Principles in Business Valuations – Christiaan Vorster

When embarking on the valuation of a non-listed business, be it for the purpose of buying a stake in a business, selling an existing holding, buying out another shareholder or needing an indication of value for any other purpose, there are some basic guidelines that you should understand and follow. These basic concepts are applicable across any business operating in any industry, be it in manufacturing, agriculture, FMCG or a service based industry.

Valuation basics

What is value?

According to the International Valuation Standard Council (IVSC) the definition of market value is: "The estimated amount for which a property should change hands on the date of the valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein both parties had each acted knowledgeably, prudently and without compulsion".

In a broader context, value arises when a choice is made between alternatives. This choice is necessitated as the principle of scarcity applies to all resources, whether they be natural or economic. Whenever a choice is made amongst possible alternatives, one is foregone. Such a concept is best illustrated with an example:

When investing in a business at a certain cost, the opportunity to invest in another business at the same cost is foregone assuming that the investee has limited investment resources. The potential benefit gained from investing in 'another business' may be defined as the "opportunity cost" of investing in the first business i.e. the benefit forgone of the best available alternative. Alternatively, the seller would assess the opportunity cost of selling his/her share relative to not owning a share in the business in the future. The actual transaction price or exchange value would ultimately be dependent on the opportunity cost of both parties to the transaction, where there is a mutual interest, in particular circumstances, at a particular time.

The impact of different degrees of ownership on valuation

The value of an interest in a business is significantly influenced by the underlying weight of the shareholding being valued within the business.

The rights attached to a majority shareholding (51% or more) can include amongst others the right to sell or issue shares, the ability to determine salaries and bonuses and the decision to pay dividends. When acquiring a majority interest in a company, the investor often pays a control premium for these privileges.

Alternatively, a minority shareholder (less than 51%) is far more reactive, and can generally only voice concern and is more often than not reliant on decisions taken by Management such as the level of dividend payouts to be received. The impact of the lack of control should be taken into account during any valuation exercise, as the power to alter the course of the business and to direct resources will ultimately have an influence on the estimation of value.

In theory, the more influence a shareholder has on the business, the higher the value and visa versa assuming that shareholder has the best interests of the business at heart and is a competent decision maker.

Relying on the valuation of an expert

Where no open market exists for the shares of a business (e.g. being traded on a stock exchange) an expert's valuation could form the basis of an indication of value at a given point in time.

One should remember that a valuation completed by any expert is merely the expert's opinion of value at a specific point in time. In determining a reasonable valuation, the expert will apply various estimates, judgements and assumptions. This by no means implies that you are bound by the valuation, except if it has been agreed upon by the relevant parties that an independent expert will value the business and that that value will be taken as the value for future references.

One should always remember that a valuation is inherently dynamic and changeable and wherever alternative estimates, judgements and assumptions are applied it will have an influence on the estimation of value. Furthermore, a valuation is merely an indication of value and not by any means a price. A valuation only becomes a price when two willing parties agree to transact at the generated valuation. Negotiation sits between a valuation and a transaction price.

Valuation models

There are several theoretical valuation models available to value a business. Highlighted below are three models commonly used by valuation experts to determine an estimation of value of a business.

Earnings Multiple based valuation approaches

This methodology involves the application of an earnings multiple to the earnings of the business being valued to derive a value for the business. A multiple can be applied to an earnings base (commonly used P/E multiple); EBIT (Earnings before interest and Tax) or EBITA (EBIT before amortization) to estimate the value of a business.

When applying a Price /Earnings (P/E) multiple, the general practise is to first identify a Price/Earnings (P/E) ratio of a comparable listed company or the average P/E ratio of the sector in which the business operates (these P/E ratios are commonly reported). The rationale behind this is that listed businesses' have a reported market value "at all times" which can be used as an indicator of the value of similar unlisted businesses. This market-based approach assumes that listed businesses are correctly valued by the market and that comparable companies or the sector as a whole are in fact truly similar to the unlisted company being valued.

As it is extremely difficult to identify listed companies that are completely similar, the identified earnings multiple is often adjusted (with a discount or premium) for points of difference between the comparable company or sector and the business being valued. These adjustments are intended to take into account the various influencing factors such as the relative risk of the business compared to the risk of the comparable business or sector, including the size and diversity of the business, the rate of growth, the diversity of product ranges, the level of borrowings and the risk arising from the lack of marketability of the shares.

