85).

Social sciences research frequently includes gathering information from people, and raises the question as to how people who provide the information must be treated by researchers, thus making it significant that the researcher defends the rights of the members and those of the establishment in which the examination is conducted. In this research study it will be the *Tampa Bay Spur*, the owners, accountants and the valuer. Ethical concerns must form part of the research design procedure because the research procedure can have an impact on individuals or groups, indirectly or directly (Winstanley, 2009:91; Oliver, 2003:10). According to Cooper and Schindler (2003:121), all parties that are involved in a research process must demonstrate ethical behaviour. According to Blakeslee and Fleischer (2007:32), research ethics relate most directly to how the research affects the participants and the setting studied, that is, the way a question is formulated and may imply to certain beliefs about participants in the research setting, and may make unintended judgements about the participants. Article ten in the Constitution of the

Republic of South Africa (2009:6) states that everybody has inherent dignity as well as the right to have their dignity protected and respected, where article 14 in the Constitution of the Republic of South Africa (2009:7) discusses privacy, declaring that everybody has the right to privacy, which consists of the right not to have their house searched, their possessions searched, their properties seized, or the confidentiality of their communication infringed. Research is an activity which involves the lives of others, and it is significant to show that there was reflected upon the impact of the research on other people (Oliver, 2009:114). According to Buys (2009:26), ethics is considered people's honourable obligation to society, and everyone in the group carries a certain amount of obligation for the welfare of others in the group. Ethical behaviour results when a person does not only do what is good him or herself, but also what is good for other people (Rossouw & van Vuuren, 2010:4).

Business ethics are the fundamental values which an organization understands by socially responsible behaviour, according to CIMA (2010:65). Furthermore CIMA (2011b:365) has fundamental principles and ethical guidelines, which are as follows:

- ***Integrity***, meaning to be honest and truthful in all professional as well as business relationships (Buys, 2009:27; Mouton, 2009:240). To be *objective*, and not tolerate prejudice behavior, conflict of interest or unjustified influences of others to dominate professional business judgments (Buys , 2009:27; Mouton, 2009:240; Ramadass & Aruni, 2009:84; Blakeslee & Fleischer , 2007:33).
- Having ***professional competence*** and ***due care,*** meaning to have a continuing responsibility to sustain professional skill and knowledge at the particular level needed, and act diligently and in accordance with appropriate professional and technical standards when providing professional services (Duffy & Chenail, 2008:34).
- Being ***confidential*** of information acquired, and not to reveal any private information to a third party without appropriate or specific authority, except if there is a professional or legal right or responsibility to disclose (Buys 2009:28; White, 2002:27).
- ***Professional behavio*****ur** should be displayed, obeying the appropriate regulations and laws and avoiding any act that dishonours the profession (Buys 2009:28; White, 2002:27).

According to Winstanley (2009:91), to make sure that the interest and rights of anyone affected by the research are protected, the following must be adhered to:

- Obeying the legislation on human rights and a data protection;
- Maintaining good quality research, consisting of data collection, storage analysis, and distribution of information;
- Gaining the informant's approval of the subject; and
- Thinking through the consequences of the work.

A researcher should be responsible to follow a prescribed code where it is applicable (White, 2002:27), and when not provided with any set of guidelines or codes of practice, the following may help when carrying out the work (Macfarlane, 2009:63):

- Only include people with their approval or awareness;
- Never force or pressurize people to take part in research;
- Under no circumstances hold back information on the true nature of the research;
- Be truthful about the research and by no means mislead participants in any way;
- Never persuade participants to do things which could harm their confidence;
- Never expose people to circumstances which could cause physical or mental stress;
- Respect the participant's right to confidentiality; and
- Treat every group in the research project the same, with respect and consideration.

When writing about methodological aspects of research, it is essential to consider and use the many ethical aspects of the research design (Oliver, 2009:119). Ethical concerns need to be embraced and acknowledged both at the start of the research and through each phase of it Blakeslee and Fleischer (2007:32). When performing research, avoid disordered research techniques, misinterpreting data, drawing conclusions from insufficient data and deliberately misrepresenting findings (Grix, 2004:142). Thus, all the associated ethical processes as well as requirements as anticipated and stated above, were constantly part of the overall assignment and monitored by the researcher in the implementation of this research study.

4.6. Data collection, collection methods, analysing and interpretation

Data collection is the procedure through which empirical data are created and collected via a number of different data sources. There are many different methods of data collection, associated with both quantitative and qualitative research, and a wide range of sources of data that can be collected (Grix, 2004:163). The two basic approaches through which information can be collected during a case study are the quantitative and qualitative methods (Brynard & Hanekom, 2008:35). Data collection procedures allow the researcher to systematically gather data about the objects of the study and about the situation in which they occur (Ramadass & Aruni, 2009:69). Data may be gathered by a variety of data collection methods, for example, observation, self-reporting, archival or documentary, and physical source (Mouton, 2009:99). Data collected may suggest new concepts that have not yet been identified by other researchers, and it may be mentioned as supporting the continued investigation of the concept. Evidence for the statements,

grounded upon quotations and extracts from the data should be provided in all cases (Oliver, 2009:119). Throughout the procedure of gathering information, the researcher is involved in what can be stated as a primary analysis of the information. If all the information has been collected, an in-depth analysis of information can be performed (Brynard & Hanekom, 2008:61). Data means very little without interpretation (Winstanley, 2009:166). In this research study, *graphs*, *pie charts*, *bar charts*, *histograms*, and *column graphs* will be used, which are all part of descriptive statistics in quantitative data research (Winstanley, 2009:182; White, 2002:27). Descriptive statistics are used to categorise and summarise the collected information in order to effectively communicate the characteristics of the research to other parties (Ryan, 2004:5). Researchers need to interpret their results in light of the research problem or determine whether the outcomes are consistent with their theories and concepts (Blumberg, 2008:76).

The results of the information will be deliberated in Chapter 5 of the research study (Empirical Case study).

4.7. Summary

The particular purpose of this chapter was to describe how the data of the literature review were obtained. In addition, this chapter described where the data for the empirical study came from and the use in the research study. The literature study in Chapters two and three found that there were various approaches and methods to do valuations in different industries, which led to the assumption that a case study is required to determine which combination of methods are the most accurate and reliable for a franchised restaurant valuation. The first step was to understand the difference between a *research methodol*ogy and a *research design*. A research design is a calculated structure specifying action plans and providing a connection between the research problem and the implementation of the research, while research methodology refers to a rational combination of approaches assisting each other in order to provide the information and conclusions that reflect the research problem and assist the research purpose. The second difference to be explained was between the *qualitative* and *quantitative* research. In a quantitative study, the motivation will be to control the activities and performances of the

participants, while in a qualitative study, the variables are commonly not manageable and this method provides the collection of data that cannot be calculated.

In the course of a research study, ethics also need to be taken in consideration. Ethics can be described as the examination and philosophy of human behaviour, emphasising the capability to differentiate between what is wrong and what is right. When research is conducted where human participants are included, it is essential that the participants of the research are given a decent explanation of the purpose of the research study, that the data will be used in a personal way, and that the participants in the research are voluntary. All associated ethical processes and requirements as anticipated and stated above were constantly part of the overall research study and monitored by the researcher in the implementation of the research.

The case study approach was chosen for this research study because it is connected to the purpose of this particular study. Researchers ground case study research on the research problem as well as the research question being examined. The *empirical* data in this study were collected by using financial statements of the *Tampa Bay Spur*, then analysing and interpreting them by using descriptive statistics.

In the next chapter of this research study, an empirical case study will be conducted, using the financial statements of *Tampa Bay Spur* to do a business valuation on the restaurant by means of various approaches and methods. The different valuation methods will be compared to each other as well as to the original valuation conducted by the *Spur*. In addition, graphs and charts will be drawn up containing information on some of the most important aspects of the *Tampa Bay Spur*.

CHAPTER 5

5. EMPIRICAL CASE STUDY

In this chapter of the research study, an empirical case study will be conducted. By using the financial statements of *Tampa Bay Spur*, a business valuation on the restaurant will be performed by using various approaches and methods. The different valuation methods will be compared to each other and to the valuation originally conducted by the *Spur*. Additionally, graphs and charts will be drawn up containing information on some of the most important aspects of the *Tampa Bay Spur*.

5.1. Background and historic data

The statement of financial position and the detailed statement of financial performance contains very important information required to perform business valuations because it is used as the groundwork. The statement of financial position and statement of financial performance is going to be showed and discussed in this chapter. In addition, growth rates as well as averages of the five years (2006 – 2010) are shown for the turnover and expenses. In table 5.1 and 5.2 the statement of financial position will be shown.

Table 5.1: Statement of financial position: Assets (Rand)

Statement of financial position	2006	2007	2008	2009	2010	Average
Non-current assets	605,601	2,345,444	2,410,405	2,585,360	2,478,194	2,085,001
Plant and equipment	605,601	2,151,103	1,940,352	2,084,821	2,084,821	1,773,340
Motor vehicles	0	0	102,097	102,097	78,908	56,620
Investments in related parties	0	194,341	367,956	398,442	314,465	255,041
Current assets	168,709	141,854	199,803	172,973	177,899	172,248
Stock on hand	98,558	133,196	169,343	141,576	131,487	134,832

Trade and other receivables	12,689	7,127	10,794	6,500	6,500	8,722
Cash and equivalents	57,462	1,531	19,666	24,897	39,912	28,694
Total assets	774,310	2,487,298	2,610,208	2,758,333	2,656,093	2,257,248

In table 5.1 the assets of *Tampa Bay Spur* are given. The non-current assets show substantial growth from 2006 to 2010, while the current assets remained constant throughout the five years. The reason for the growth in non-current assets is mainly the growth of plant and equipment.

Table 5.2: Statement of financial position: Equity and liabilities (Rand)

Statement of financial position	2006	2007	2008	2009	2010	Average
Capital and reserves	33,459	1,941,786	1,728,584	1,881,390	2,061,505	1,529,345
Share capital	850	850	850	850	850	850
Retained earnings	32,609	78,508	237,791	390,597	428,179	233,537
Revaluation reserves	0	1,862,428	1,489,943	1,489,943	1,632,476	1,294,958
Non-current liabilities	453,121	132,522	88,925	12,872	0	137,488
Interest bearing borrowings	453,121	132,522	88,925	12,872	0	137,488
Current liabilities	287,730	412,990	792,699	864,071	594,588	590,416
Trade and other payables	209,139	242,020	337,199	395,826	253,562	287,549
Bank overdraft	0	95,002	390,371	396,222	327,467	241,812
Current portion of interest-bearing	78,591	75,968	65,129	72,023	13,559	61,054

borrowings						
Total equity and liabilities	774,310	2,487,298	2,610,208	2,758,333	2,656,093	2,257,248

In table 5.2 the equity and liabilities of the *Tampa Bay Spur* are shown in the statement of financial position. The capital and reserves show tremendous growth from the year 2006 to the year 2010. The main reason for this is the growth in the revaluation reserves. The share capital stayed the same throughout the five years, while the retained earnings also displayed a big growth during the five years. The non-current liabilities only consist of interest bearing borrowings. From 2006 to 2010 the amount gets less every year until it reaches zero in the year 2010. The current liabilities show a growth from 2006 to 2009 and then a drop in the year 2009. The main reason for that is the drop in trade and payables in 2009. In table 5.3, 5.4 and 5.5 the statement of financial performance will be shown.

Table 5.3: Statement of financial performance: Income (Rand)

Statement of financial performance	2006	2007	2008	2009	2010	Average
Income	3,703,432	4,211,071	4,277,503	4,740,043	4,960,982	4,378,606
Sales	6,904,790	7,914,196	8,221,609	8,657,323	8,411,335	8,021,851
Cost of sales	3,230,696	3,716,925	3,944,106	3,947,766	3,465,540	3,661,007
Gross profit	3,674,094	4,197,271	4,277,503	4,709,557	4,945,795	4,360,844
Interest received	29,338	13,800	0	30,486	15,187	17,762

In table 5.3 the income as shown in the statement of financial performance, indicates that there was growth in income over the five years, and the main reason is the growth in sales/turnover.

Table 5.4: Statement of financial performance: Expenses

Statement of financial performance	2006	2007	2008	2009	2010	Average
Expenses	3,669,383	4,164,517	4,118,220	4,587,237	4,923,400	4,292,551
Accounting fees	13,203	8,899	13,696	10,500	15,637	12,387
Advertising	363,709	472,947	411,401	431,585	406,969	417,322
Auditor's remuneration	13,666	19,178	15,975	14,995	4,385	13,640
Bank charges	107,558	113,931	130,915	135,108	151,408	127,784
Cleaning and refreshments	71,706	60,652	141,069	143,934	144,969	112,466
Depreciation	394,771	342,899	133,046	91,147	165,722	225,517
Directors salary	240,000	280,000	250,000	615,569	1,033,931	483,900
Electricity and water	66,775	85,068	113,027	110,531	128,600	100,800
Entertainment	8,300	76,150	9,491	60,221	20,318	34,896
Finance charges	23,471	16,087	20,451	13,573	9,770	16,670
General gas	76,929	116,778	180,076	183,874	184,065	148,344
Insurance	40,046	51,271	59,562	57,182	50,307	51,674
Interest	80,245	66,706	38,516	44,505	37,085	53,411

Licenses	6,162	9,920	7,926	7,702	7,825	7,907
Motor vehicle expenses	59,573	54,786	57,876	58,150	65,189	59,115
Printing and stationery	26,112	34,097	45,301	30,376	20,923	31,362
Protective clothing	12,679	23,735	26,087	29,699	24,814	23,403
Rent	151,356	180,798	187,900	194,556	171,579	177,238
Repairs and maintenance	198,816	163,080	213,724	118,775	164,744	171,828
Royalties	344,440	395,718	406,298	440,866	420,566	401,578
Salaries and wages	1,279,299	1,482,974	1,512,188	1,685,854	1,610,130	1,514,089
Security	3,207	7,427	5,391	5,526	7,115	5,733
Subscriptions	27,460	38,806	59,261	37,117	20,527	36,634
Telephone and postage	49,126	55,886	66,802	53,974	51,929	55,543
Training	5,653	2,200	4,991	5,897	0	3,748
Travelling and accommodation	5,121	4,524	7,250	6,021	4,893	5,562

In table 5.4 the expenses in the statement of financial performance are shown. There was a growth in expenses throughout the five years. The main reason for the growth in expenses is the growth in the director's salary, especially in the last two years (2009 and 2010). The other expenses remain constant throughout the five years.

Table 5.5: Statement of financial performance: Profit (Rand)

Statement of financial performance	2006	2007	2008	2009	2010	Average
Revenue (Gross Profit)	3,674,094	4,197,271	4,277,503	4,709,557	4,945,795	4,360,844
Interest received	29,338	13,800	0	30,486	15,187	17,762
Operating expenses	3,589,138	4,097,811	4,059,253	4,529,159	4,876,545	4,230,381
Surplus from	114,294	113,260	218,250	210,884	84,437	148,225

operations						
Finance costs	80,245	66,706	58,967	58,078	46,855	62,170
Profit before taxation	34,049	46,554	159,283	152,806	37,582	86,055
Taxation (28%)	9,533.72	13,035.12	44,599.24	42,785.68	10,522.96	24,095
Net profit for the year	24,515	33,519	114,684	110,020	27,059	61,959

In table 5.5 the profit of the *Tampa Bay Spur* is shown in a shortened statement of financial performance format. The profit grows from 2006 to 2008 and then drops with just over R4000 from 2008 to 2009. From the year 2009 to 2010 the profit drops with just over 75%. The main reason is because the director's salary for the year 2010 was 330% higher than in 2006. Figure 5.1 will show the growth in sales/turnover for the last five years.

