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Challenges in the valuation

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Any kind of valuation exercise is a complex process that requires the not application of the vast knowledge of many fields of science. However, valuation is more of an art and not an exact science, though the value of a business can be objectively determined employing valuation approaches. This value is still subjective, dependent on buyer and seller expectations and subsequent negotiations and use of professional judgment is an essential component of estimating value. Hence Business valuation is as much an art as it is a science.

In the present world, the terms enterprise value and valuation are of great importance. To know how much an enterprise is worth is of fundamental importance for both the owner of that company and investors when negotiating the price of an enterprise at the time of conducting a commercial transaction.

There are many scientific and practical problems associated with valuation. Despite the fact that a group of specialists has already done much in terms of efforts to standardize the valuation process, there are still many unsolved problems or controversial solutions adopted. Methods of the valuation of enterprises and their organized parts have not been regulated legally as strictly binding.

There is no closed and complementary set of rules applicable to this process. The lack of uniform regulations is primarily due to the fact that it is not possible to fully codify a process that may relate to entities with different specificities, legal forms, assets or ownership structures. However, there are standards that allow for its partial structuring. Therefore, in many countries of the world, for many years, there have been standards for business valuation.

Experts are bound by codified procedures and standards of conduct, which guarantee the comparability of valuations and ease of their verification. Such a situation contributes to the security of business transactions.

Determination of the final value of the entity is difficult due to the subjectivity of the concept of “value” itself. The problem is also the fact that business valuation is the combination of both theory and practice. It also depends on the capabilities of the business model used by the specific economic entity. It should be remembered, though, that the actual market value of the enterprise is very rarely exclusively determined by the assets taken into account in the balance sheet. The actual valuation is

determined by a number of variable factors, such as the economic situation of the country, attractiveness of the market, the company's development strategy, human resources, the nature and manner of the use of assets owned.

Generally, the objective of business valuation is always to facilitate strategic decision-making in terms of organization, shares or investments. Valuation enables the selection of both ownership and financial options in assets and liabilities. It is actually the opinion of the value prepared by specialized experts, analysts and valuers on the basis of the collected and properly utilized information about the company considered and the environment of its operations.

Another component resulting in problems in the valuation of fair value is the growing importance of intellectual capital. This is due to global technological and organizational transformations, which have led to the knowledge-based economy. Intellectual capital, among others, consists of legal assets, technology and relationships with customers. At the same time, among the issues of intellectual capital, there are many ambiguous and various solutions for both theory and practice. Due to difficulties in the valuation of intangible and legal assets, which primarily determine the contemporary value of enterprises, in particular highly developed ones, in terms of technology, one deals with difficulties in achieving the so-called fair business valuation.

The methodology of the valuation of intangible and legal assets is subject to constant changes in search of a universal method. Therefore, at present, in the subject literature, the conclusion is that, in order to make the best possible valuation, it is necessary to value individual components affecting the value of the company with separate methods that best reflect the nature of their value. The existence of many subjective factors affecting the valuation may lead to abuse, pressure and the desire to influence the experts' decisions, which result in the distortion of fair value. Therefore, in order to streamline business valuation, there is the need to develop an universal, yet consistent, methodology for the valuation of basic parameters. This also requires the implementation of appropriate regulations or standards concerning the generally accepted methods of business valuation since, depending on the subjective choice of the method by the appraiser, significant differences in the final valuation may be observed, resulting in low values of the company.

The Balance Sheet, missing consideration

In many cases, the balance sheet is not given adequate consideration. Those preparing business valuations typically focus on the future cash flow that a company will generate. The balance sheet sets out the net operating assets a company requires to generate the cash flow upon which the valuation is premised.

An appropriate business valuation exercise should include an analysis of the normalized level of non-cash working capital (e.g. accounts receivable, inventories, accounts payable, deferred revenues, etc.) required to support the company's operations. Where appropriate, an adjustment to the equity value

conclusion should be made where the actual amount of working capital at the valuation date (or the closing date of a transaction) is greater than (or less than) the estimated normalized amount. Adjustments are particularly applicable (and often missed) where the business is seasonal in nature.

Another common error is to automatically add cash on hand to the equity value conclusion (or apply cash on hand against outstanding debt) without assessing whether that cash is required in order for the company to maintain an adequate level of working capital.

Finally, the balance sheet may include redundant assets that can be withdrawn without disrupting the operations of the company. In some cases, redundant assets are not obvious. Missing these redundant assets can understate the value conclusion. Examples of where hidden redundant assets may exist include the following:

- **Fixed assets & Real Estate:** which may include unused equipment that can be disposed of where a company owns the property in which it operates, it may be better to assess the value of the real estate separately from the business itself. Quality real estate assets often fetch higher valuation multiples than operating businesses, which can significantly impact value.
- **Accounts receivable:** which may include non-trade receivables, such as amounts owing from shareholders or employees.

