Valuation Methodologies

By Robin McGregor

There are many different approaches to valuation, but broadly these recognise that any asset has either a capital value or a potential to generate recurring income. The recognition of the capital value is reflected in 'net assets' approaches and the income is used in 'earnings' approaches. A net assets approach focuses on the balance sheet of the business and adjusts the 'book values' of the assets and liabilities to a current fair market value. This approach would be relevant to businesses that have a high level of assets but have low turnover or profitability. One example might be a property-holding company. This approach is not suitable for businesses that have few physical assets such as a service business, for instance an estate agency. The restated fair market value of the assets less the liabilities gives the value of the business.

An earnings valuation is based on the profitability of a business. Using historical profit trends and future projections if available, a valuer will make an assessment of the likely future performance of the business. That figure is known as Future Maintainable Earnings and the valuer will then capitalise that future income stream to reach a conclusion on the value of the business. The most common ways of capitalising the value of the business is either to use an earnings multiple (obtained by comparing the value ascribed to other similar businesses) or to calculate the level of return that a potential purchaser is likely to target to compensate them for the risk associated with the business. This approach is based on the assumption that a rational investor will balance greater risk by seeking an appropriately higher rate of return. Hence a risk-averse investor might be happy to receive only a few percent interest on a cash deposit, certain in the knowledge that the capital value is not going to be eroded. So, an investor buying a business where there is a greater risk of losing some or all of the capital invested should be seeking much higher rates of return.

For comparative purposes, the risk-free rate of return is the generally taken to be equivalent to the return on a 10-year government bond, presently around 5.3%. An average risk premium above the risk-free rate that an investor might expect from investing in the UK Stock Market might be in the range 4% to 6%, with certain industries and specific companies being perceived as lower or higher risk outwith this band. The valuer will then consider other specific risks to the business being valued. Therefore, it is possible to build-up a picture of the level of risk that a particular company should be carrying based on broad market, industry and general economic conditions. Hence, a rational investor should seek to compensate that level of risk by requiring an appropriate level of return, otherwise they should choose to invest in a different less risky asset. These approaches are illustrated in the example below.

In each of the illustrations below assume that the Company has been estimated to have post-tax Future Maintainable Earnings of £100,000.

Purchaser A expects the Company to perform well and considers the published price-earnings (P/E) ratios of similar companies. The published P/E ratios are based on profits after tax and an analysis of these reveals that an average multiple of 7 times is reasonable. Therefore, the value that Purchaser A attaches to eth Company is simply £100,000 x 7 = £700,000.

Purchaser B also expects the company to perform well and thinks that the risk associated with investing in the Company is only slightly higher than that of a Stock Market investment. So Purchaser B has calculated that the required rate of return is 10% (risk free rate of 1.2% + equity risk premium of 7% + specific company risk of 1.8%). Therefore, Purchaser B's valuation of the business is £100,000 divided by 10% = £1,000,000.

Purchaser C considers that the Company is poorly positioned in relation to its competitors. Therefore, Purchaser C considers that an investment in the Company is at least twice as risky as investing in the Stock Market and then there is an additional competitive risk. Consequently, Purchaser C has calculated

the rate of return required to be 20% (risk free rate of 1.2% + equity risk premium of 7% + specific company risk of 11.8%). Therefore, Purchaser B's valuation of the business is £100,000 divided by 20% = £500,000.

Business valuation is not a black-art and should be conducted using an evidence based approach. Consequently, a business valuation should be transparent and well-reasoned. If these basic principles are adopted, then the valuation report will withstand challenge in Court as it will be both theoretically sound and robust on a practical basis.

Robin McGregor is a principal in Christie Griffith, an independent practice specialising in forensic accounting, corporate finance and business valuation matters. Christie Griffith provides litigation support and forensic accounting services that are designed to present complex financial transactions and information in a clear and focused way. Christie Griffith cover all types of disputes and represent clients from all sectors.

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