Figure 5.1: Sales/Turnover for Tampa Bay Spur for the last five years

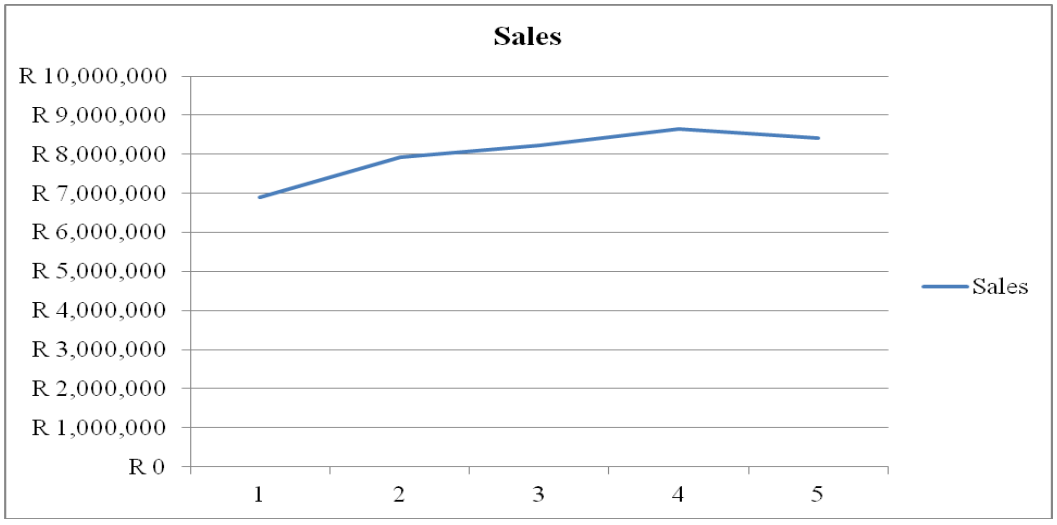


Figure 5.1 shows how the sales/turnover increased from 2006 to 2008 and then decreased from 2008 to 2009. In figure 5.2 the expenses for the last five years will be shown.

Figure 5.2: Expense for Tampa Bay Spur for the last five years

Figure 5.2 shows how the expense of the *Tampa Bay Spur* had an incline and a decline over the five years. The expenses grew tremendously from 2008 to 2009 and the reason is mainly the increasing of the director's salary.

5.1.1. Performing different valuation methods on the Tampa bay Spur

Calculating the rule of thumb valuation method's value

When the rule of thumb valuation method is used, it can categorize the *Spur* into three categories, consisting of a casual style restaurant, full service restaurant, as well as a franchised restaurant. Every category applies a different method of calculating the value of the *Spur*. In table 5.6 the different methods of the rule of thumb valuation method are shown. In addition, seven variations of values will be calculated as well as an average of the seven variations.

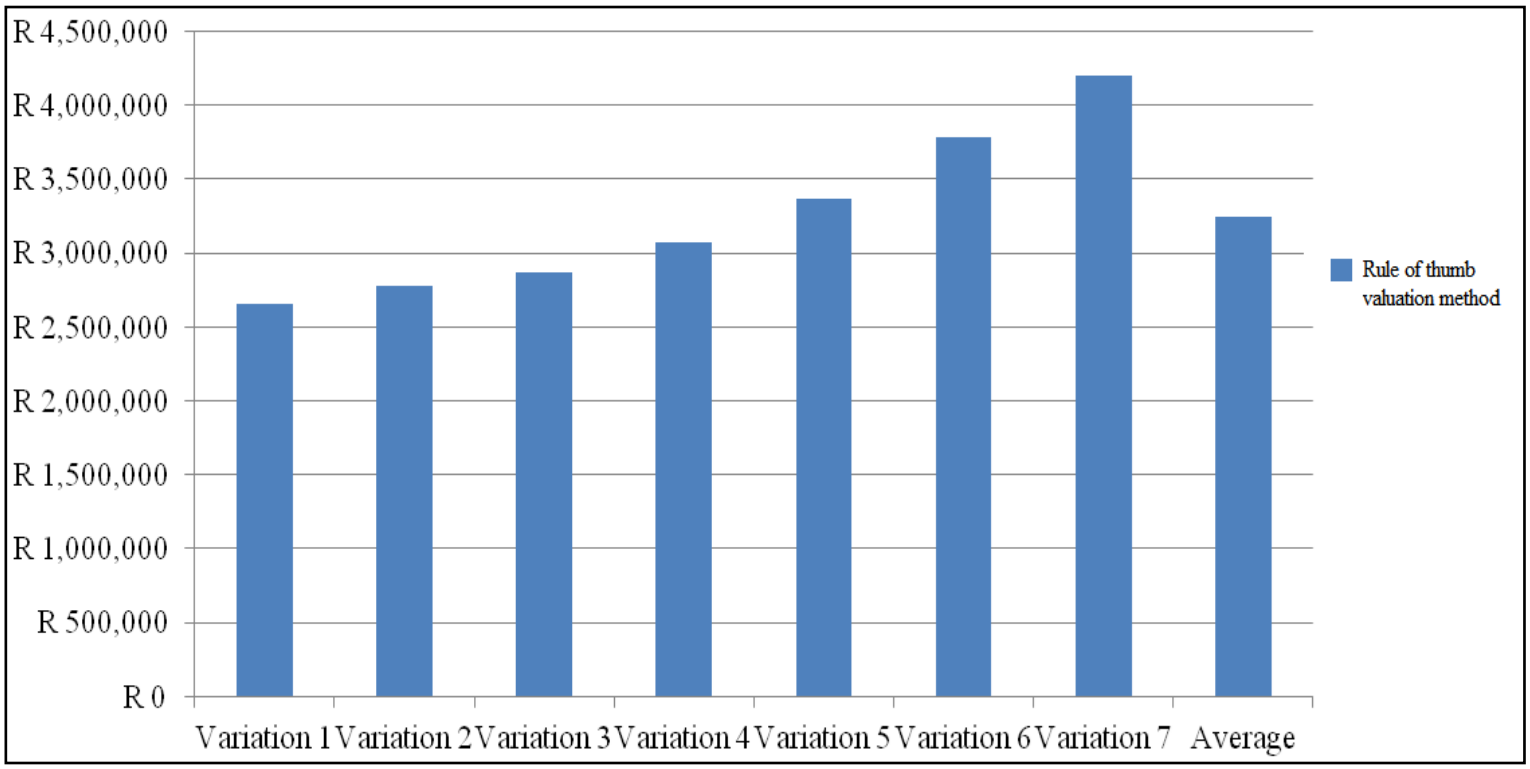
Table 5.6: Rule of thumb valuation method

Casual style restaurant	33% of annual sales
2010 – Sales	R 8,411,335
	R 2,775,741
Full service restaurant	30% - 35% of annual sales + inventory
2010 – Sales	R 8,411,335
2010 – Inventory	R 131,487
Lowest = 30 %	R 2,654,888
Highest = 35 %	R 3,075,454
Average = 32.5 %	R 2,865,171
Franchised restaurant	40% - 50% of annual sales
2010 – Sales	R 8,411,335
Lowest = 40 %	R 3,364,534
Highest = 50 %	R 4,205,668
Average = 45 %	R 3,785,101
Variations:	

Variation 1	R 2,654,888
Variation 2	R 2,775,741
Variation 3	R 2,865,171
Variation 4	R 3,075,454
Variation 5	R 3,364,534
Variation 6	R 3,785,101
Variation 7	R 4,205,668
Average	R 3,246,651

In table 5.6 the *Spur* was categorized into three categories, namely a casual style restaurant, a full service restaurant as well as a franchised restaurant. Seven different variations of values were calculated as shown in table 5.6. In figure 5.3 the variations are compared to each other. In addition, an average value of the seven variations is shown.

Figure 5.3: Calculating the rule of thumb valuation method's value



When using the rule of thumb valuation method, three different types of calculations were used. *Spur* can be categorized as a casual style restaurant, full service restaurant, or franchised restaurant. All three options were used to get the most values possible and calculate an average. Seven different variations can be used, as well as an average. The rule of thumb valuation method is not a very popular method and just gives a fairly basic amount without using several complicated calculations.

5.1.2. Calculating the market derived valuation method's value

In table 5.7 the unadjusted values for the statement of financial performance for 2010 are presented. Adjustments will be made to values which are extraordinarily high or low. The fourth column in table 5.7 shows the values after adjustments have been made.

Table 5.7: Unadjusted and adjusted statement of financial performance for 2010 (Rand)

	2010	Adjustments	Adjusted
Income	4,960,982	None	4,960,982
Sales	8,411,335	None	8,411,335
Cost of sales	3,465,540	None	3,465,540
Gross profit	4,945,795	None	4,945,795
Interest received	15,187	None	15,187
Expenses	4,923,400		4,373,369
Accounting fees	15,637	None	15,637
Advertising	406,969	None	406,969
Auditor's refreshments	4,385	None	4,385
Bank charges	151,408	None	151,408
Cleaning and	144,969	None	144,969
Depreciation	165,722	None	165,722
Directors salary	1,033,931	Avg past 5	483,900
Electricity and water	128,600	None	128,600
Entertainment	20,318	None	20,318
Finance charges	9,770	None	9,770
General gas	184,065	None	184,065
Insurance	50,307	None	50,307
Interest	37,085	None	37,085
Licences	7,825	None	7,825
Motor vehicle expenses	65,189	None	65,189
Printing and stationery	20,923	None	20,923
Protective clothing	24,814	None	24,814
Rent	171,579	None	171,579
Repairs and maintenance	164,744	None	164,744
Royalties	420,566	None	420,566
Salaries and wages	1,610,130	None	1,610,130
Security	7,115	None	7,115
Subscriptions	20,527	None	20,527
Telephone and postage	51,929	None	51,929
Travelling and	4,893	None	4,893
Profit before taxation	37,582		587,613
Taxation	10,523		164,532
Profit after taxation	27,059		423,081

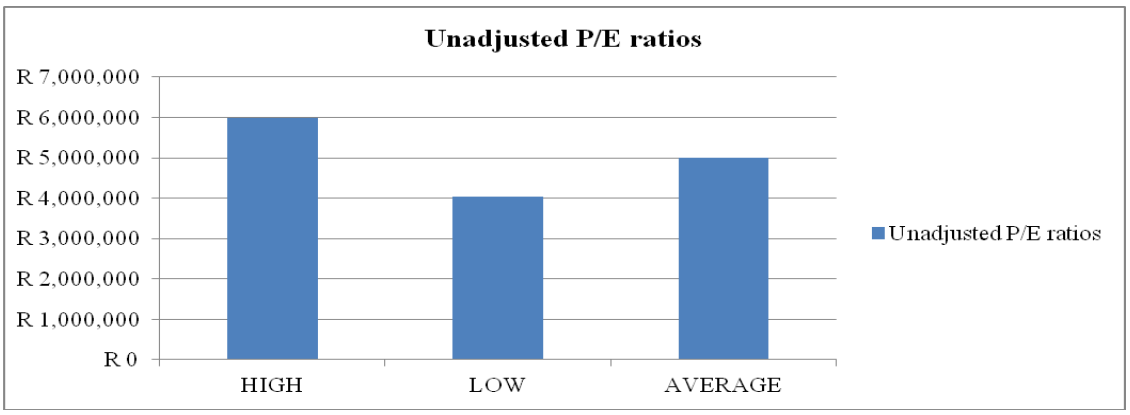
In table 5.7 the statement of financial performance was used. It has only one adjustment, and that is the director's salary, because the director's salary had grown by an extraordinary percentage in 2008 and 2009, so that it affected the profit by nearly R400 000. In table 5.8 the unadjusted P/E ratio is shown. Adjustments will be made to value the *Tampa Bay Spur* because the P/E ratio in the unadjusted column in table 5.8 is the P/E ratio of Spur Corporation which is listed on the JSE, and the *Tampa Bay Spur* is only one of nearly 300 *Spur* outlets.

Table 5.8: Unadjusted and adjusted P/E ratios

	Unadjusted P/E ratio Spur Corporation	Adjustment	Adjusted P/E ratio Tampa Bay Spur
P/E High - Last 5 Years	14.15	Minus 10 %	12.735
P/E Low - Last 5 Years	9.53	Minus 10 %	8.577
P/E Average - Last 5 Years	11.84	Minus 10 %	10.656
HIGH	R 5,986,601	HIGH	R 5,387,941
LOW	R 4,031,965	LOW	R 3,628,769
AVERAGE	R 5,009,283	AVERAGE	R 4,508,355

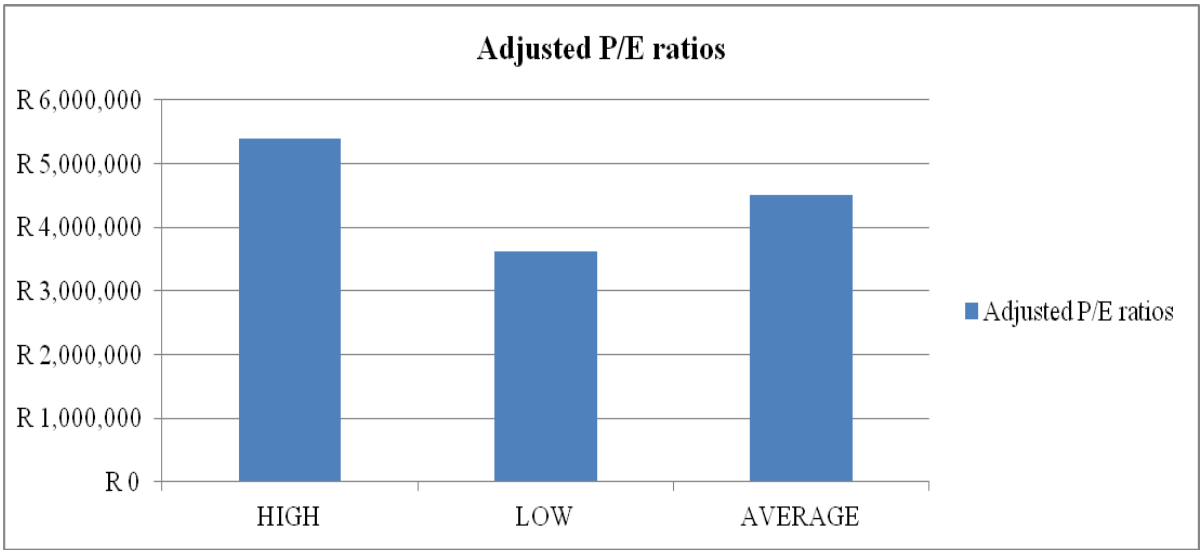
In table 5.8 the unadjusted and adjusted values of the P/E ratio of the *Tampa Bay Spur* are given. The P/E ratios for the last five years were used, consisting of a highest value, lowest value, as well as an average for the five years. In figure 5.4 the unadjusted P/E ratios, consisting of a high, low, and average value are shown.

Figure 5.4: Calculating unadjusted P/E ratios



In figure 5.4 the unadjusted P/E ratios were used to calculate an amount for a valuation. The highest P/E ratio for the last five years gave a value of R 5,986,601, the lowest P/E ratio for the last five years gave a value of R 4,031,965, making an average of R 5,009,283. In figure 5.5 the adjusted P/E ratios, consisting of a high, low, and average value are shown.

Figure 5.5: Calculating adjusted P/E ratios



In figure 5.5 the adjusted P/E ratios were used to calculate an amount for a valuation. The highest P/E ratio for the last five years gave a value of R 5,387,941, the lowest P/E ratio for the last five years gave a value of R 3,628,769, making an average of R 4,508,355.

The P/E ratios of the *Tampa Bay Spur* were adjusted with minus 10% of the Spur Corporation's P/E ratio because the *Tampa Bay Spur* operates as a smaller business entity than the Spur Corporation franchise does. Tampa Bay Spur is located in Jeffrey's Bay which generates more income in the holiday season, thus operating as a seasonal business entity which makes the risk higher and the P/E ratio lower. Lowering the P/E ratio with 10% as an adjustment is a fair assumption to make.

