

Business Valuations - Ensuring all the valuer's ducks are in a row

By Christiaan Vorster

An attorney often needs to liaise with or refer his or her clients to an independent valuer to determine the value of a business, whether owned by a legal entity, an individual or a partnership. This may be to assist a client wishing to sell a business to determine the value thereof, to determine value for purposes of resolving shareholders' disputes, to comply with the Companies Act 71 of 2008, for objecting to property valuations, or for a myriad other reasons.

Valuations have increasingly become a specialised field and care should be taken when appointing a valuer to ensure that he or she will be capable of defending his or her valuation if it becomes necessary to do so, whether in the course of negotiations, legal proceedings or at any other time. This increased specialisation is due mainly to technical developments that have taken place in regard to various valuation methodologies coupled with arguments that have developed around the applicability of different methodologies, the correct application of different models and the underlying assumptions used in connection with the valuation.

Accordingly, whenever a party scrutinises a valuation, a range of areas should be probed to ensure that the value can be defended, including –

- the reason for having chosen the particular valuation methodology;
- the applicability of the methodology;
- whether the valuation model has been correctly applied;
- the quality and reliability of the information used; and
- the underlying assumptions applied in connection with the valuation.

This article elaborates on some of these aspects.

Areas that need to be probed when scrutinising a valuation

Below are brief commentaries on some of the areas that need to be probed when scrutinising a valuation.

General principles

First and foremost, the underlying principles applied by the valuer must be sound, particularly if the valuation may need to be defended. These include:

Frameworks and standards: All valuations should be based on a sound framework and an acceptable standard. For instance, the International Valuation Standard Council's international valuation framework (IVF) and valuation standards are recognised as international generally accepted standards for supporting valuations (also by various professional bodies in South Africa).

The definition of 'market value': According to the IVF, the definition of 'market value' is: 'The estimated amount for which an asset should exchange on the valuation date between a

willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeable, prudently and without compulsion'.

This definition should form the basis of any valuation of market value.

Judgements and assumptions

Whatever the valuation model applied, the valuation process will entail estimates, scenarios, judgements and assumptions by the valuer. It is up to the valuer to decide how these elements will be incorporated during the valuation process and to what degree they will influence the value. More often than not, a financial forecast will also form part of the valuation and here too different forecasting techniques can be used. Consequently, there is scope for differences of opinion on numerous levels.

The valuer must be able to justify his or her estimations and assumptions and be able to demonstrate their influence on value under different scenarios. This will give clarity on how the valuation will change when possible differences of opinion are applied to the model or where circumstances change significantly.

Importance of information used

The information furnished to a valuer for purposes of the valuation determines the valuation methodology that will be applied and the underlying assumptions that will be made, and will show up potential areas requiring more research or additional information. The reliability of information is of critical importance.

It should be clear from the valuation itself that the valuer has applied his or her mind to the quality and applicability of the information used. In this regard, independent verification always remains an option.

Impact of different degrees of ownership on valuations

The value of an interest in a business is significantly influenced not only by the weight of the shareholding being valued but also by the actual rights that attach to the shareholding.

In theory, the more influence a shareholder has on the business, the higher the value (control premium) and vice versa (minority discount), assuming that the shareholder has the best interests of the business at heart and is a competent decision-maker.

The factors influencing a value and the degree to which those factors influence the value form part of the valuer's judgement. A clear understanding of the valuer's thought process and reasoning is thus essential when scrutinising a valuation.

Exposure to risks

Different businesses are exposed to different risks. Consequently, these risks first need to be identified and, secondly, the impact of the risks needs to be factored into the value. The principle is that the higher the risk, the higher the required return, which in turn influences the value, since a higher required return will lead to a lower value.

Risks can be categorised as systematic risks (all businesses are exposed to these risks although on different levels, eg, inflation risk, interest rate risk, foreign exchange risk, etc) or specific risks (specific to the business, eg, dependence on key management, one key customer or supplier, start-ups, etc). Technically, these risks are dealt with differently in different valuation models.

In addition, the marketability of shares in an unlisted company should be taken into account.

Again, it is in the discretion of the valuer to determine the applicability of the risks influencing value and the degree to which those risks do so. Once more, a clear understanding of the valuer's thought process and reasoning is essential when scrutinising the valuation.

Applicability of valuation methodologies

The choice of valuation model will most probably have the biggest influence on the final value determined by the valuer.

There are several theoretical valuation methodologies available to value a business. These include Gordon's dividend growth model, market approaches, income approaches, for example, discounted cash-flow models (free-cash-flow-to-firm and free-cash-flow-to-equity models), the net asset value approach and the economic value-added (EVA) approach.

As the application of a particular model is in the discretion of the valuer, the reasons for having chosen a particular model and the applicability thereof should also be apparent from the valuation itself.

Conclusion

The calculation of the value of an interest in a business is a process in which various building blocks are used, information is analysed and different methodologies are available for application.

The credibility of a valuation ultimately lies in the ability to support the value and to be able to substantiate and verify the reasoning behind the chosen methodology and the underlying assumptions. This is, more often than not, dependent on a complete theoretical understanding of the various valuation methodologies, an ability to apply financial modelling techniques (eg, forecasting and discounting techniques), experience in incorporating assumptions, being abreast of market conditions and the ability to evaluate applicable risk factors.

To ensure that a valuation is able to withstand scrutiny, a party to the valuation must ensure that, at the very least, the matters raised in this article have been dealt with.

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