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Valuation approaches and the financial crisis. Part 1 – market methods

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A key part of an expert witness's role involves explaining, in as clear terms as possible, complex accounting, economic and valuation concepts, to arbitration lawyers who may be less familiar with or even daunted by the world of finance.

My suspicion is that expert witnesses could do much more to assist the arbitration community in their dealings with the important issue of quantum. Without wishing to make sweeping generalisations, I do wonder whether some arbitrators' relative lack of familiarity with different approaches to measuring damages might be at least a partial explanation for the following:

• The existence of relatively few awards which explain in any real detail arbitrators' reasoning for preferring one valuation approach over another and hence their eventual award for damages.
• The perception that arbitrators 'split the baby' i.e. issuing an award for damages that is somewhere in the middle of two experts' valuations, despite said valuations having been produced using entirely different methodologies and/ or assumptions.

In a similar vein, whilst many lawyers I have met say they understand (for example) discounted cash flows (DCF), it is not always clear to me that their knowledge of this methodology extends beyond the pure mechanics of the calculation. What is also needed when analysing a DCF calculation is a proper awareness of the importance and role of assumptions and the various sensitivities in a DCF calculation.

Given the above, I thought it might be helpful to produce a short series of blog postings covering the rudiments of the most common valuation methodologies. Each post will explain the basic mechanics of the valuation approach, its applicability to different situations and its strengths and weaknesses. Finally, I will explain how the ongoing financial and economic crisis may impact a valuation performed under the particular valuation approach being considered.

Introduction

Forensic accountants and other valuation professionals are frequently involved in the arbitral process to assist disputing parties and tribunals quantify economic loss as a result of a given breach or act. In order to determine the amount of economic loss (e.g. suffered by a business), an expert will often need to perform two different valuations: a counterfactual (or 'but for') valuation and an 'actual' valuation' where the difference between the two represents the loss. There are many different methodologies for valuing a business, with the following being the most common approaches:

• Market-based approach (e.g. comparable transactions)
• Income-based approach (e.g. DCF)
• Asset-based approaches (e.g. adjusted net book value)

This article will focus on the market approach; subsequent articles will discuss the DCF and asset-based approaches.

Overview of the market approach

Underpinning the market-based approach is the basic principle that a business is only worth what somebody is prepared to pay for it. For this reason, when attempting to value a given business (let's call it Company A) in the context of a dispute, an expert may firstly look at the value of any past transactions in Company A itself. Recent past transactions in Company A may be the best available evidence of the value of Company A, although the details of such transactions would need to be studied carefully before arriving at such a conclusion. It is not uncommon, however, that the expert will find few, if any, recent transactions in Company A; any transactions that he does find may not have been made at arm's length (hence failing one of the tests in the definition of fair market value – see below) or else made in the distant past (and hence not reflecting current information).

In lieu of (or in addition to) using own-company transaction data, the expert will research recent transactions in businesses he deems to be similar to Company A. The premise supporting this approach is that if Company A is similar to Company B, and Company B has a value of X (assuming that we know the value of Company B), it is reasonable to assume that Company A's value can be determined by reference to X. In this example, X might refer to any of Company B's share price, the transaction price for the sale of the entire business, total enterprise value (value of both shareholders' equity and debt) or equity value (the value attributable to shareholders) among other values.

The first step then for the expert who wishes to value Company A using comparable transactions is to identify businesses which are similar to Company A in that they have share common characteristics. Characteristics that are commonly taken into account include:

• Industry/ business sector
• Size of organisation (number of employees, turnover, geographical spread)
• Product mix
• Financial structure (e.g. mix of debt/ equity)
• Geography
• Maturity of the business i.e. does Company A have stable/ predictable revenues or is it a young fast-growth company?
• Profit margins

It will be appreciated that, in reality, no two businesses are exactly alike in all respects. Whilst an expert may successfully identify a business (Company B) which provides a close match to Company A, there will often be important differences between the businesses. The expert will need to take these differences into account when performing his valuation.

Putting aside for the time being the above practical considerations, assuming that the expert does find a reasonably close match, he will then seek to use the (known) valuation of Company B to inform his valuation of Company A. Today, the expert benefits from being able to access a wealth of publically available information from a variety of sources. By accessing a suitable database (e.g. Bloomberg), the expert can obtain and use details of Company B's key financial metrics. He may discover, for example, that the enterprise value of Company B is a multiple of 10 times EBITDA (Earnings Before Interest Tax Depreciation and Amortisation). To conclude this simplistic example, the expert may decide that Companies A and B are so similar that the former should also be valued on a multiple of 10 times EBITDA. Alternatively, he might observe that Company B was recently sold for a price X and conclude that this price should inform the value of Company A.

In some industries, key drivers of value are used as relative valuation multiples, for example:

• value per customer or subscriber (telecoms, financial services, internet businesses)
• value per square foot (retail)
• revenue per available room (RevPar) (hotel industry)
• value per unit of proven reserves (mining companies, oil companies)
• value per unit of sales (value per bottle in the champagne industry in France, daily milk bottle sales in dairy industry)

As variants on the above, the study of comparable businesses may also be relevant in the following circumstances:

• selection of an appropriate discount rate for the purposes of the income (DCF) approach – discussed in the next posting. If Companies A and B are similar (e.g. large mobile phone companies operating in a given country), the discount rate for Company A at a certain date may be a sensible proxy for that of Company B on a slightly different date, although again care needs to be taken to ensure one is truly comparing like with like; and

• understanding how a business might have performed (but for a breach) by reference to the trading performance of a similar business in the same time period.