The only adjustment made in the statement of financial performance was the director's salary which was too high for one year. It was adjusted it by changing the director's salary to the average salary that the director/owner took over the past five years (2006 - 2010). Six variations of values can be used in the market derived valuation method, consisting of a high, low, and average unadjusted value, and a high, low and average adjusted value, demonstrated in figure 5.4 and figure 5.5.

5.1.3. Calculating the asset accumulation valuation method's value

In table 5.9 the statement of financial position is given for the year 2010. Adjustments will be made to the 2010 values, by revaluing them at what they are worth in 2011.

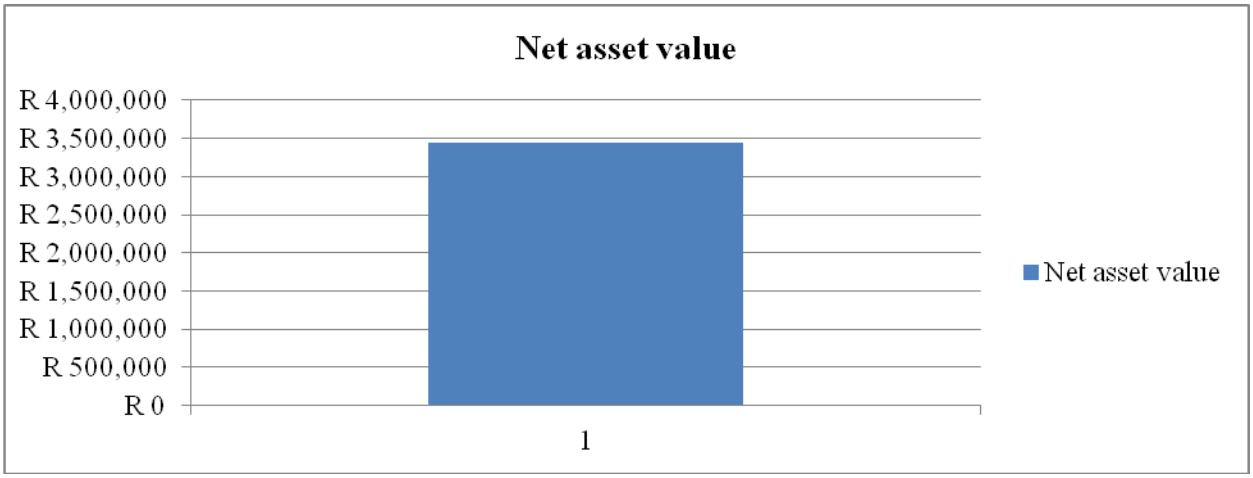
Table 5.9: Statement of financial position with adjustments for 2010 (Rand)

	2010	Adjustments	2010 - After adjustments	
Non-current assets	2,478,194	751,806	3,230,000	
Plant and equipment	2,084,821	665,179	2,750,000	New equipment and revaluation
Motor vehicles	78,908	1,092	80,000	Upgrade and revaluation
Investments in related parties	314,465	85,535	400,000	Increase in investment
Current assets	177,899	28,601	206,500	

Stock on hand	131,487	18,513	150,000	Increase in stock on hand
Trade and other receivables	6,500	0	6,500	No adjustment
Cash and equivalents	39,912	10,088	50,000	Increase in cash
Total assets	2,656,093	780,407	3,436,500	
Capital and reserves	2,061,505	139,345	2,200,850	
Share capital	850	0	850	No adjustment
Retained earnings	428,179	21,821	450,000	Increased retained earnings (decrease in directors salary)
Revaluation reserves	1,632,476	117,524	1,750,000	Increased revaluation reserves
Current liabilities	594,588	0	0	
Trade and other payables	253,562	0	0	No more trade and other payables
Bank overdraft	327,467	0	0	No more bank overdraft
Current portion of interest-bearing borrowings	13,559	0	0	No more debt (interest-bearing borrowings)
Total equity and liabilities	2,656,093	139,345	2,200,850	

In table 5.9 the statement of financial position is shown for 2010. After speaking to the new owners of the *Tampa Bay Spur* and revaluing the values, adjustments were made. The third column in table 5.9 shows the values of the financial position after making adjustments by revaluing the assets and liabilities. Figure 5.6 will show the net asset value for the *Tampa Bay Spur* after adjustments were made as shown in table 5.9.

Figure 5.6: Calculating the asset accumulation valuation method's value



The asset accumulation method gives the minimum value of a business entity. This is not a popular method to use for a going concern business entity. Adjustments were made from 2010 to 2011 by replacing the book value of the assets and liabilities with the market value of the assets and liabilities. This method provides the amount that the assets are worth at present according to the market. The *Tampa Bay Spur* paid off all debt and doesn't have a bank overdraft in 2011, thus making them a business entity without any liabilities. New equipment was bought and the building was revamped, thus, making the net asset value higher. Even with the higher net asset value, this method still gives a minimum value.

5.1.4. Calculating the discounted economic income valuation method's value

Table 5.10 shows how the discount rate is calculated and where the information was received in performing the calculation. To calculate the discount rate, the risk-free rate, Beta, market risk premium and market rate of return are required.

Table 5.10: Calculating the discount rate

Discount Rate Element	Value	Notes	Data gathered from: (Bibliography)
Risk-free rate of return (Rf)	7.31%	S.A Reserve bank (R157)	http://www.resbank.co.za/Pages/default.aspx
			http://www.jse.co.za/Home.aspx
			http://www.bloomberg.com/
			http://www.reuters.com/
Beta (B)	0.5	Bloomberg/Reuters	http://www.bloomberg.com/
			http://www.reuters.com/
			http://www.spurcorporation.co.za/
Market risk premium (Rm - Rf)	5.80%	PWC/Analysts	.http://www.scribd.com/doc/32121177/Market-Risk-Premium.
Market rate of return (Rm)	13.11%	Calculated	(10.21 = 7.31 + 0.5 (Rm - 7.31) - Rm = 13.11

In table 5.10 the discount rate was calculated. The discount rate requires the risk free rate, which is 7.31% according to the S.A reserve bank (Bond R157), the Beta, which is 0.5 according to Bloomberg and Reuters, and a market rate premium which is 5.8 according to PwC. In table 5.11 the CAPM is calculated. The discount rate in this case study will be the CAPM because there is not any debt in the Tampa Bay Spur, and it only consists of equity.

Table 5.11: Calculating the CAPM

CAPM	
Risk free rate (Rf)	7.31%
Beta (B)	0.50
Market rate of return (Rm)	13.11%
Discount rate (Required rate of return)	10.2100%

In table 5.11 the CAPM was calculated using the following formula:

Ke = Rf + B (Rm - Rf)

Calculating the weighted average cost of capital (WACC) and the capital asset pricing model (CAPM) is very important because it calculates the discount rate. To get the value of the required rate of return, also referred to as the discount rate, is a crucial aspect in valuations because the discount rate is used to convert a predicted future value into a specific present value The discount rate is not only used in the discounted economic income valuation method, but is needed in the capitalised economic income and the excess earnings valuation methods as well.

For the reason that the *Tampa Bay Spur* has no debt, the discount rate used will be only CAPM and not WACC. The Tampa Bay Spur is 100% financed with equity and 0% financed with debt..

In figure 5.7 the financial indicators of the Spur are shown. The financial indicators of a business entity can be found on the internet by using websites such as www.Bloomberg.com, www.Reuters.com, as well as www.McGregor.com. The Beta is an important indicator used to calculate the CAPM and is shown in figure 5.7.

Figure 5.7: Spur financial indicators

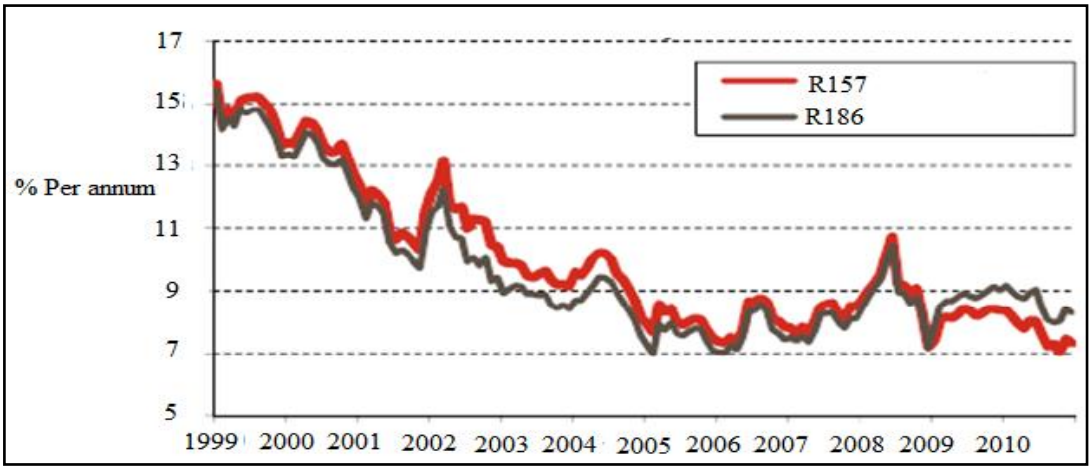
Overall		Financials			
Beta:	0.50		SURJ.J	Industry	Sector
Market Cap (Mil):	1,352.21	P/E	15.34	32.64	21.17
Shares outstanding (Mil):	97.63	EPS	15.58	0	0
Annual Dividend:	61.00	ROI	17.04	9.75	2.23
Yield (%):	4.40	ROE	19.74	12.65	3.70

(Source: www.bloomberg.com)

Figure 5.7 shows the financial indicators of the Spur. The Beta, which is 0.5 according to figure 5.7 was a very important indicator to get when calculating the CAPM. In figure 5.7 the Beta and

P/E ratios are given which have been used in this case study. Figure 5.8 shows what the South-African bond yield for 2010 is. South-Africa uses the R157 bond yield and it is used as the risk-free rate in the CAPM calculation.

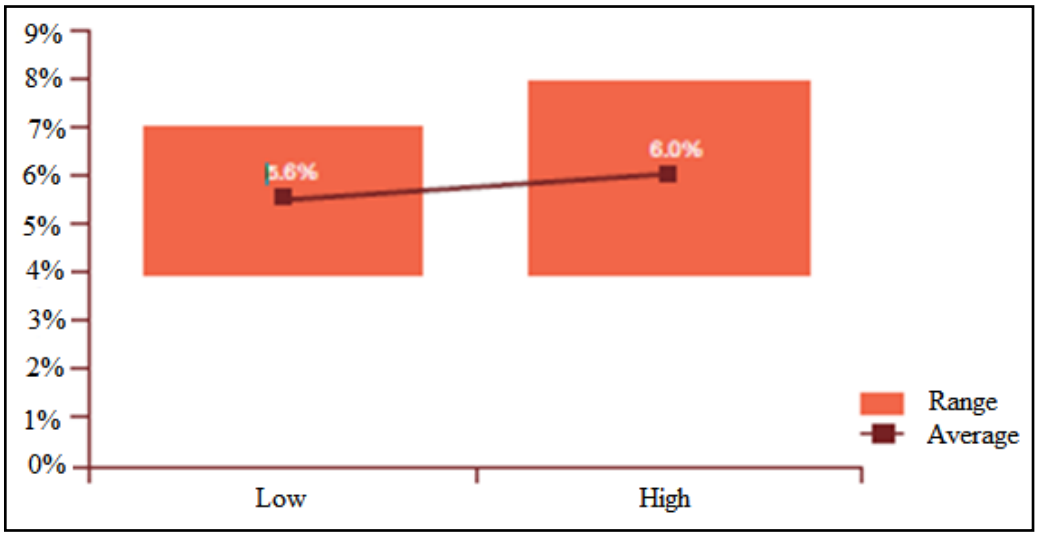
Figure 5.8: South-Africa bond yield for 2010



(Source: www.resbank.co.za)

Figure 5.8 showed that South-Africa uses a bond yield of 7.31%. The 7.31% will be used as the risk-free rate in the CAPM calculation. In figure 5.9, the market risk premium of South-Africa is shown for 2010. The market risk premium is used when calculating the CAPM.

Figure 5.9: Average market risk premium in South-Africa for 2010



(Source: www.reuters.com)

Figure 5.9 shows that the market risk premium in South-Africa for 2010 had a low value of 5.6% and a high value of 6%. In this case study an average of 5.8% was used. In table 5.12 the market risk premiums of different countries are shown. The important market risk premium in this table is the one of South-Africa.

Table 5.12: Market risk premiums used in 2010

	Average	Std. dev	Max	Q3	Median	Q1	Min.	Number of analysts
South Africa	5.8	0.7	7.3	6.0	6.0	5.0	4.9	13
Thailand	6.9	2.2	12.0	7.5	6.4	5.0	4.9	13
Turkey	6.0	1.1	8.3	6.6	6.0	5.0	4.5	21
UK	5.2	1.4	10.0	5.7	5.0	4.1	3.5	31
USA	5.1	1.1	10.0	5.5	5.0	4.5	2.5	104
Grand Total	5.6	1.9	25.0	6.0	5.0	4.5	0.7	601

(Source: /www.scribd.com/doc/32121177/Market-Risk-Premium)

Table 5.12 confirms what is shown in figure 5.9, which is that South-Africa has an average market risk premium of 5.8%. In figure 5.7, figure 5.8, figure 5.9 and table 5.12 the information is given that is required to calculate the discount rate. In this case study, there is no debt, meaning that only CAPM is required to calculate the discount rate. The formula for CAPM is as follows:

$Ke = Rf + B (Rm - Rf)$

According to the formula the information needed to calculate the discount rate is the beta of Spur, given in figure 5.7, the risk free rate in South Africa, given in figure 5.8, but using the R157 bond yield, and the market risk premium,given in figure 5.9 and table 5.12.

In table 5.13 the forecasting variables are shown. The forecasting variables are used when calculating the value of the business entity with the discounted economic income valuation method. The forecasting variables are assumptions made about how the *Tampa Bay Spur* will

opperate in the future regarding the expected grow in revenue, expected expenses, expected depreciation, as well as the expected sustainable growth rate.

Table 5.13: Forecasting variables

		2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue growth factor		20%	15%	10%	10%	10%	5%	5%	5%	5%	5%
Expected GP margin		60%	58%	57%	56%	55%	54%	54%	54%	54%	54%
S, G, & A expense % of revenue		40%	45%	47%	48%	49%	50%	50%	50%	50%	50%
Amort. % of revenue		2%	2%	2%	2%	2%	3%	3%	3%	3%	3%
Capital expenditure growth factor		0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Net working capital to sales ratio		2%	2%	2%	2%	2%	2%	2%	2%	2%	2%

Tax rate (%)	28										
LT sustainable growth rate (%)	3	after 2020									
Discount rate (%)	10										
Valuation Model Outputs:											
GP margin		60%	58%	57%	56%	55%	54%	54%	54%	54%	54%
Net operating profit margin		13%	8%	6%	4%	3%	1%	1%	1%	1%	1%
Free cash flow (R)		1,543,648	1,181,759	1,014,044	913,196	782,040	618,918	649,863	682,357	716,475	752,298
Terminal value (R)											10,747,114
Operation's PV (R)		4,113,546									
Entity's MV (R)		4,291,445									

When making assumptions for growth rates that are going to be used in the discounted future economic valuation method, it was taken in consideration that the *Tampa Bay Spur* has recently (1 March 2011) been taken over by a new owner, and it has also just been revamped. After talking to people who have been involved in *Spur Ranches* for many years, the conclusion was made that after a revamp and with new ownership, the turnover would be 15 % higher in the following year than normal. According to calculations, the average growth rate of the *Tampa Bay Spur* for the previous five years was 5%. Thus, taking the revamp and new ownership in consideration, a growth rate for 20% is expected for the following year. After the following year, the growth rate will systematically drop till it reaches a stable yearly growth rate back to 3%., which was the average growth rate of the *Tampa Bay Spur* for the previous three years and is also used as the assumed long-term sustainable growth rate. A higher percentage turnover will also affect other growth rates, for example the expected gross profit margin, and the selling, gross and administrative expenses to the revenue. All of the calculations are shown in detail in the discounted cash flow column in the research study. In table 5.14 the forecasting variables in table 5.13 are used to create a free cash flow model for future years. The future predictions are made for 2011 to 2020.