Unrealistic Cash Flow Projections

The value of a business is a function of the cash flow that a company is expected to generate in the future and the risks relating thereto. Cash flow forecasts are often prepared to aid in this regard. However, cash flow forecasts often contain errors and inconsistencies that cause the valuation conclusion to be meaningless or misleading. Common deficiencies in this regard include the following:

- **High growth revenue expectations:** In general most forecasts have an upward bias. There is a natural tendency to overstate a company's growth prospects. A breakdown of revenue by customer, product and service offering and other metrics can help in assessing the degree to which growth will be generated by existing customers vs. new customers; existing product and service offerings vs. New offerings, etc. Where revenue growth is expected through new customers or new product and service offerings, there can be added challenges or costs involved. While developing a detailed forecast is onerous and subjective, doing so forces the consideration of how growth can be achieved.
- **Inconsistency in operating expenses:** adequate consideration must be given to the operating costs required to generate projected revenues. In many cases, those preparing forecasts believe that the existing cost infrastructure can be leveraged, such that profit margins increase over time, thereby resulting in much higher value conclusions. To help avoid these types of errors, the financial model should incorporate analytical tests, such as revenue per

employee and other operational metrics that aid in assessing the reasonableness of the expense projections.

- **Capital expenditure requirements:** growing companies often require additional fixed assets. In some cases this can be significant, such as where facilities expansion is required to accommodate revenue growth. The valuation model should incorporate capacity-related metrics relating to equipment; facilities; distribution assets and other categories in order to assess when capital additions are required.
- **Working capital requirements:** growing revenues generally leads to higher accounts receivable, inventories and other current assets. In many cases, these requirements are partially offset by higher accounts payable, accruals and deferred revenue. However, net working capital requirements usually increase, which represents a drain on cash flow and value. Metrics such as days' sales in receivables, inventory turnover and net working capital as a percentage of revenues can help in ensuring working capital requirements are adequately considered.

Reliance on the Multiple of EBITDA Methodology

Business values are often expressed as a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization). Despite the popularity of the multiple of EBITDA methodology, it is fraught with challenges. The multiple of EBITDA methodology does not explicitly consider key value drivers such as capital expenditure requirements, income taxes or working capital to support growth. Rather, these variables are inherently buried in the valuation multiple adopted. While the multiple of EBITDA methodology is useful as a preliminary indication of value, or as a test of reasonableness on the value conclusions derived pursuant to other valuation methodologies (such as the DCF methodology), sole reliance on this methodology can result in misguided decisions.

Reliance on Comparable Company Multiples

The natural tendency is to look at the multiples of similar companies when conducting a business valuation. Comparable company analysis is sometimes helpful in ensuring that valuation conclusions are reasonable in the context of prevailing industry and economic conditions. However, the application of comparable company multiples, be it from public companies or recent industry transactions - can be fraught with challenges.

With respect to public company data, it's important to recognize the fundamental differences between valuation multiples applicable when valuing a company, and those implied by the trading prices of publicly listed shares. Shares of public companies represent small lots of highly liquid securities with known prices. This degree of liquidity and price discovery is not inherent in the valuation of a company, which leads to additional risk.

Furthermore, public companies are usually much larger and more diversified than private companies that are the subject of a notional valuation or open market transaction. As a general rule, smaller companies within a given industry segment trade at lower valuation multiples than their larger counterparts.

Over-reliance on the valuation multiples implied by open market transactions can also be hazardous. Transaction multiples (where they are disclosed) can be misleading for a variety of reasons, such as the following:

- **The EBITDA base:** reported EBITDA multiples may be calculated based on actual EBITDA as opposed to normalized EBITDA, which adjusts actual results for unusual items and excessive or deficient payments to related parties.
- **Terms of the deal:** non-cash terms such as promissory notes, share exchanges and earn-outs can distort the stated purchase price, which in turn distorts the implied valuation multiples.
- **Relative negotiating position:** in some cases, the buyer or seller may have been in a weak negotiating position (such as a seller being compelled to transact for health reasons), which influenced the price paid. Such factors would not be known outside the parties to a transaction.

Technical Errors in Rates of Return and Valuation Multiples

The determination of an appropriate rate of return or valuation multiple to apply in a particular business valuation inherently is a subjective exercise. However, rates of return and valuation multiples must be reasonable and internally consistent, in order to develop a meaningful valuation conclusion. There are a variety of technical errors that are commonly made when determining and applying rates of return and valuation multiples. Among the most common are the following:

- Inconsistency in the rate of return and the cash flow against which it is applied: for example, where the cash flow to be discounted is determined on an “unlevered” basis (i.e. before consideration of debt servicing costs), the discount rate should be expressed as a “weighted average cost of capital”.
- Double-counting of risk factors: for example, where a risk premium is added on account of “small business risk”, that same risk premium should not be afforded for considerations such as limited market presence.
- Double-counting of growth: where the cash flow forecast incorporates an element of growth, that same growth factor should not be incorporated in the rate of return or valuation multiple.
- Overstating the long term growth rate: a capitalization rate is calculated as the discount rate (which is a function of the risks relating to the business itself, the industry in which it operates

and general economic conditions), less a long-term growth rate. The long term growth rate incorporates long-term inflationary growth and, in some cases, real growth (beyond inflation). The real rate of growth represents the extent to which a company can generate a return on its capital in excess of its cost of capital. In most cases, high rates of real growth are difficult to achieve over the long-term, due to competitive pressures that exist in any given industry. Overstating long-term growth can cause the value conclusion to increase geometrically, thereby significantly overstating the value conclusion.



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