That then is the (over) simplified overview of the market/ comparables approach. I set out below some of the key strengths and weaknesses of this methodology.

Strengths and weaknesses of the comparables approach.

By way of an opening comment, it should be recognized that the market/ comparable businesses approach is generally accepted within the professional valuation community and is widely used. If properly prepared, an independent valuation which is supported by reference to real-life transactions in comparable companies demands to be taken seriously and may be difficult to criticize.

A further strength of this methodology is that the expert can access a huge amount of data in his search for a comparable company. By way of illustration, when searching recently for a particular type of manufacturing company in Eastern Europe, a database returned over 30 possible results, showing all the financial and accounting data I could possibly need and more besides.

One obvious reason why the market approach is often used in arbitration for the purposes of calculating damages is that, on the face of it, the approach itself seems entirely straight-forward and reasonable. From personal experience, it is often easier to explain to lawyers than DCF!

On a cynical view, however, in preparing its claim, a party might rely on this approach precisely because it knows it is conceptually simple and can usually be understood more easily by the lay person than a claim which is based on a complicated DCF model. As we shall see in the next article, however, the DCF approach is widely used and generally accepted in the professional valuation community. Becoming even more cynical, it can be observed that M&A transactions often reflect a heavy 'control premium' that might not arise in valuations produced under other methodologies. Put simply, the market approach can sometimes give higher values (and thus work in the claimant's favour) than either the income or asset based approaches, although this does also depend on prevailing market sentiment.

What then are the flaws of using what seems to be an approach grounded in common sense and straight-forward logic?

Firstly, there exist relatively few truly comparable companies. Even assuming one is able to find a similar company in terms of size, product, geography, capital structure etc, any differences in other factors (e.g. the actual profit margins earned and/ or the profit growth rates) can mortally wound the comparison or else require complicated adjustments to be made to the valuation to create an artificial comparability.

A second difficulty is that historical transaction values may not reflect current values and, as we know, market sentiment can change quickly. The M&A market in spring 2007 (i.e. prior to the onset of the financial crisis) was completely different to that in the fall of 2008 i.e. post Lehman collapse.
The following is a non-exhaustive list of other potential weaknesses/ drawbacks:

• Given the (sometimes) large population of notionally comparable businesses, it may be tempting for a party to 'cherry-pick' the businesses that support a pre-determined valuation; an experienced expert charged with rebutting a claim should be able to identify the existence of such bias by getting to the same overall population
• A deep understanding of the relevant industry/ sector may be required in order to decide which businesses truly are comparable
• Particular care needs to be taken when dealing with businesses with little history and/ or high growth
• The assumptions underpinning valuations based on comparable companies can be far less transparent than is generally the case in say a DCF valuation.
• The approach may not be possible in the case of start-up ventures
• Important intangible differences between otherwise comparable companies tend to be glossed over, such as brands, management styles, culture etc.

Impact of the financial crisis on the application of the market-based approach

Whilst the market-based approach continues to be as relevant today as it ever was, in this writer's view, additional caution is warranted now when researching past transactions to ensure one is truly comparing like with like. The global financial and economic crisis does not look like it will dissipate in a hurry and hence its impact of valuation needs to be taken seriously. A sensible starting point for this discussion is the International Glossary of Business Valuation Terms' definition of Fair Market Value, which is:

“the price, expressed in terms of cash equivalents, at which the property would change hands between a hypothetical willing and able buyer and hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market when neither is under the compulsion to buy or sell and when both have reasonable knowledge of the relevant facts” [emphasis added]

In conducting a review of market transactions for the purposes of identifying comparable business valuations, the absence of one or more of the above highlighted factors in a given transaction may render the transaction data useless, for the reasons explained below.

Hypothetical willing and able buyer – As is well-known, in the immediate aftermath of the Lehman’s collapse in 2008 and ensuing credit crunch, the M&A market collapsed. Whilst there has been a slight pick-up in the volume of deals since 2008, the global M&A market remains well below levels seen in spring 2007, the high watermark. An obvious implication of the depressed market is that there remains a continued lack of buyer appetite (and greater aversion to risk?) and hence numbers of buyers. Current restrictions on credit do not help. Of relevance here is the importance of geography; to pose a rhetorical question, are lending conditions in Spain – one of the countries most badly affected by the crisis – the same as in say France? If lending conditions are different, this may limit the comparability of French and Spanish businesses in a way that may not have been the case pre-crisis; both countries are, after all, members of the euro zone.

Open and unrestricted market – to what extent can pricing data, obtained from market transactions, be trusted to reflect underlying supply & demand factors, given that governments now regularly intervene in that market? By its very nature, government intervention generally makes markets less transparent and open. To use an extreme example, is the fair market value of a (toxic) derivative instrument truly its face-value simply because a government agency intervenes and purchases it for this price?

Neither is under the Compulsion to buy or sell – In reality, many transaction values since the beginning of the financial crisis may represent “fire sales”, where a vendor may have been under the compulsion to sell an asset or business and may have done so for less than it would have been able to sell it for under different circumstances. In a similar vein, due to heightened volatility, the market may not reflect “long term” view / “value-in-use”

Conclusion

It should be recalled that the market approach is only one of several possible valuation methodologies. Best practice requires that, where practicable, a valuer should seek to apply more than one valuation method, if only to cross-check the results of the different calculations in reaching a final view on value. Thus, the market approach might be used to support a valuation produced using DCF or vice-versa.
In the next article, I will discuss the DCF methodology.

1. A control premium is the excess price a buyer is willing to pay over the current market value of

publicly traded shares.

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