Table 5.14: Calculating the market value of the Tampa Bay Spur (Rand)

	Actual	Forecast						
	2010	2011	2012	2013	2014	2015	2016	2017
Total revenue	8,411,335	10,093,602	11,607,642	12,768,407	14,045,247	15,449,772	16,222,260	17,033,374
C.O.G.S	3,465,540	4,037,441	4,875,210	5,490,415	6,179,909	6,952,397	7,462,240	7,835,352
GP	4,945,795	6,056,161	6,732,432	7,277,992	7,865,338	8,497,375	8,760,020	9,198,022
Selling & admin	4,757,678	4,037,441	5,223,439	6,001,151	6,741,719	7,570,388	8,111,130	8,516,687
EBITDA	188,117	2,018,720	1,508,993	1,276,841	1,123,619	926,987	648,890	681,335
Depreciation	165,722	201,872	232,153	255,368	280,905	308,995	486,668	511,001
EBIT	22,395	1,816,848	1,276,840	1,021,473	842,714	617,992	162,222	170,334
Net taxable earnings	22,395	1,816,848	1,276,840	1,021,473	842,714	617,992	162,222	170,334
Income Taxes	6,271	508,717	357,515	286,012	235,960	173,038	45,422	47,693
NOPAT	16,124	1,308,131	919,325	735,460	606,754	444,954	116,800	122,640
(+) Depr.	165,722	201,872	232,153	255,368	280,905	308,995	486,668	511,001
(-) Cap. Exp.	0	0	0	0	0	0	0	0
(-) New Net Working Capital	4,926	33,645	30,281	23,215	25,537	28,090	15,450	16,222
Free Cash Flow	186,772	1,543,648	1,181,759	1,014,044	913,196	782,040	618,918	649,863
Terminal value, 2020								
PV of Free Cash Flows		583,900	405,600	315,794	258,042	200,509	143,985	137,178

PV of Company Operations	4,113,546							
(+) Current Assets	177,899	from 2010						
Total Market Value	4,291,445							

In table 5.14 the percentages estimated in table 5.13 were used to calculate future values of the *Tampa Bay Spur*. Using the discount rate, calculated in table 5.10 the predicted future cash flow of the *Tampa Bay Spur* was converted back to a present value, thus giving the market value of the *Tampa Bay Spur* according to the discounted economic income valuation method. The value is calculated at R 4,291,445.

5.1.5. Calculating the capitalised economic income method's value

In table 5.15 the capitalised economic income method is used to calculate a value for the *Tampa Bay Spur*.

Table 5.15: Calculating the capitalised economic income method's value

Discount rate (Required rate of return)	10.21%	
Projected sustainable growth	3%	
Capitalisation rate	7.21%	
Income estimated in 2011	R 423,081	Market value 2010
Value of business entity	R 5,867,980	
The capitalised economic income method	R 5,867,980	

As shown in table 5.15, to calculate the capitalisation rate, the discount rate is required as well as the forecast in economic income. According to this case study, the discount rate is 10.21% and the forecast in economic growth is 3%. The growth must be subtracted from the discount rate to get a capitalisation rate, which in this case study is 7.21%. An economic income must be estimated and divided by the capitalisation rate to get the total value of the business entity. In this case study, adjustments were made from 2010 to 2011 to get an estimated amount for 2011.

5.1.6. Calculating the capitalised excess earnings valuation method's value

In table 5.16 the capitalised excess earnings valuation method is used to value the *Tampa Bay Spur*.

Table 5.16: Calculating the capitalised excess earnings valuation method's value

Net tangible assets	R 3,436,500	
Normalized economic income	R 1,132,060	
Required rate of return	25.99%	
Capitalisation rate	7.21%	
Net assets x Required rate of return	R 893,199	Answer 1
Normalized income - Answer 1	R 238,862	Answer 2
Answer 2/Capitalisation rate	R 3,312,920	
Value of business entity	R 4,444,980	
Capitalised excess earnings method	R 4,444,980	

In table 5.16 the capitalised excess income earnings valuation method was used. The required rate of return is 25.99% (calculated in table 5.17) and the capitalisation rate is 7.21% (calculated in table 5.15). This method works in three steps. Firstly, the net asset value is multiplied with the required rate of return, giving the first answer of R 893,199. Secondly, the normalized income (table 5.18) is deducted with the value calculated in the first step. Lastly, the answer calculated in the second step is divided by the capitalisation rate, giving a value of R 4,444,980. In table 5.17 the required rate of return is being calculated.

Table 5.17: Calculating the required rate of return

	Required rate of return
Average non-current assets	R 2,085,001
Average sales	R 8,021,851
Required rate of return	25.99%

In table 5.17 the required rate of return is calculated. It was calculated by dividing the average non-current assets with the average sales, giving a required rate of return of 25.99%. In table

5.18 the expected income for 2011 is calculated. The values for 2010 are given and forecasts for 2011 made. In the fourth column the reason for the adjustments is given.

Table 5.18: Expected income or 2011

Detailed statement of	2010	Forecast for 2011	Adjustments
Income	R 4,960,982	R 5,935,038	
Sales	R 8,411,335	R 10,093,602	Turnover increase with 20%
Cost of sales	R 3,465,540	R 4,158,564	Cost of Sales/Sales = 41.2%
Gross profit	R 4,945,795	R 5,935,038	
Interest received	R 15,187	R 0	
Expenses	R 4,923,400	R 4,362,732	
Accounting fees	R 15,637	R 18,000	R15,000 per month
Advertising	R 406,969	R 403,744	4 % on sales
Auditor's refreshments	R 4,385	R 6,000	R500 per month
Bank charges	R 151,408	R 144,000	R12,000 per month
Cleaning and refreshments	R 144,969	R 120,000	R10,000 per month
Depreciation	R 165,722	R 216,373	10% of assets
Director’s salary	R 1,033,931	R 480,000	R40,000 per month
Electricity and water	R 128,600	R 100,800	Average
Entertainment	R 20,318	R 12,000	R1,000 per month
Finance charges	R 9,770	R 16,670	Average
General gas	R 184,065	R 148,344	Average
Insurance	R 50,307	R 51,674	Average
Interest	R 37,085	R 0	No loans/Debt
Licenses	R 7,825	R 7,907	Average
Motor vehicle expenses	R 65,189	R 59,115	Average
Printing and stationery	R 20,923	R 31,362	Average
Protective clothing	R 24,814	R 23,403	Average
Rent	R 171,579	R 240,000	R20,000 per month
Repairs and maintenance	R 164,744	R 171,828	Average
Royalties	R 420,566	R 504,680	5 % on sales
Salaries and wages	R 1,610,130	R 1,514,089	Average
Security	R 7,115	R 7,200	R600 per month
Subscriptions	R 20,527	R 24,000	R2,000 per month
Telephone and postage	R 51,929	R 55,543	Average
Training	R 0	R 0	No training
Travelling and	R 4,893	R 6,000	R500 per month
Profit before taxation	R 37,582	R 1,572,306	
Taxation	R 10,523	R 440,246	

Profit after taxation	R 27,059	R 1,132,060	

In table 5.18 various adjustments have been made to calculate an expected income for 2011. Some of the main adjustments are the turnover that has increased with 20% because of a completed revamp and new owners. In the adjustments column of table 5.18 are the expected changes which the new owners are going to make after taking over the *Tampa Bay Spur*. The expected profit for 2011 will be R1,132,060, which is considerably more than the profit of R27,059. The main reasons for the increase in the profit are the 20% expected increase in turnover, and the reduction in director's salary. In table 5.19 the seller's discretionary cash flow for 2011 is calculated.

Table 5.19: Seller's discretionary cash flow for 2011

Detailed statement of financial performance			
Income	R 4,960,982	R 5,935,038	
Sales	R 8,411,335	R 10,093,602	Turnover increase with 20%
Cost of sales	R 3,465,540	R 4,158,564	Cost of Sales/Sales = 41.2%
Gross profit	R 4,945,795	R 5,935,038	
Interest received	R 15,187	R 0	
Expenses	R 4,923,400	R 3,648,359	
Accounting fees	R 15,637	R 18,000	R15,000 per annum
Advertising	R 406,969	R 403,744	4 % on Sales according to Spur

Auditor's refreshments	R 4,385	R 6,000	R1,000 per month
Bank charges	R 151,408	R 144,000	R12,000 per month
Cleaning and refreshments	R 144,969	R 120,000	R10,000 per month
Depreciation	R 165,722	R 0	N/A
Directors salary	R 1,033,931	R 0	N/A
Electricity and water	R 128,600	R 100,800	Average
Entertainment	R 20,318	R 0	N/A
Finance charges	R 9,770	R 16,670	Average
General gas	R 184,065	R 148,344	Average
Insurance	R 50,307	R 51,674	Average
Interest	R 37,085	R 0	No loans/Debt
Licenses	R 7,825	R 7,907	Average
Motor vehicle expenses	R 65,189	R 59,115	Average
Printing and stationery	R 20,923	R 31,362	Average
Protective clothing	R 24,814	R 23,403	Average
Rent	R 171,579	R 240,000	R20,000 per month
Repairs and maintenance	R 164,744	R 171,828	Average
Royalties	R 420,566	R 504,680	5 % on sales according to Spur
Salaries and wages	R 1,610,130	R 1,514,089	Average
Security	R 7,115	R 7,200	R600 per month
Subscriptions	R 20,527	R 24,000	R2,000 per month
Telephone and postage	R 51,929	R 55,543	Average
Training	R 0	R 0	No training
Travelling and accommodation	R 4,893	R 0	N/A
Profit before taxation	R 37,582	R 2,286,679	

Taxation	R 10,523	R 640,270	
Sellers discretionary cash flow	R 27,059	R 1,646,409	

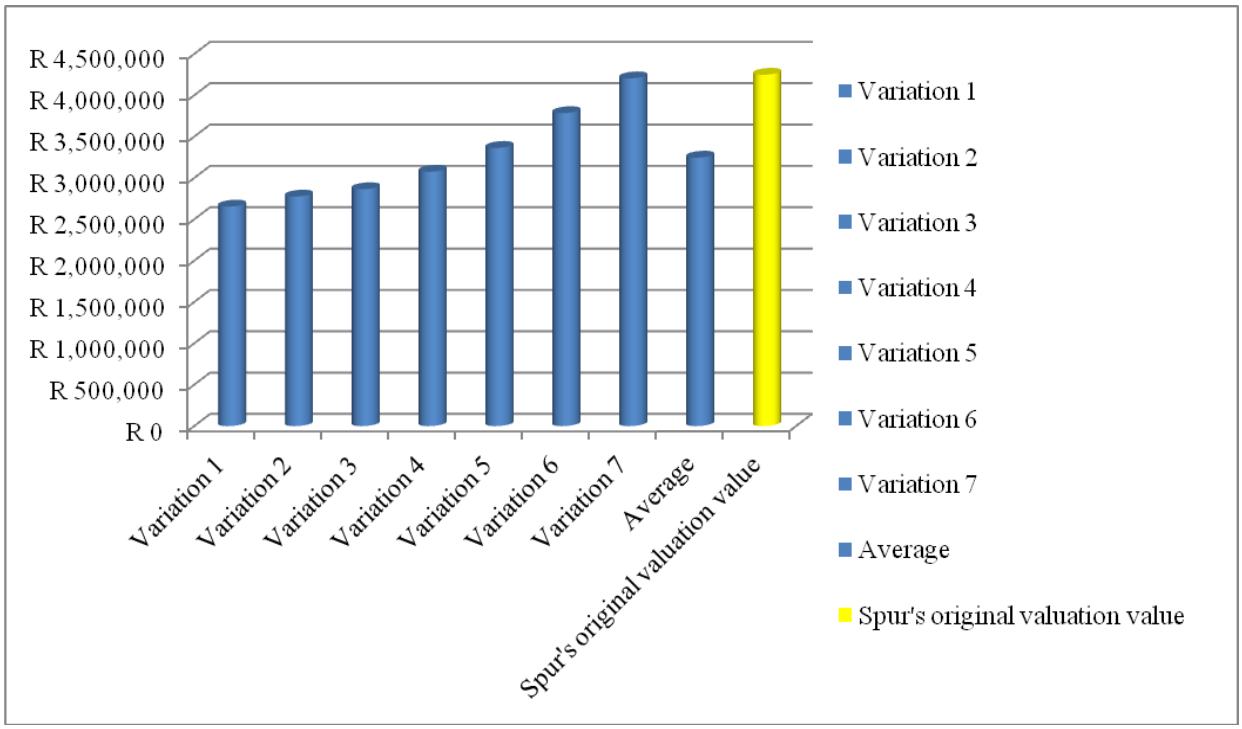
The expected income for 2011 is calculated in order to calculate the value of the business entity by using the capitalised excess earnings valuation method. The seller's discretionary cash flow is calculated in order to calculate the value of the business entity by using the discretionary economic income valuation method. In addition, the seller's discretionary cash flow will be used to calculate the value of the Spur in a model that will be created in chapter 6 as a contribution from this research study.

5.2. Comparison of Tampa Bay Spur valuations

5.2.1. Rule of thumb valuation method

In figure 5.10 the rule of thumb valuation method's variations are compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur*.

Figure 5.10: Comparison of rule of thumb valuation method

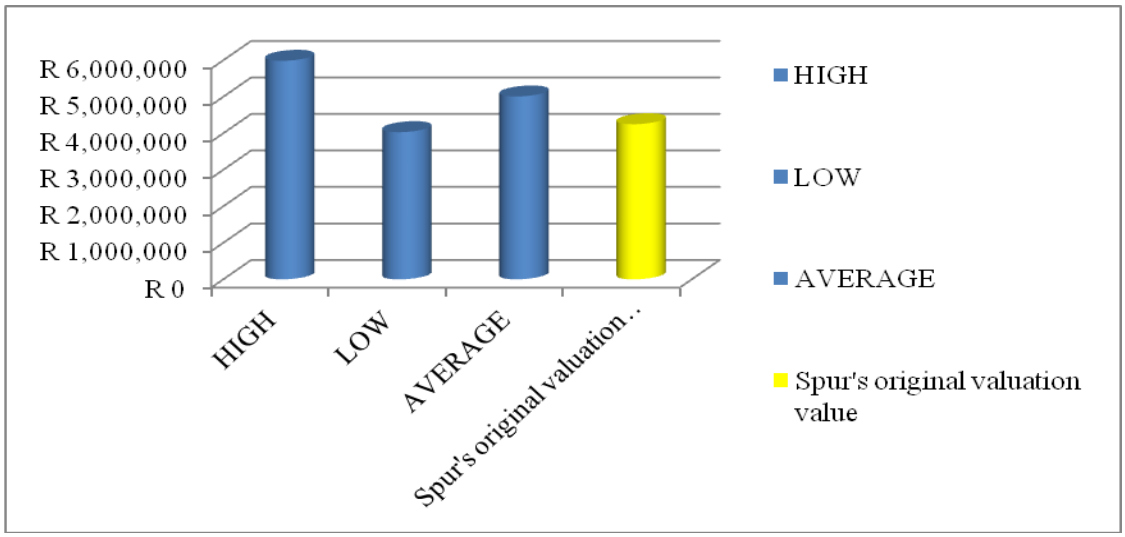


In figure 5.10 the values calculated for the rule of thumb valuation method are compared to the original value which the Spur Corporation valued the *Tampa Bay Spur*. As seen above, the Spur Corporation calculated a higher value than the average of the rule of thumb valuation method.

