



# Understanding the ASSOB valuation model

One of the keys to the ASSOB platform, for both issuers and investors, is to understand our valuation model. While ASSOB does list some offers by companies with long trading histories, many are early stage and some are even start-ups. Because in these cases investors are investing in future earnings, traditional valuation models based on historical financials can't apply. This often means that an emerging company selling equity to raise capital is exploited because the principals can't value the equity and sell it too cheaply.

Another consideration is the fact that all investment offers that appear on the Australian Small Scale Offerings Board are unlisted public companies. While they must prepare audited financials annually, they aren't always subject to the rigours of continuous disclosure. Further, there are liquidity issues with unlisted companies, whether or not they use the ASSOB platform to facilitate the sale and transfer of their shares. All of these things (and more) have been considered in the valuation methodology we've developed and it is applied to each company listing its offer on ASSOB.

Before we go through an example, let's discuss a major consideration for companies when raising capital, their exit or "liquidity event". Most companies listing offers on ASSOB are aiming to exit via a trade sale, sell-down to an institutional investor, or to list on a stock exchange. In today's environment we assume that a listed "micro cap" (less than \$100M market cap) can expect a price to earnings ratio (PE Ratio) of between 7 and 9 times their earnings (before interest and tax, ie "EBIT"). In other words, if a company is earning \$1M EBIT then they could expect a valuation of between \$7M and \$9M if listed on an exchange such as the Australian Stock Exchange. (Worth noting is the fact that the average PE ratio of a listed small-cap company [less than \$500M market cap] was just over 18 times earnings in 2007. Since the sub-prime crisis, the average PE has fallen for small-caps to around 13 times earnings).

In a nutshell, the ASSOB valuation model works like this.

## Step 1 – 4 year conservative EBIT forecast

First we ask the issuer to provide a conservative EBIT forecast, supported by assumptions and facts that substantiate the numbers over the next 4 years. The company must assume that it raises the funds it is seeking and have applied them appropriately when doing this calculation.

## Step 2 – Annualise, then discount the projected EBIT

We then annualise those forecasts and discount them depending on the stage of development and level of experience of the directors/key management. We use the following as a guide:

- Start-up with limited board experience** - 75%
- Start-up with proven board and industry experience** - 60%
- More than 2 years trading history but not in profit** - 40%
- More than 2 years trading history and in profit\*** - 30%

\* after paying market salaries

## Step 3 – Apply a PE to the annualised, discounted, projected EBIT

Once we have this annualised, discounted EBIT number, we ensure that the implied notional valuation based on the last round of funding in their Offer Document does not exceed 5 times. We call this figure the "ASSOB Cap Limit".

Here's an example:

- Company name** - Innovation Limited
- Stage of development** - Strong board, 2 years + trading, in profit.
- Discounting applied to projections** - 30% of projected annualised EBIT
- Amount they want to raise** - \$2,000,000
- Equity on offer** - 40%
- By Rounds:**
  - Round 1 - \$300,000 @ 2c/share
  - Round 2 - \$300,000 @ 4c/share
  - Round 3 - \$1,400,000 @ 8c/share
- Shares on issue R1** - 15,000,000 shares (Implied value of \$1.5M)
- Shares on issue R2** - 7,500,000 shares (Implied value of \$3.3M)
- Shares on issue R3** - 17,500,000 shares (Implied value of \$8M)

All of this information is available in every ASSOB Offer Document.



## Is this good value? Let's see.

### Conservative projected 4-year forecast

|                                   |  |
|-----------------------------------|--|
| Year 1                            | - \$500,000  |
| Year 2                            | - \$1,500,000  |
| Year 3                            | - \$2,500,000  |
| Year 4                            | - \$5,000,000  |
| <b>Total over first 4 years</b>   | <b>- \$9,500,000</b>                                     |
| <b>Annualised EBIT</b>            | <b>- \$2,375,000 (\$9.5M divided by 4)</b>               |
| <b>Discount of 30%</b>            | <b>- \$712,500 (This accounts for risk)</b>              |
| <b>Discounted annualised EBIT</b> | <b>- \$1,662,500 (Annualised EBIT less the discount)</b> |
| <b>ASSOB Cap Limit</b>            | <b>- \$8,312,500 (5 x discounted, annualised EBIT)</b>   |

In this case, the implied value at 8c a share in Round 3 (\$8,000,000) is less than the ASSOB Cap Limit (\$8,312,500), which means that the proposed raising passes our value test.

## Why is this good for investors?

The point of investing, of course, is to get a return on your investment. Some investors like their return in capital growth, in other words, growth in the value of the shares they purchase. Other investors like their returns in dividends, paid each quarter. Most investments don't have both capital growth and pay dividends – they are either high-growth companies and reinvest all available cash, or they are low-growth but predictably pay dividends to shareholders. ASSOB investors prefer capital growth, as long as there is a liquidity event, when they can sell their shares.

In the example shown, if this company's liquidity event is a stock exchange listing at the end of the fourth year, it could probably expect to be valued at a multiple of between 7 and 9 times, depending on the company's industry.

So if you look at its projected 4th year earnings of \$5,000,000 here's what a company's valuations might look like under PE scenarios of 7 and 9.

| Earnings             | PE 7  | PE 9  |
|----------------------|-------|-------|
| \$2M (40% of target) | \$14M | \$18M |
| \$3M (60% of target) | \$21M | \$27M |
| \$4M (80% of target) | \$28M | \$36M |
| \$5M (Target)        | \$35M | \$40M |

## What did ASSOB investors effectively pay?

|                   |            |      |
|-------------------|------------|------|
| Round 1 investors | at 2c each | \$2M |
| Round 2 investors | at 4c each | \$4M |
| Round 3 investors | at 8c each | \$8M |



## Why is there such a difference?

There are several factors built into the ASSOB valuation model that have the effect of discounting the share price to ASSOB investors to account for the risks involved in investing in early stage companies. This is designed to provide significant upside opportunity and to encourage investors to invest early thereby supporting Australian innovation.

Of course, investing in any company's shares is risky, whether it's listed on a stock exchange or not (as has been shown since the sub-prime crisis of late 2007 and 2008) and you should seek professional advice and conduct due diligence before you do. But if you can reduce the risks by investing wisely and in companies where you can visit the management and discuss their plans, these kinds of investments can be a great addition to your portfolio.

1. ASSOB valuations are done on discounted earnings. So if revenue targets are met, the investor is in front immediately.
2. ASSOB valuations are based on annualised earnings not the last and the highest year of earnings. If listing on a stock exchange, it's the last and highest year of earnings that is valued by the market.
3. ASSOB valuations are based on a maximum multiple of 5, not 7-9 like listed entities. That's a maximum of 5 times the already-discounted and annualised projections.
4. ASSOB valuations are based on justifying the highest share price round (Round 3 at 8c in this case). If you invest in Round 1 or 2 you are buying at a significant discount. At Round 1 you are buying in at a valuation of \$1.5M or an 81% discount to the Round 3 price. If you buy in at Round 2 you are buying at a valuation of \$3.3M or a 58% discount to the Round 3 price.