The adjusted earnings multiple is then applied to a reasonable estimate of maintainable earnings of a business to derive at an estimation of value. A reasonable estimate of maintainable earnings is generally calculated by taking the historical earnings figures (or reliable forecast earnings figures) and adjusting it for exceptional or non-recurring items.

If, for example, an EBIT multiple is used, the same rationale will be followed, an applicable EBIT multiple will be identified, the EBIT of the business will be adjusted if needed (for non-recurring, non-operating items, etc) and a value will be calculated. The value as determined by the above calculation will in turn be adjusted for business specific circumstances and risks to get an estimation of value.

Discounted Cash Flow

This methodology involves deriving the value of a business by calculating the present value of the expected future cash flows of the company. In other words, the expected cash flows generated by the business are discounted at a fair rate of return to calculate an estimation of value at the current valuation date. The sum of these present values and a terminal value forms the basis of an estimate of value of the business. The terminal value is the projected value of the business at the end of the businesses lifespan.

The Discounted Cash Flow ("DCF") technique consists of two distinct parts. Firstly, an estimation must be made of the amount and timing of all cash flows during the likely period or future lifespan of the business. The likely lifespan will differ from business to business and amongst different industries.

The basic information required to determine the projected cash flows would include, amongst other things, the estimates of earnings, depreciation and tax payable, net movements in working capital year-on-year, net realisable value of all surplus assets and estimations of the likely delay in selling them and the amount and timing of capital expenditure, all on an annual basis over the forecast period.

Secondly, a discount rate must be selected and applied to the cash flows to convert them into the present value. Generally the discount rate will be based either on the Weighted Average Cost of Capital of the business, adjusted for specific factors or it will be determined taking a holistic view on the required rate of return for the business (taking into account the systematic and unsystematic risk factors applicable to the business).

The estimation of the enterprise value will then be calculated by discounting the estimation of cash flows by the calculated discount rate. To get an estimation of value for a shareholding, total debt will be deducted from the calculation above.

Net Asset Value approach

This methodology indicates the value of a business by adjusting the business's assets and liabilities to their market value equivalents. This model is most applicable for the valuation of businesses that derives its value from investments.

For all other businesses, it is advisable, under certain circumstances, to only apply this method if the business is on the verge of liquidation or split-up, or as a sense check of other valuation methodologies.

Judgements and assumptions

Throughout any valuation process, whatever the valuation model, the valuation expert will have to make his/her own estimations, judgements and assumptions based on information at his/her disposal. Because valuations entail many difficult estimates, scenarios, judgements and assumptions, there is scope for differences of opinion. A valuation can never be a precise figure, it is rather an indication of value which is often portrayed as a range of values.

As mentioned, if there is a difference of opinion, you are by no means bound to a transaction by a valuation expert's estimate of value, except if it has been agreed upon beforehand by the relevant parties.

Understanding the valuation model, estimates, assumptions and their implications

When using the services of a valuation expert, on presentation of the valuation report by the expert, you as the client should interrogate the expert with reference to the choice of model applied. Further to this, the expert should explain all possible deviations from the chosen model and explain its implementation in detail so that you the client/business owner have the same understanding of the underlying model as the valuation expert.

Furthermore, you the client should also question the valuation expert on the estimations and assumptions that he/she has made and the associated influence of these assumptions on his/her valuation, so that you are able to fully understand the impact of changing macro and microeconomic circumstances. This will allow you to see how the valuation will change when differences in opinion are applied to the model or where market circumstances change significantly.

Information

All applicable information needs to be taken into account during the valuation process, from an industry analysis, to financial information (financial statements and management accounts), risk analysis to all relevant legal documents. The quality of information going into the valuation process will influence which model will be used, the estimates, assumptions and ultimately the quality of the estimation of value. Care should be taken that all applicable and necessary information should be taken into account when calculating an estimation of value.

The same holds true should the valuation be performed by an expert – the quality of information given to the expert will determine the quality of the estimation of value. Garbage in equals garbage out.

Conclusion

The calculation of the estimation of value of an interest in a business is a process where various building blocks are used, information analysed, with different models available for application. The answer is always an indication of value and at best an informed estimation of value.

Ultimately, it is always still up to the potential buyer or seller to negotiate the final price and terms and conditions of a potential transfer of interest.

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