5.2.2. Market derived valuation method

In figure 5.11 the unadjusted high, low, and average values of the market derived valuation method are compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur*.

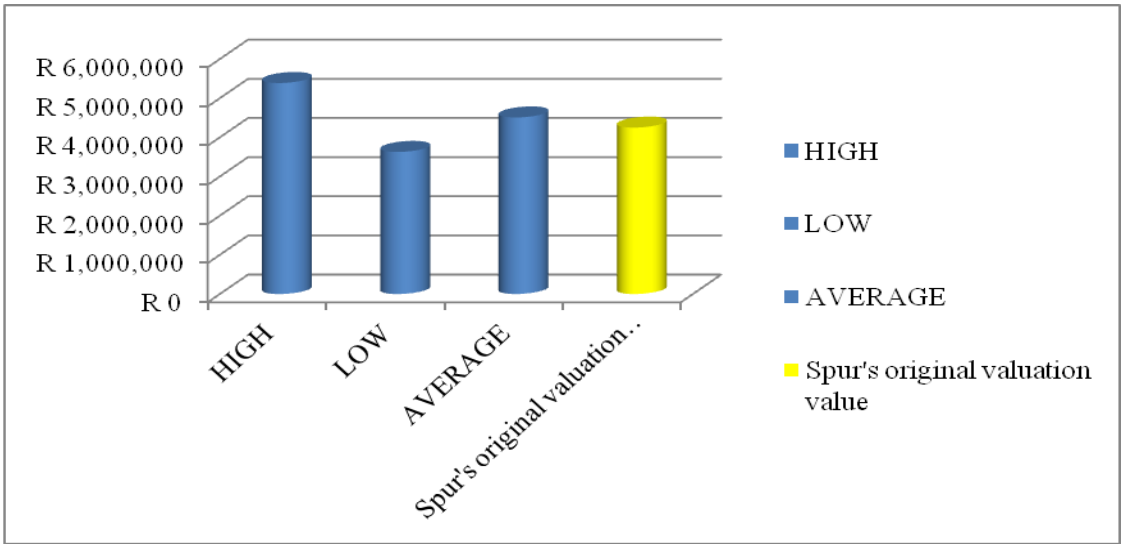
Figure 5.11: Comparison of unadjusted market derived values



In figure 5.11 the values calculated for the market derived valuation method are compared to the original value at which the Spur Corporation valued the *Tampa Bay Spur*. The unadjusted values are used. As seen in figure 5.11, the Spur Corporation calculated a lower value than the average of the market derived valuation method.

In figure 5.12 the adjusted high, low, and average values of the market derived valuation method are compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur*.

Figure 5.12: Comparison of adjusted market derived values

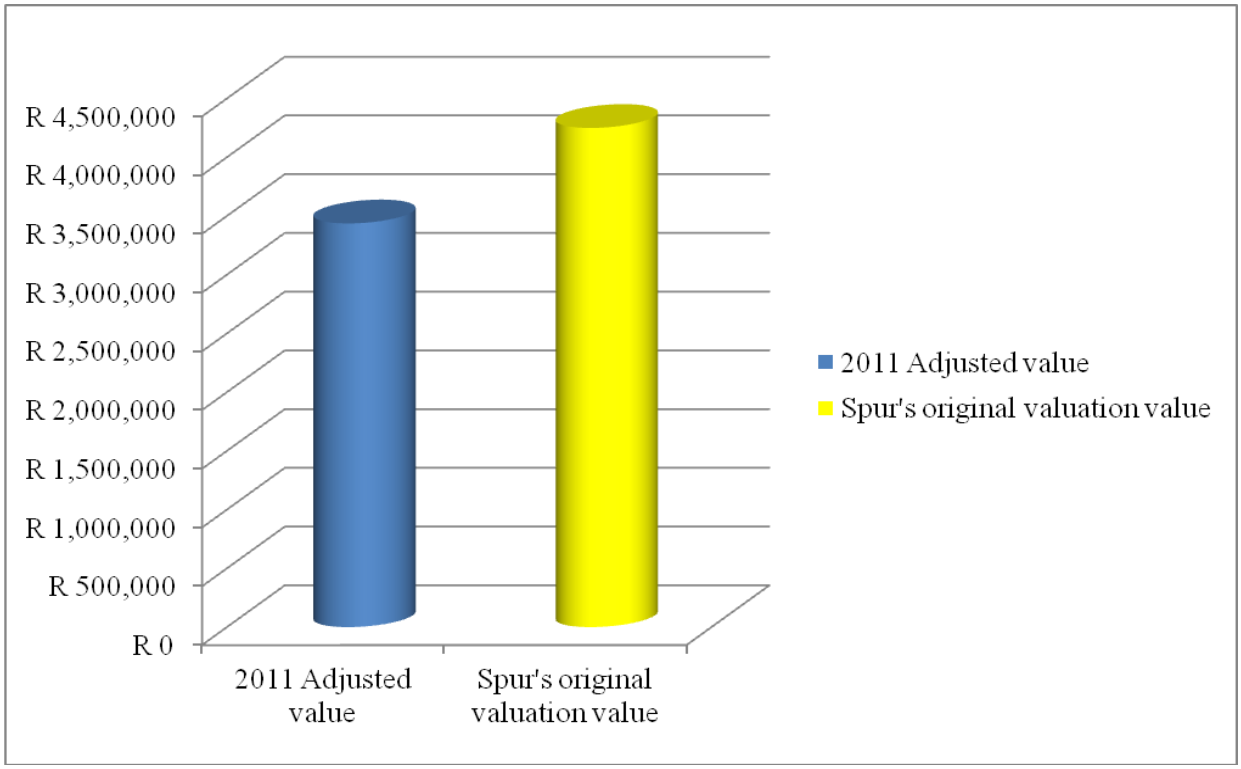


In figure 5.12 the values calculated for the market derived valuation method are compared to the original value at which the Spur Corporation valued the *Tampa Bay Spur*. The adjusted values are used. As seen above, the Spur Corporation calculated a lower value than the average of the market derived valuation method, but the values are very close to one another.

5.2.3. Asset accumulation valuation method

In figure 5.13 the value of the asset accumulation valuation method is compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur*.

Figure 5.13: Comparison of the asset accumulation valuation method

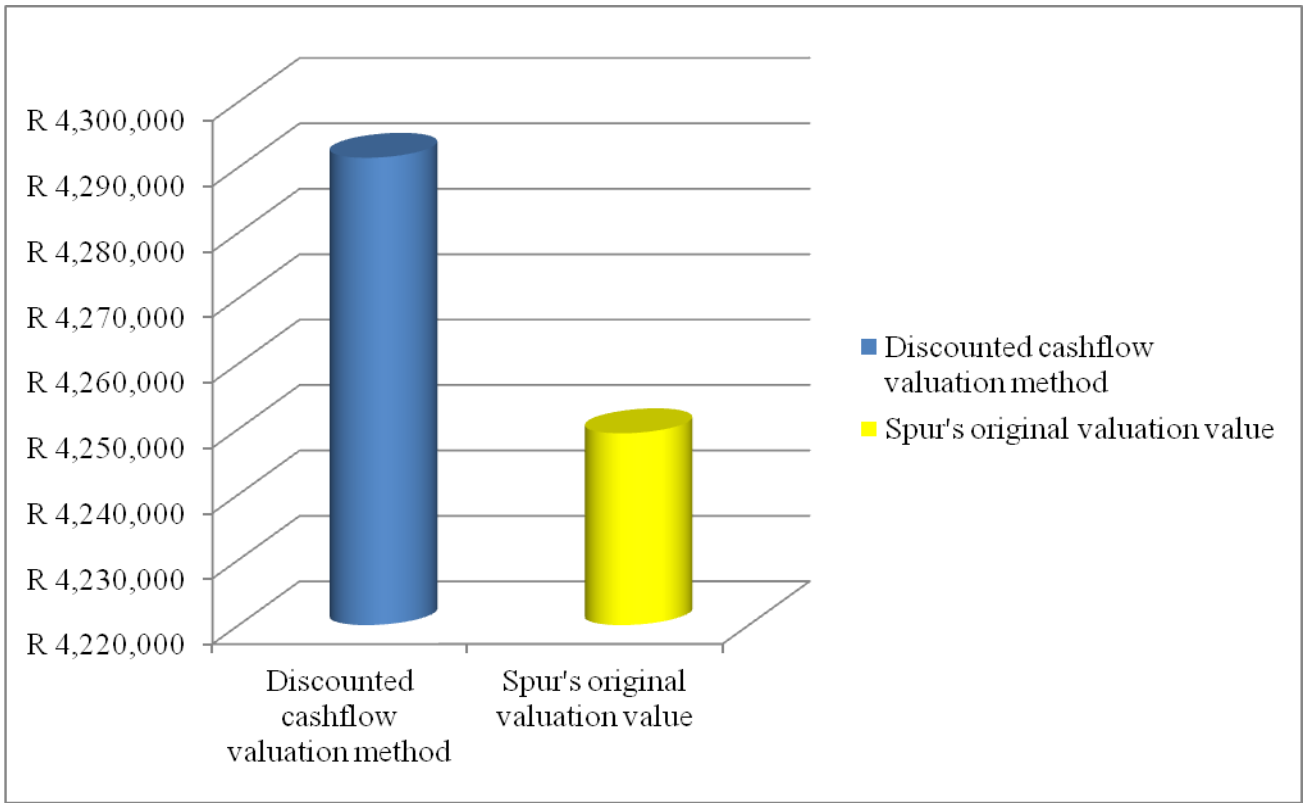


In figure 5.13 the value of the asset accumulation valuation method is compared to the value which the Spur Corporation originally valued the Spur. As seen in figure 5.13 the asset accumulation valuation method gives a lower value than the Spur's original valuation. The asset accumulation valuation method is known as a method that gives a minimum value, according to the theory provided in chapter 2.

5.2.4. Discounted economic income valuation method

In figure 5.14 the value of the discounted economic income valuation method is going to be compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur.*

Figure 5.14: Comparison of the discounted economic income valuation method

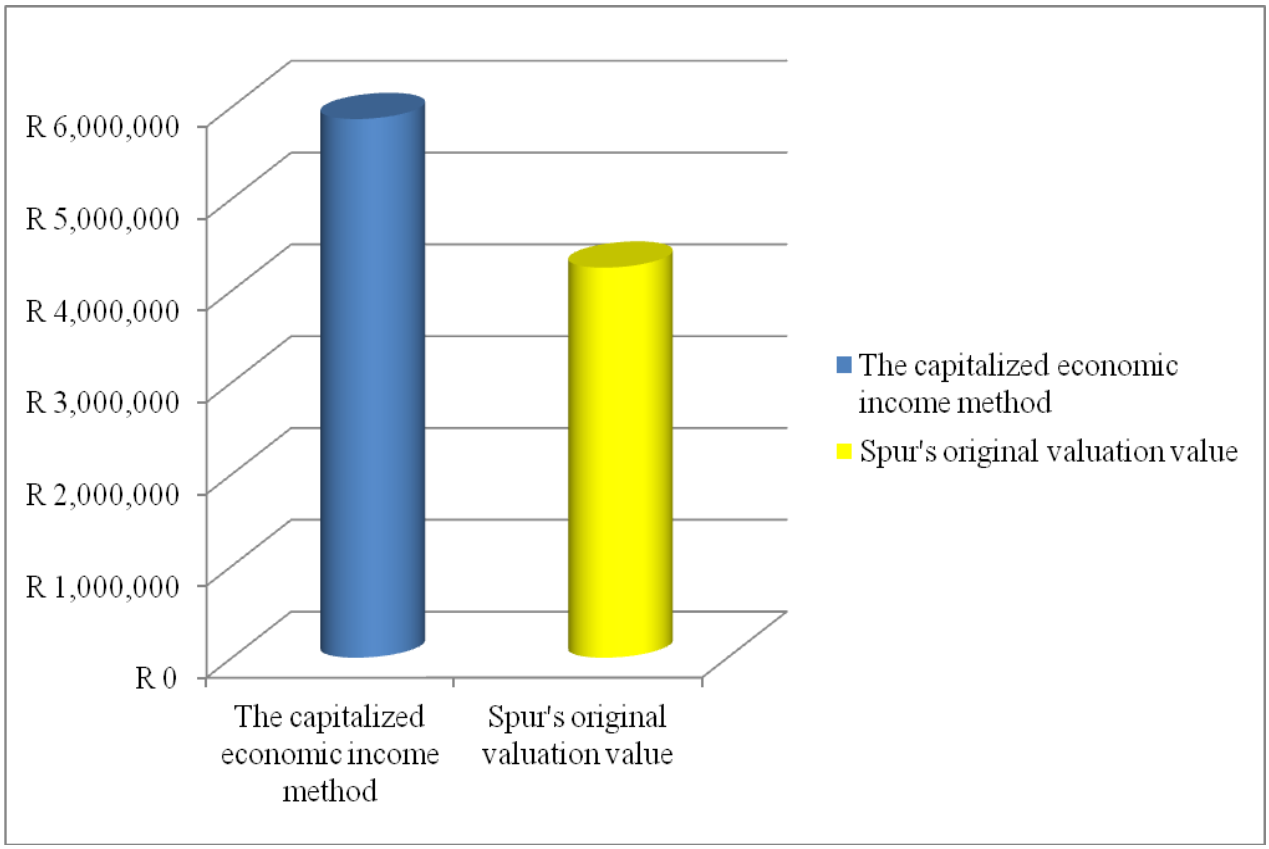


In figure 5.14 the value calculated using the discounted economic income valuation method is compared to the value that the Spur Corporation reached after doing a valuation using their method. The discounted economic income valuation method is an accurate method according to theorists, explained in detail in chapter 2 of this research study. As demonstrated in figure 5.14, the two values are fairly close to each another, differing with less than R50 000. This proves that the method the Spur currently uses is fair.

5.2.5. Capitalised economic income valuation method

In figure 5.15 the value of the capitalised economic income valuation method is compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur*.

Figure 5.15: Comparison of the capitalised economic income valuation method



In figure 5.15 the value of the capitalised economic income valuation method is compared to the original value that the Spur calculated after valuing the Tampa Bay Spur. Figure 5.15 reveals that the capitalised economic income valuation method is a reasonable amount more than the value calculated by the Spur Corporation.

5.2.6. Capitalised excess earnings valuation method

In figure 5.16 the value of the excess earnings valuation method is compared to the value which the Spur calculated when doing a valuation on the Tampa Bay Spur.

Figure 5.16: Capitalised excess earnings valuation method

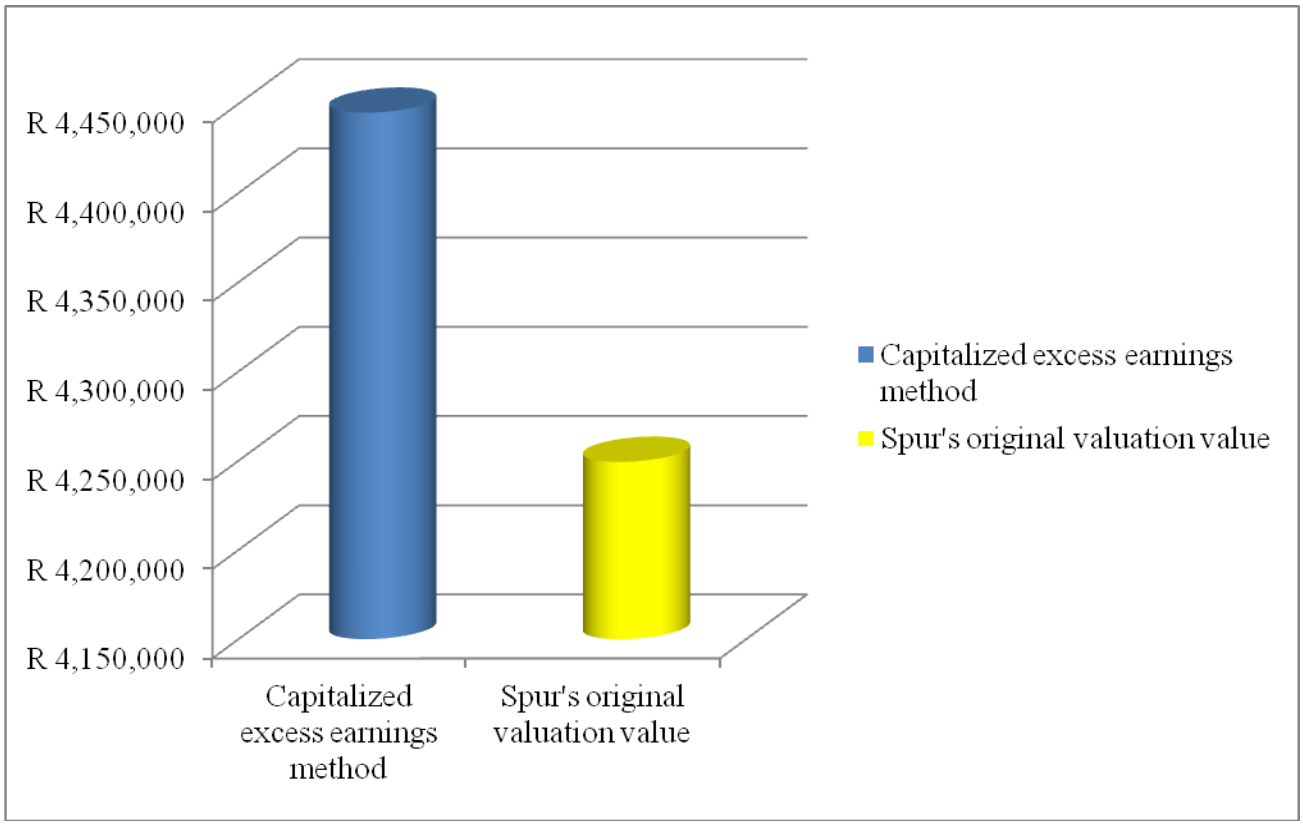


Figure 5.16 takes the capitalised excess earnings valuation method and the value of the Spur Corporation's current valuation method and compares them to each other. According to figure 5.34, the two amounts calculated are fairly close to each other, not differing with more than R200,000 which is between 5% and 6% difference.

5.2.7. Overall comparison of valuation methods

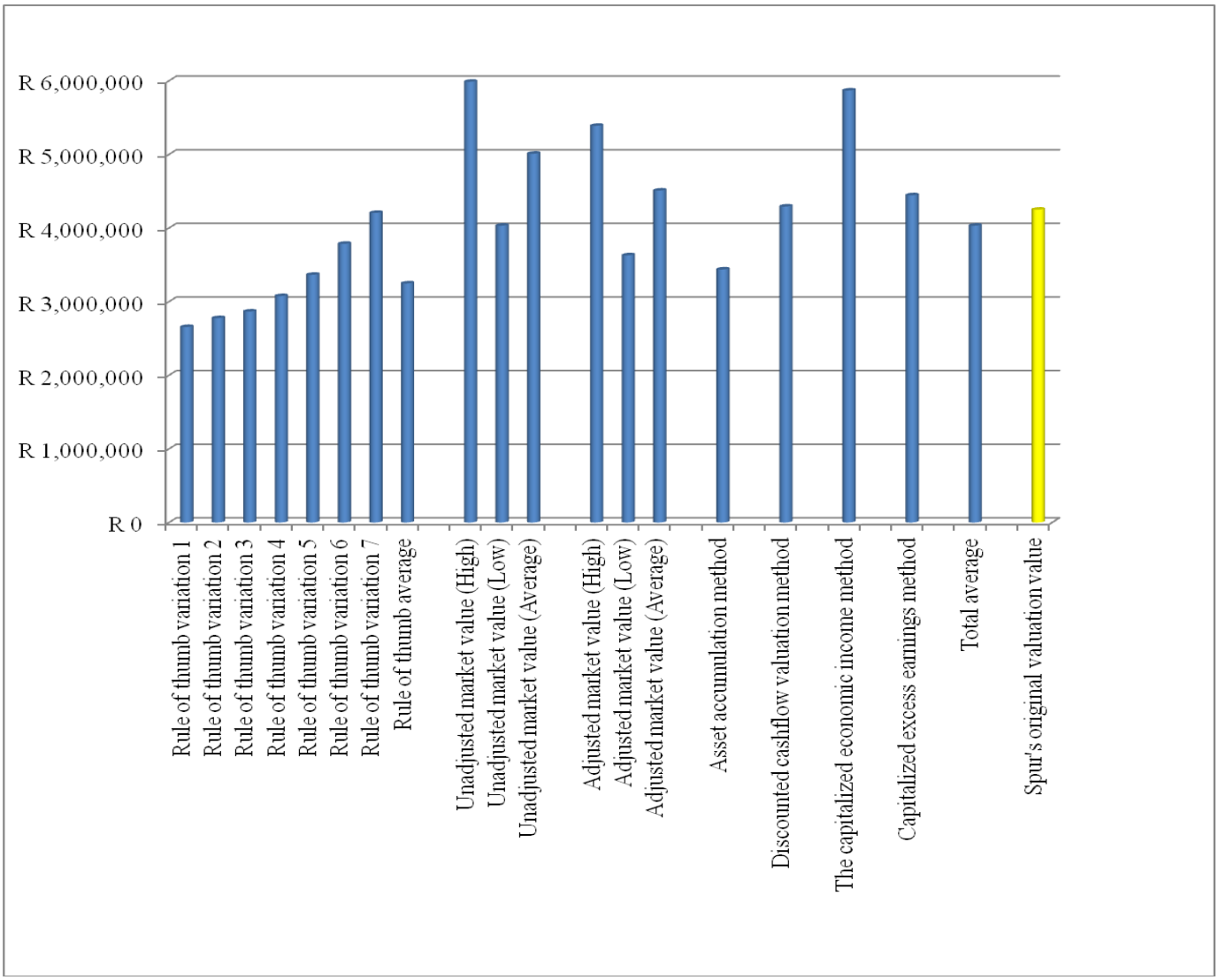
In table 5.20 all the different variations for all the different valuation methods are going to be showed.

Table 5.20: Overall comparison values

Rule of thumb variation 1	R 2,654,888
Rule of thumb variation 2	R 2,775,741
Rule of thumb variation 3	R 2,865,171
Rule of thumb variation 4	R 3,075,454
Rule of thumb variation 5	R 3,364,534
Rule of thumb variation 6	R 3,785,101
Rule of thumb variation 7	R 4,205,668
Rule of thumb average	R 3,246,651
Unadjusted market value (High)	R 5,986,601
Unadjusted market value (Low)	R 4,031,965
Unadjusted market value (Average)	R 5,009,283
Adjusted market value (High)	R 5,387,941
Adjusted market value (Low)	R 3,628,769
Adjusted market value (Average)	R 4,508,355
Asset accumulation method	R 3,436,500
Discounted cash flow valuation method	R 4,291,445
The capitalised economic income method	R 5,867,980
Capitalised excess earnings method	R 4,444,980
Total average	R 4,031,501

Table 5.20 shows all the different variations of all the different valuation methods and calculated an average value of R4,031,501. In figure 5.17 the values of all the different variations of the different valuation methods. The average of all those values is compared to the value which the Spur calculated when doing a valuation on the Tampa Bay Spur.

Figure 5.17: Comparisons of all the valuation values



As seen in figure5.17, by using different approaches and methods for valuing a business entity, there are numerous amounts that can be selected from. According to this case study, seven variations are given for the rule of thumb valuation method, six variations for the market derived valuation, and only one amount for the asset accumulation method, the discounted future economic income method, the capitalised economic income method and the capitalised excess earnings method respectively. In figure 5.17 all of the methods are compared to the original value which the Spur Corporation got after performing a valuation on the *Tampa Bay Spur*. The last blue column in the figure (total average), is the average of all the valuation methods used in this case study. When comparing this value to the yellow column (Spur Corporation's original

value), it demonstrates that the two values are very close to each another. For that reason, the assumption can be made that the Spur's valuation method is a fair method and gives a fair and reliable value.

5.2.8. Comparison of average valuation values

In table 5.21 the average values of the different valuation methods are shown.

Table 5.21: Comparison of average valuation values

Rule of thumb average	R 3,246,651
Unadjusted market value (Average)	R 5,009,283
Adjusted market value (Average)	R 4,508,355
Asset accumulation method	R 3,436,500
Discounted cash flow valuation method	R 4,291,445
The capitalised economic income method	R 5,867,980
Capitalised excess earnings method	R 4,444,980

Table 5.21 shows the average values of the different valuation methods. In Figure 5.18 the average values of the different valuation method s are compared to the value which the Spur calculated when doing a valuation on the *Tampa Bay Spur*.

Figure 5.18: Comparison of average valuation values

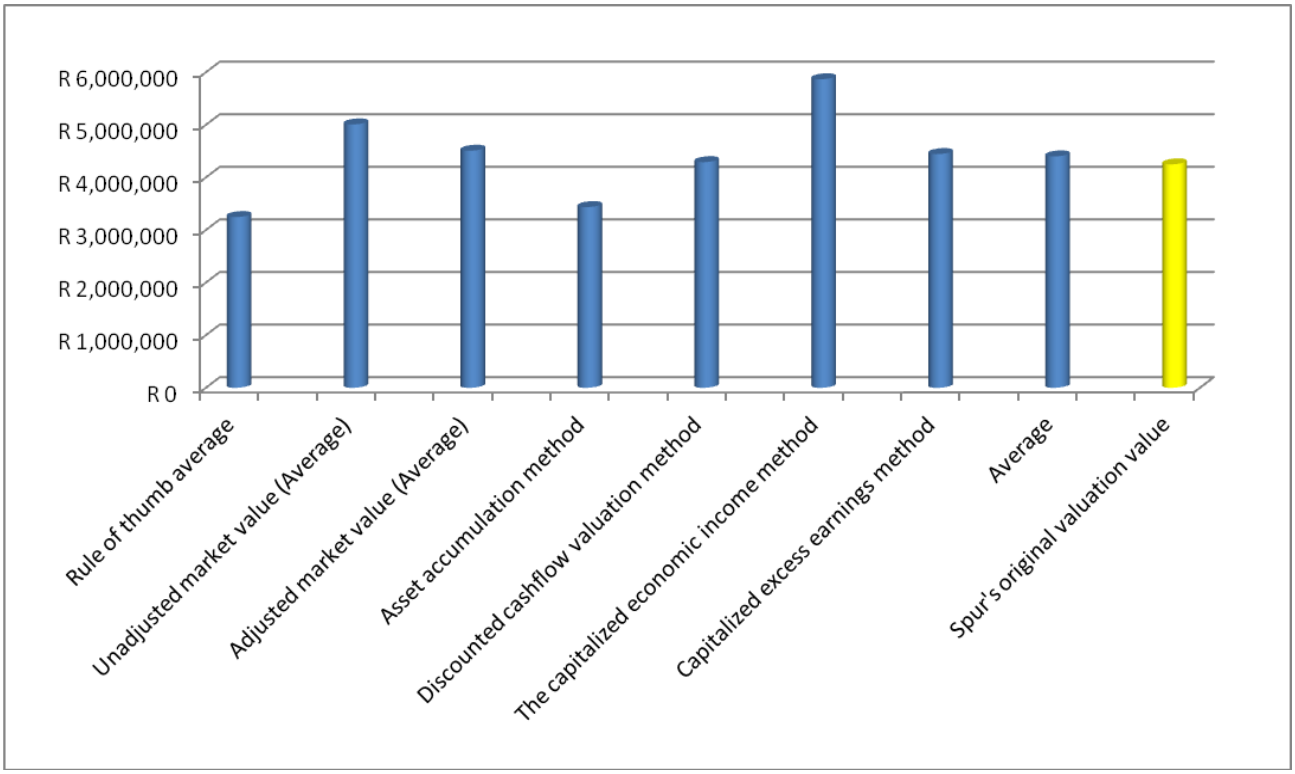


Figure 5.18 can be seen as a shortened version of figure 5.17. In figure 5.18 the six valuation methods used in this case study are divided into six separate values, each value being the average of the specific valuation method used. For example, the rule of thumb valuation method gives seven different values to choose from after performing a valuation based on that method, as seen in figure 5.17, but in figure 5.18 only one value is given in the rule of thumb valuation method, that value being the average of the seven different values. That applies to all of the other methods as well. After doing that, the average of all the averages is calculated and compared to the original value calculated by the Spur after performing a valuation on the *Tampa Bay Spur*. As seen in figure 5.18 the average calculated from using the averages of all the other methods is slightly higher than the Spur's original value calculated after performing the valuation on the *Tampa Bay Spur*. After that comparison the assumption can be made that the Spur's value is reasonable and fair.

5.3. Summary

The purpose of this chapter was to use different valuation approaches and methods to value the *Tampa Bay Spur* and compare it to the original value that the Spur calculated after performing a valuation on the *Tampa Bay Spur*. By using different approaches and methods to value the Spur, this chapter showed the different possible values which could be used as a fair price of what the Tampa Bay Spur is worth. The methods consist of the rule of thumb valuation method, the market derived valuation method, the asset accumulation method, the discounted future economic income method, the economic income capitalisation method and the capitalised excess earnings method. All of the methods gave a total value of what the restaurant is worth. Charts were drawn up and values were compared to one another as well as to the original value that the Spur was valued at. In conclusion, all of the methods' total values, including the average values they were calculated for were compared to the original valuation conducted by the Spur.

In the next chapter of this study a summary is given pertaining to the objectives given in the first chapter, discussing the conclusions and recommendations of the study. In addition, a new valuation model will be constructed to value a franchised restaurant, based on the discretionary economic income valuation method. The reason for creating a new valuation model is because the present valuation method used by the Spur is not very explanatory, thus, not showing exactly how the valuation was done. The new model will provide the buyer and seller of the business entity with sufficient enough information to understand completely why a specific value is given to the restaurant.

CHAPTER 6

6. SUMMARY, CONCLUSION AND CONTRIBUTION

A summary of the objectives given in the first chapter of this research study will be given in this chapter, and conclusions and recommendations will be made. Additionally, a new valuation model will be constructed and illustrated. The objective of the new valuation model will be to value a franchised restaurant, especially a Spur Steak Ranch. The new valuation model will be grounded on the discretionary economic income valuation method. The purpose for constructing a new valuation model is because the valuation method currently used by the Spur is not very explanatory, thus not displaying precisely how the valuation was constructed. The role of the new model is to give the buyer and seller of the business entity sufficient information on and understanding of why a particular value is given to the restaurant.

6.1. Research findings

6.1.1. Literature study findings

The literature study was conducted in chapter 2 and chapter 3 of this research study. The first part of this literature study examined the different approaches and methods used by different theorists and practitioners in the process of performing a valuation on a business entity. The fundamental principles of business valuations were discussed. Before any business valuation can take place the financial statements are required (Holten & Bates, 2009:112) because the financial statements contain the information that serves as the foundation of business valuations. The primary valuation approaches and methods were discussed in detail in chapter 2. Business valuations have three primary approaches, namely the income based valuation approach, the market based valuation approach, and the asset based valuation approach (Dellinger, 2010:59; Modica, 2010:193;2002:4; Pratt & Niculita, 2008:10; Smith & Smith, 2005,:18; Van Vleet, 2004:74; Reilly, 2003:94; Gabehart & Brinkley). Each one of these three primary approaches has secondary methods which can be used in these approaches when performing a business valuation. In this research study, only two popular methods under each one of these three

primary approaches were examined. Under the income based valuation approach, the discounted economic income valuation method and capitalised economic income valuation method were examined. The guideline publicly traded company valuation method and the merger and acquired company valuation method are the two secondary methods examined under the market based valuation approach. The examination of the asset accumulation valuation method and the capitalised excess earnings valuation were conducted under the asset based valuation approach. A conclusion was also reached that the different valuation approaches and methods are dependent on one another, for example, a method used under the income approach is reliant on the market to develop its discount and capitalisation rates, and a method used under the asset-based approach capitalises excess income, which relies on the market for capitalisation rates (Kalajian, 2003:5).

When examining the income based valuation approach, the discounted future economic income method and the capitalised economic income method were discussed in detail. Both of these methods' formulas were examined and compared to each other. The discounted economic income valuation method uses a discount rate and the capitalised economic income valuation method uses a capitalisation rate. There are critical differences between the discounting and capitalisation method (Reilly, 2003:94). A discount rate converts the complete expected future returns of an investment into a specified present value (Richardson, 2008:28). A capitalisation rate converts only a *single* expected economic return amount to a specified present value. A discount rate is a rate of return that is used to convert an economic amount, payable or receivable in the anticipated future, into a present value. A capitalisation rate is any divisor, usually expressed as a specific percentage, used to convert expected economic benefits of a single period into a value (Pratt & Niculita, 2008:238; Van Vleet, 2004:74). The capitalisation method is straightforward in methodology (Bakken, 1999:264) and is basically a shortened version of the discounted future economic income method. Under the income based valuation approach the discount rate and capitalisation rate is discussed in detail, showing how to perform the WACC, CAPM and build-up model formula. The Beta, risk-free and market rate of return is also discussed.

When examining the market based valuation approach, the guideline publicly traded company method and the merger and acquired company valuation method were discussed in detail. The valuation multiples used in the market approach are compared to each other. According to PwC (2010:62), the three valuation multiples used under the market based valuation approach are the MVIC/EBIT, the MVIC/EBITDA, and the price/earnings ratios. In addition, the different time periods that can be used to perform a valuation based on the market based valuation approach were discussed, and it was found that the preferred time periods used are the latest economic year, the estimations for the upcoming year, the simple average of a certain number of past years, or the weighted average of a certain number of past years (Pratt & Niculita, 2008:265; McCarter & Aschwald, 1999:212). The last aspect which was discussed under the market based valuation approach is where the data can be found to compare business entities in different industries and with different sizes in different areas with each other. The USA uses databases such as *Pratt's Stats*, *Done Deals*, *Bizcomps* and *IBA Market Databases*. South-Africa does not use any of these. When searching for data to compare business entities with each other, and to find the suitable economic information about specific business entities, South Africa uses *Bloomberg*, *Reuters*, *JSE*, and the *McGregor databases*.

When the asset based valuation approach was examined, the capitalised excess earnings valuation method, which is a combination of the income and asset approach, was discussed in detail. Several specialists regard this method as an asset-based approach, while others allocate it to the income approach, according to Kalajian (2003:5). The asset accumulation valuation method which is a balance sheet oriented valuation method, and where the business entity's balance sheet is restated to current value, was discussed in detail as well. This usually involves the identification, valuation of otherwise unrecorded tangible, as well as intangible asset and liabilities already recorded on the balance sheet. The asset valuation approach values each element of a business entity individually, according to Hughes (2003:10).The asset-based valuation approach is not ordinarily used to value a non-controlling equity ownership interest of a profitable going concern operating business entity (Van Vleet, 2004:76). Valuations of fixed assets to be shown in financial statements are essential for purposes such as annual accounts of business entities as stated in the *Companies Act 1967,* takeover bids, flotation, business entity borrowing, capital re-organisation, insurance, taxation, liquidation, bankruptcy, and

receiverships (Butler & Richmond, 1990:209). The asset-based approach valuation is not used as much as the *income* and *market approach* for the reason that a business entity is worth more than the value of its assets in liquidation (Dellinger, 2010:60).

In chapter three of this research study, some history and background concerning franchises, restaurants, and especially the *Spur Steak Ranch*, was discussed. In addition, two popular valuation methods used in the restaurant industry were discussed in chapter three, consisting of the rule of thumb valuation method and the seller's discretionary cash flow valuation method. Franchising has been established over time as an effective way to do business. The term franchise means 'liberty and freedom', according to Daszokowski (2011). There are several different types of franchises, including financial services, health and fitness, automotive, cleaning, and maintenance franchise. A franchise is a right granted to an individual or group to market a business entity's products or services within a certain territory or location (Weaven & Frazer, 2006:225; Gonzalez *et al.*, 2010:1568; Daszkowski, 2011a). Franchising is a method of expanding a business entity on less capital than would otherwise be likely or possible. The franchisee pays a capital lump sum to enter the franchise and also agrees to take some of the running costs of its outlet. The franchise offers the franchisee the use of the franchise name as well as any goodwill associated with it, the use of its business systems and support services, its product and service to sell, and management and staff training programmes. In return the franchisee pays the franchisers for being granted their rights (CIMA, 2011b:197). *McDonalds*, *Wimpy*, *KFC* and *Spur* are several examples of today's popular franchises in South Africa.

According to Allen & Albala (2007:323), any facility that cooks individual meals for eating on or off the premises falls under the title "*restaurant"*. The word *restaurant* is derived from the French word '*resaurer*', meaning *'to restore'* (Montagne, 1999). The *Spur Steak Ranch* as a franchised restaurant in South Africa originated in the year 1967 in Newlands, Cape Town. The name of this *Spur* was the *Golden Spur* and it was started by Allen Amber when he invested R4000 in it (Hasenfuss, 2008:31). The *Spur Steak Ranch* listed on the JSE in 1986 (Coulsaon, 2007:45). Today the Spur is a very popular franchised restaurant in South Africa consisting of 245 local and 32 international outlets. In this research study the *Tampa Bay Spur* was used in the

case study. The *Tampa Bay Spur* is located in Jeffrey's Bay and was taken over by new owners in March 2011.

The two valuation methods discussed in chapter three are the rule of thumb valuation method and the seller's discretionary cash flow valuation method. These two valuation methods are the methods used mainly in the restaurant industry, according to Parker (2008) and Perkins (1999:332). The Rule of thumb method of valuing a business entity provides general guidance on categories of business entities and gives buyers and sellers a ballpark figure on what average a business entity in a certain industry is worth (Holten & Bates, 2009:132). Possibly better than every other valuation method, the multiple of discretionary cash flow attempts to measure the economic as well as the lifestyle characteristics perceived by the people who buy and serve small to midsize business entities (Jones, 1999:232).

As seen from the literature study in chapter two and three in this research study, there are several ways to value a business entity. Different approaches and methods exist for different types of industries and business entities. There is not one specific approach or method that can be used for a specific industry or business entity. According to this literature study, the appropriate thing to do is to use a combination of approaches and methods to do a business valuation on a restaurant. There is not one amount that can be correct or wrong, but after combing several approaches and methods to perform a business valuation, there are numerous amounts which can give an indication to the buyer and seller of what the business entity is worth.

6.1.2. Empirical research findings

The empirical results were discussed in Chapter 5 of this research study. The empirical study was conducted by using a case study based on actual financial statements of the *Tampa Bay Spur*. With the help of the financial statements as well as databases like Bloomberg, Reuters, the McGregor database and the JSE a business valuation was performed on the Tampa Bay Spur.

The **first objective,** as stated in chapter 1 (refer to section 1.6 on page 9), was to critically evaluate and compare popular valuation approaches and methods with each other. The study revealed that the seven variations of the rule of thumb valuation method were the most

inconsistent, giving a minimum value of R2,654,888 and a maximum value of R4,205,668. The average amount of the seven variations used in the rule of thumb valuation method was R3,246,651. The asset based valuation approach, which is known to give the minimum or floor value, gave an amount of R 3,436,500 when using the asset accumulation valuation method. By using the capitalised excess earnings valuation method, the amount calculated was R4,444,980. The capitalised excess earnings valuation method can fall under the category of the asset based valuation approach or the income based valuation approach. The R4,444,980 seems to be far from the minimum value which the asset accumulation calculated. When using the income based valuation approach, the two methods used were the discounted economic cash flow valuation method and the capitalised excess earnings valuation method. The amount calculated when using the discounted economic income valuation method was R4,291,445 and the amount calculated when using the capitalised excess earnings valuation method was R5,867,890. When using the market based valuation approach, an adjustment was made to the financial statements and P/E ratios as stated in Chapter 5 (refer to section 5.3.2 on page 125). The adjusted and unadjusted method was split into three categories, namely high, average and low P/E ratio. The unadjusted market value was R5,986,601 for the high P/E ratio, R4,031,965 for the low P/E ratio, and R5,009,283 for the average P/E ratio. The adjusted market value was R5,387,941 for the high P/E ratio, R3,628,769 for the low P/E ratio, and R4,508,355 for the average P/E ratio. After taking the values of all the above mentioned methods in consideration, the total average was a value of R4,400,742.

The **second objective**, as stated in chapter 1 (refer to section 1.6 on page 9) was to deliberate on the advantages and disadvantages of each of the methods. Starting with the income based valuation approach; the first method to be discussed is the discounted economic income based valuation method. The advantages of the discounted economic income valuation method are the following:

- It is very accurate and reliable.
- It takes a lot of information into consideration.
- It can be used for a going concern business entity.

The disadvantages of the economic income valuation method are as follows:

- It requires difficult calculations.
- It requires the CAPM or WACC to be calculated which involved many uncertainties.
- Predictions need to be made which are not always very accurate.

The second method in the income based valuation approach is the capitalised excess earnings valuation method. The following are the advantages of this method:

- It is a shortcut version of the discounted economic income valuation method, thus, when having the information to calculate the discounted economic income valuation method, the capitalised excess earnings valuation method can be calculated.
- It takes a lot of information in consideration just like the discounted economic income valuation method.
- It can be used for a going concern business entity.

The disadvantages of this method are as the following:

- It is not a very popular or accurate valuation method.
- It requires difficult calculations.
- Predicting and calculating the capitalisation rate can be a very difficult task and is neither completely accurate nor reliable.

The market derived valuation approach consists of two popular valuation methods discussed in this research study, namely the guideline publicly traded valuation method and the merger and acquired valuation method. For the reason that the *Spur Steak Ranch* is a franchise and listed on the JSE, and is not being merged or acquired, only one guideline publicly traded valuation method was used in this research study. The advantages of the guideline publicly traded valuation method are as follows:

- It is very accurate, before and after adjustments.
- It is easy to calculate.
- It is easy to get the relevant information to do the calculations.

The disadvantages of this method are the following:

- Adjustments are required and can be inaccurate or unreliable.
- The high, low, and average value can differ a lot.
- There are different time periods from which information can be used and it is difficult finding the time period which is the most reliable.

The asset based valuation approach has two methods which were discussed. The first method was the asset accumulation valuation method. The advantages of the asset accumulation valuation method are the following:

- It is easy to calculate.
- It can be used in cases of liquidation.
- It only requires information in the statement of financial position.

The disadvantages of this method are the following:

- It calculates the minimum value.
- Adjustments need to be made which could be very time consuming and unreliable.
- It is neither very accurate nor reliable.

The second method discussed in the asset based valuation approach was the capitalised excess earnings valuation method. The advantages of this method are as follows:

- It is accurate and reliable.
- It has been used for many years and is well known to theorists and practitioners.
- It requires a lot of information which makes it more trustworthy.

The disadvantages of this method are the following:

- It requires the capitalisation rate which is very difficult to calculate.
- The capitalisation rate required in this method can be inaccurate and unreliable because predictions need to be made.
- This method is categorized under the income based valuation method by some theorists and practitioners, while others categorise it under the asset based valuation approach, which could be confusing.

The rule of thumb valuation method for performing a business valuation is discussed in chapter three of this research study. This method is used by a lot of theorists and practitioners when valuing a restaurant. The advantages of this method are the following:

- It is very easy to calculate.
- It has straightforward calculations and is easy to understand.
- It is not very time consuming.

The disadvantages of this method are the following:

- It is not very accurate nor reliable.
- It is not a well-known valuation method.
- It gives a lot of variations which could be confusing.

The **third objective**, as stated in chapter 1 (refer to section 1.6 on page 9), was to point out the uncertainty factors in valuations, like the cost of capital in the income based valuation approach and calculating the WACC or CAPM. The study revealed that by calculating the cost of capital, also known as the discount rate that uncertainty factors do exist. To calculate the discount rate WACC, CAPM or a built up model must be used. The uncertainty factors are the risk-free rate, the equity risk premiums as well as the beta. In addition, predictions must be made. The predictions are made on the growth of the sales of the business entity, the expected gross profit margin, the expected expenses, as well as the assumed long term sustainable growth rate, which can be inaccurate and unreliable. For the reason that there are those uncertainty factors in calculating the discount rate, it is a difficult task to perform a business valuation because every practitioner will use different predictions and different rates.

The **fourth objective**, as stated in chapter 1 (refer to section 1.6 on page 9), was to develop an empirical case study based on actual information of a selected *Spur Steak Ranch*, and compare different valuation approaches and methods with the original valuation performed by the *Spur Steak Ranch*. In this research study the selected Spur that was used was the *Tampa Bay Spur*. After the *Spur Steak Ranch* performed a business valuation on the *Tampa Bay Spur*, the amount which they calculated was R4,249,325. The *Tampa Bay Spur* used the multiple of seller's discretionary cash flow valuation method. After conducting the case study in this research study by using various popular valuation approaches and methods, an average valuation amount of R4,400,742 was calculated. The total amount calculated in chapter 5 in this research study which is R4,400,742 is R151,417 more than the amount calculated by the Spur after performing a valuation based on the multiple of seller's discretionary cash flow. This is only 3.56% more, which indicates that the current method the Spur uses is fair and reliable.

The **fifth objective**, as stated in chapter 1 (refer to section 1.6 on page 9), was to make recommendations regarding the valuation method which the Spur currently uses. After comparisons had been made between the amounts calculated by the valuation performed by the Spur and the valuation performed in chapter 5 of this research study, using several popular valuation approaches and methods and calculating an average, the conclusion was reached that the method which the Spur uses is fair and accurate. The reason for making that statement is because the difference in values between the amounts calculated by the Spur and in chapter 5 is 3.56%. The valuation amount calculated in chapter 5 is a fair and accurate value because several valuation approaches and methods were used in performing the business valuation. The Spur uses only one method when valuing a restaurant. Using only one method can give an unfair and unreliable value because there is only one value to choose from. When using a variety of business valuation approaches and methods when valuing a business entity there are a variety of values to choose from. In chapter 5 of this research study there is a variety of 17 values to choose from. Using the 17 values and calculating an average gives the buyer and seller a total of 18 values to pick from. For the reason that the method which the Spur uses is only 3.56% less than the average calculated in chapter 5, an assumption can be made that the method used by the Spur as well as the valuation amount calculated by the Spur is fair and reliable. The current valuation method used by the Spur is not easy to understand and does not give a lot of information on how

they calculated the value. This could lead to confusion for the buyer and seller. In conclusion, the recommendations that can be made to the Spur are to use more than one method when performing a business valuation, and to make it easier and more comprehensible for the buyer and seller to negotiate on an amount.

6.2. Contribution: Proposed valuation model for a franchised restaurant

As mentioned earlier, a 'new' proposed valuation model franchised restaurants will be developed, based on the results and experiences of this study. The data from the case study (Tampa Bay Spur) will be used to illustrate the model.

Table 6.1: Seller's discretionary cash flow for 2011

Multiple of discretionary cash flow method (Own model)

Detailed statement of financial performance	2010	2011	
Income	R 4,960,982	R 5,935,038	
Sales	R 8,411,335	R 10,093,602	Turnover increase 20%
Cost of sales	R 3,465,540	R 4,158,564	Cost of Sales/Sales = 41.2%
Gross profit	R 4,945,795	R 5,935,038	
Interest received	R 15,187	R 0	
	R 0	R 0	
Expenses	R 4,923,400	R 3,648,359	
Accounting fees	R 15,637	R 18,000	R15000 per annum
Advertising	R 406,969	R 403,744	4 % on Sales according to Spur
Auditor's refreshments	R 4,385	R 6,000	R1,000 per month
Bank charges	R 151,408	R 144,000	R12,000 per month

Cleaning and refreshments	R 144,969	R 120,000	R10,000 per month
Depreciation	R 165,722	R 0	N/A
Director's salary	R 1,033,931	R 0	N/A
Electricity and water	R 128,600	R 100,800	Average
Entertainment	R 20,318	R 0	N/A
Finance charges	R 9,770	R 16,670	Average
General gas	R 184,065	R 148,344	Average
Insurance	R 50,307	R 51,674	Average
Interest	R 37,085	R 0	No loans/Debt
Licences	R 7,825	R 7,907	Average
Motor vehicle expenses	R 65,189	R 59,115	Average
Printing and stationery	R 20,923	R 31,362	Average
Protective clothing	R 24,814	R 23,403	Average
Rent	R 171,579	R 240,000	R20,000 per month
Repairs and maintenance	R 164,744	R 171,828	Average
Royalties	R 420,566	R 504,680	5 % on sales according to Spur
Salaries and wages	R 1,610,130	R 1,514,089	Average
Security	R 7,115	R 7,200	R600 per month
Subscriptions	R 20,527	R 24,000	R2,000 per month
Telephone and postage	R 51,929	R 55,543	Average
Training	R 0	R 0	No training
Travelling and accommodation	R 4,893	R 0	N/A
Profit before taxation	R 37,582	R 2,286,679	
Taxation	R 10,523	R 640,270	
Seller's discretionary cash flow	R 27,059	R 1,646,409	

Table 6.1 is a duplicate of table 5.19 and the use for the seller's discretionary cash flow is explained in chapter two as well as in chapter five of this research study. The seller's

discretionary cash flow is used to create the model for a franchised restaurant. The value of the seller's discretionary cash flow must be divided by 12 in order to determine a monthly value of seller's discretionary cash flow. In this case study the value of the seller's discretionary cash flow is R1,646,409. When this amount is divided by 12, it makes a total monthly amount of R137,201. It is estimated that a business entity that performs well can make the money back in four years, which adds up to 48 months, which is used as the maximum multiplier in the calculation. When constructing the valuation model, there are several criteria that must be followed in order to get a fair multiplier. The criteria are explained in table 6.2. The criteria used for this model works as follows:

Table 6.2: Criteria for a franchised restaurant

Service Assessments (Spur)	A	6
	B	5
	C	4
	D	3
	E	2
	F	1
Operations Assessments (Spur)	A	6
	B	5
	C	4
	D	3
	E	2
	F	1
Product and hygiene assessments (Spur)	A	6
	B	5
	C	4
	D	3
	E	2
	F	1
Equipment condition (Spur)	Excellent	6
	Very good	5
	Good	4
	Average	3
	Below average	2

	Bad	1
Kiddies playroom condition (Spur)	Excellent	6
	Very good	5
	Good	4
	Average	3
	Below average	2
	Bad	1
Percentage growth in turnover - (Last 3 years'average)	> 5 %	6
	4% - 5 %	5
	3% - 4 %	4
	2% - 3 %	3
	1% - 2 %	2
	< 1%	1
Food cost (Cost of sales/Sales) - (Last 3 years' average)	<40%	6
	40% - 42 %	5
	42 - 44 %	4
	44% - 46%	3
	46% - 48 %	2
	48% - 50%	1
Total expenses/Sales - (Last 3 years' average)	<50%	6
	50% - 52%	5
	52% - 54%	4
	54% - 56%	3
	56% - 58%	2

	58% - 60%	1

There are eight categories in which the Spur is evaluated. The first one consists of a service assessment that the Spur performs every month. The second one is an operation assessment also performed monthly by the Spur. Thirdly, there is a hygiene and product assessment and fourthly an equipment assessment, which rates the condition of the equipment, also performed monthly by the Spur. In the first three categories the Spur gives ratings from A, which is excellent, to F, which is bad. For the reason that there are eight categories used as criteria for this model, there is a multiplier given from one, which is the worst, to six, which is the best. In the fourth category, where the equipment is rated, the Spur uses an 'excellent' if the equipment is in excellent condition. If the equipment is in a good condition, but not excellent to the liking of the person performing the assessment, a 'very good' or 'good' may be given. If the equipment is not in great condition, for example if some of the items are broken or not working to full potential, an 'average' or 'below average' may be given. In rare cases, where most of the equipment is broken, a 'bad' is given as the rating. Once again, six is the maximum multiplier and one the minimum multiplier. The kiddies' playroom, which is very important to the Spur franchise, is also rated by the Spur in the same way as the equipment. Every Spur is obligated to have one. In cases where there is not a kiddies' playroom, a 'bad' is automatically given as a rating.

The Spur Corporation takes royalties from a Spur franchise monthly as their share for promoting the franchise. The amount of royalties is 5% of the turnover. In addition, the Spur Corporation also takes 4% of the turnover monthly for advertisement. Thus, the more turnover the franchise generates, the more it is worth. The next criteria are based on the growth of yearly turnover for a three year average. A growth rate of 5% per year for a three year average gives the Spur a maximum value of six for the multiplier because 5% growth per year in any business entity is seen as excellent. The less the growth rate is, the less the multiplier gets, as seen in figure 6.1.

The next aspect rated is the food cost, which is basically cost of sales divided by sales. In this model, a food cost of less than 40% per year is seen as excellent, that gets a maximum multiplier of six. The higher the food cost gets, the less the multiplier gets, according to table 6.1. The last rating used for this model is expenses divided by sales. Any business entity that can keep its expenses low in comparison to the turnover is seen to be a well performing business entity, and

has the potential of earning a higher net profit. According to this model, when the expenses are 50% or lower when divided by the turnover, it earns a maximum multiplier of six. The higher the percentage of expenses gets, the less potential the business entity has to generate a high net profit, and the lower the multiplier gets. When the percentage of expenses to turnover hits the 60% mark, it gets the minimum multiplier of one, meaning that the business entity does not possess the potential to generate a decent net profit.

When all of the eight categories are added up, it can get a multiplier up to a maximum of 48. The minimum of the multiplier is eight, meaning that the business entity is in terrible condition. In this model, any multiplier over 30 is a decent multiplier. Only the best performing Spur franchises can get a multiplier of 40 to 48, which mean that the business entity is worth buying, even though it is going to have a high value according to the valuation model.

In table 6.3 the *Tampa Bay Spur* was evaluated using the criteria of the new proposed valuation method and by using the seller's monthly discretionary cash flow. The reason for creating a new value for doing a valuation on a *Spur Steak Ranch* is to give the buyer and seller a better insight and understanding where the value came from and exactly how it was reached and for what reasons, for example, the different criteria that were created. The new valuation model created will give a fair value and indication to the buyer and seller for the reason that the value reached differs by a mere 0.24% and the criteria are set very clearly. The new valuation method/model created in the contribution part of this research study is very easy to understand and very user friendly. The *Tampa Bay Spur* was valued by this model as follows (as shown in table 6.3):

Table 6.3: Tampa Bay Spur's valuation results

Criteria		
Service Assessments (Spur)	(1 - 6)	5
Operations Assessments (Spur)	(1 - 6)	5
Product and hygiene assessments (Spur)	(1 - 6)	4
Equipment condition (Spur)	(1 - 6)	4
Kiddies playroom condition (Spur)	(1 - 6)	4

Percentage growth in turnover - (Last 3 years' average)	(1 - 6)	3
Food cost (Cost of sales/Sales) - (Last 3 years' average)	(1 - 6)	3
Total expenses/Sales (Last 3 years' average)	(1 - 6)	4
	48	32

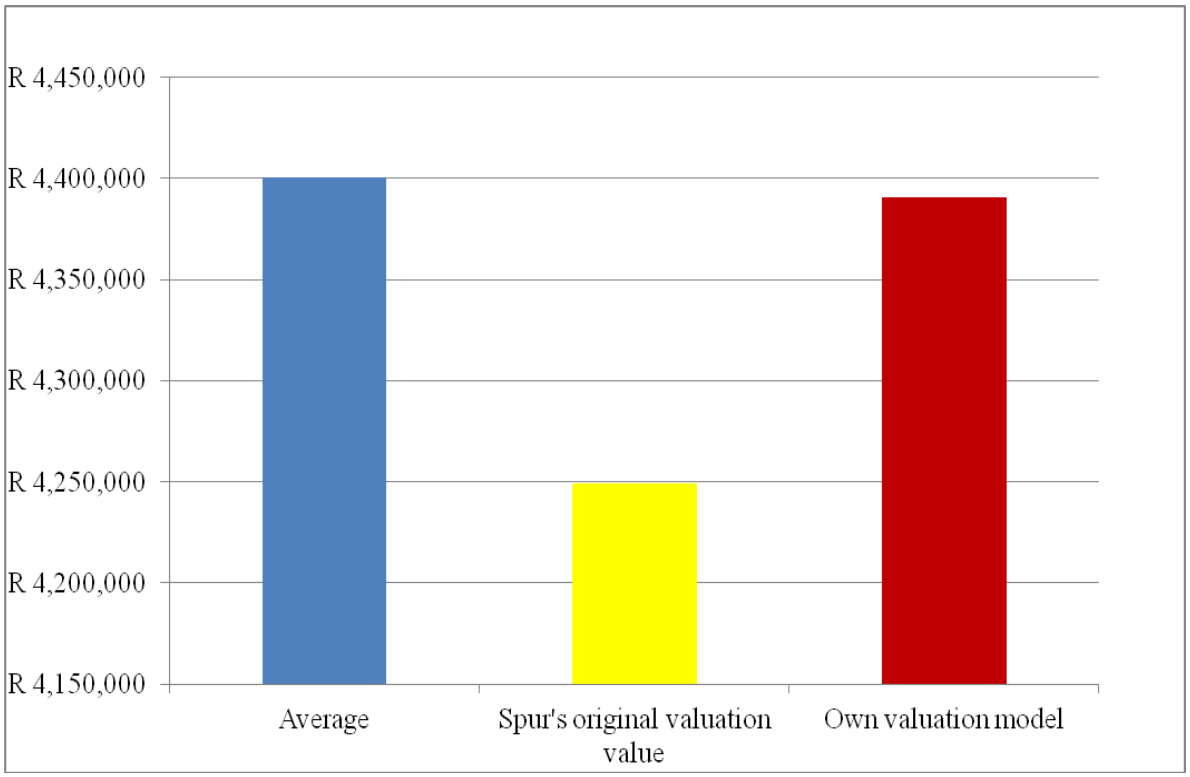
Seller's monthly discretionary cash flow = **R137,201**

Multiplier = **32**

Value of business entity (R137201 x 32) = **R4,390,423**

The *Tampa Bay Spur*, after being valued according to this valuation model got a value of R4,390,423, which is R 141,098 higher than the original valuation performed by the Spur and R10,319 less than the average value of all the valuation methods used to value the Spur in this research study. The difference in the value calculated by the new model and the original value calculated by the Spur Steak Ranch is 3.32%. The difference in value by using the new model and the value calculated by using the average value of various valuation approaches and methods in the case study of this research study is 0.24% which is a very narrow margin. As seen above, the monthly seller's discretionary cash flow resulted in a value of R137,201. When using the criteria set for a franchised restaurant based on the new proposed valuation method, the multiplier received 32 out of a possible 48. When multiplying the monthly discretionary cash flow with the multiplier, the value of the *Tampa Bay Spur* according to the proposed valuation method is R4390423. In figure 6.1 the new proposed valuation model is compared to the average of all the different valuation methods used in chapter 5 of this research study, as well as to the original value which the Spur calculated when performing a valuation on the *Tampa Bay Spur*.

Figure 6.1: Comparing the new proposed valuation method



In figure 6.1 the value of the new proposed valuation model (own model) is compared to the average value when performing the six different valuation methods in this research study and to the value which the Spur calculated when performing a valuation on the Tampa Bay Spur. As seen in figure 6.1, all three values are close to each other. The value of the new proposed valuation model is very close to the value of the average of the six methods used in this research study, even closer than the value which the Spur calculated. For that reason, the assumption can be made that the new proposed valuation model is fair and reliable.

6.3. Conclusion

After conducting the research study, thoroughly examining various valuation approaches and methods as well as doing a case study based on actual financial statements, a conclusion was drawn that the *Spur Steak Ranch* uses a valuation method which is fair. The value that the *Spur Steak Ranch* calculated as the value of what the *Tampa Bay Spur* is worth was R 4,249,325. The

value calculated by using various approaches and methods to value the Tampa Bay Spur ended up on a value of R 4,400,742 when using the average of different approaches and methods used. An overall total of 18 different varieties of values were calculated which to choose from, and from those 18 different values, six different methods were used, and the average of the six methods gave the total of R 4,400,742 which is only R 151,417 more than the original value which the *Spur Steak Ranch* calculated. The difference in value of the original value that the *Spur Steak Ranch* calculated as the value of the *Tampa Bay Spur* and the value calculated by using various approaches and methods used world-wide by different practitioners and theorists was a mere 3.56%.

When answering the questions asked in the problem statement of this research study which were "is the value calculated by the *Spur Steak Ranch* fair?" and "should the *Spur Steak Ranch* use more than one method to value a Spur?" the following conclusion was reached:

The value calculated by the *Spur Steak Ranch* is fair according to the calculations made in the case study of this research study. The difference of 3.56% gives a clear indication that the current method the *Spur Steak Ranch* uses is fair. The current valuation method used by the *Spur Steak Ranch* does however give very little information on how the value of the restaurant was calculated, thus not giving the buyer and seller of the business entity a clear indication and understanding of how they reached the final value. When using various approaches and methods, doing more calculations and showing them on the valuation document, a better insight and understanding will be given to the buyer and seller of the business entity and a agreement on a particular value can be reached quicker and more fairly.

6.4. Limitations of the study

There are a number of limitations to the research study. Firstly, only a single franchised restaurant was used to perform a business valuation on. There are numerous franchised restaurants in the world and in South Africa. In this research study a *Spur Steak Ranch* was used. There are 245 Spur Ranches in South Africa and 32 internationally. Using only a single Spur (*Tampa Bay Spur*) is very limited. Secondly, the business entity used in this research study is a restaurant. There are several different industries, for example, fast food, bars, coffee shops,

supermarkets, pharmacies and a lot more. Thirdly, the *Tampa Bay Spur* is situated in a location which is seasonal, thus, only attracting customers at certain times of the year. There are *Spur Steak Ranches* located in cities which operate throughout the year and perform consistently, as well as *Spur Steak Ranches* located in little towns with minimum tourism attractions. Finally, only five years' worth of financial statements was used in this research study. If more years' financial statements could be used, it could make it more reliable when making predictions and estimations.

6.5. Recommendations for further research

Further research in this field, focusing on different *Spur Steak Ranches* would also be beneficial, as it could provide an approximation on how good the valuation method used by the Spur is. According to this research study the difference between the valuation method used by the Spur and the valuation performed in chapter 5 is merely 3.56%. Valuations could also be performed on other franchised restaurants and other industries and compared to the amount which is calculated by the original valuation method used by those restaurants or industries.

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