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BUSINESS VALUATIONS - THE MODERN APPROACH

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The recent article which discussed capital acquisitions tax on the disposal of a business set out two methods of valuing majority interests - capitalised earnings (multiple of earnings per share) and net assets per share - which have no basis in theory or fact and which almost invariably result in an over-valuation of unquoted shares.

FUNDAMENTAL ELEMENTS

The article failed to identify the fundamental elements that determine the value of any financial asset: prospective cash; the time of its receipt; and the risks relating thereto.

The fundamentals are easier to appreciate if viewed from the investor's point of view. In all cases, the investor is buying the vendors right to a future flow of income, irrespective of whether the flow of income and its timing is certain, eg, an investment in government stocks (gilts) or uncertain, eg, an investment in company shares (equities).

The investor is only interested in the cash he will or hopes to get from the asset - what the Revenue will get (tax on half-yearly interest or dividends) is of no value to him.

EQUITIES - Higher Risk

As all investors are risk averse, they seek a higher return to invest in equities, ie, they will pay a lower price for equities than for gilts for a given prospective flow of income. The excess annual return sought by investors in equities is called the risk premium.

Studies of returns on the US and UK markets over long periods suggest a risk premium of 7% for large quoted companies and 13% for small quoted companies; the latter group includes all UK companies with a market capitalisation of up to £112m (average £31m).

To invest in an unquoted company, an investor would require a substantially higher return on account of its small size and lack of marketability of its shares.

LACK OF MARKETABILITY

This comprises two elements: restrictions in the Articles of Association and lack of a quotation. In the valuation of majority interests, the restrictions in the Articles are generally not a significant element.

The depreciatory effect of not being quoted has been the subject of a number of studies in the US to ascertain the discount required by investors to invest in unquoted stock. Results indicate that an investor in an unquoted company which may never be quoted would require an additional discount of 40 to 50%.

TOTAL RETURN REQUIRED

Given alternative investment opportunities, an investor in unquoted equities, whether it be a majority or a minority interest should be seeking substantial return. For a top rate taxpayer, who can get a certain net income of 7% on gilts, an additional risk premium of 20 to 30 per cent would be justified. This may appear high, however, it must always be remembered that the prospective income is uncertain. If the uncertainty is low then the risk premium would be low and visa versa.

PROSPECTIVE INCOME FLOW
When valuing a majority interest, projected accounts for two to five years, including funds flow statements, should be prepared.

If the prospects are for rapid growth in the short and medium term, the prospective rate of return on capital employed would probably exceed the long term average. For the long term, the valuer will have to make a judgement as to the average rate of return on capital employed for mature companies in the trade or industry.

SUSTAINABLE GROWTH
Growth in profits is the product of profits retained and the rate of return on capital employed. For example, if the prospective average rate of return on capital employed for the period 1990 to 1995 is 20% and, on average, 90% of the profits will be retained, then the prospects for the period 1990 to 1995 are for growth in profits of 18%, ie, 90% of 20%. This concept of sustainable growth is used in valuing income in the longer term.

INVESTOR'S PROSPECTIVE INCOME
The prospective available cash which the company is producing is generally not fully receivable by the investor - additional income tax may have to be paid on its receipt: it is only the net (after tax) cash which is of value to the investor.

PRESENT VALUE OF INCOME
The present value of the investor's prospective income is got by discounting it to its present day value.

Investment analysts use a formula or model for ascertaining the present value of future income. It's simplest form is

$$\frac{D}{R - G}$$

where D = dividend/income
R= required rate of return
G = sustainable growth

It is called a dividend discount model (DDM) or Gordon's valuation model - he was the first to apply it to investment income.

In practice, analysts use variations of the DDM, details of which can be got from most books on modern investment theory.

OTHER VALUATION METHODS
Other methods, such as, a multiple of profits or net assets per share are so remotely and indirectly related to the fundamentals, ie, prospective cash flow to the investor, its timing and related risk, that they should be avoided when valuing any holdings, quoted or unquoted.

Nevertheless, they are used as proxy methods by practitioners for commercial and fiscal purposes despite the almost inevitable over-valuation of the shares. An examination of the basic components of a multiple of earnings approach shows how indirectly related it is to the fundamentals;

MULTIPLE OF EARNINGS
This approach takes no account of:

(a) prospective profits - past profits are invariably used;

(b) future investment needed in fixed and working capital;

(c) the future tax profile of the company being valued;

(d) the prospects for distributable cash;

(e) the timing of cash flow to the investor;

(f) the future tax profile of the investor - he invariably will have to pay additional income tax and levies on cash received;

(g) the related risk, expressed as the rate of return which an investor would require for such a company - not to be confused with net yield, which is the required rate of return less average growth.

NET ASSETS PER SHARE
In addition to suffering from the same defects as a multiple of earnings, this approach ignores the fundamental concept of a share. As a member of a company, a shareholder is bound by the articles of association, which set out his rights and obligations, such as, a right to vote, to a dividend, etc.

He has no right to a proportionate share of the company's assets. This view is well established in case law. In the Irish case; HM Attorney-General v Jameson KB Division (1903) at page 669, Kenny J. stated: "No shareholder has any right to any specific portion of the company's property..." and at 670 "There is no interest in land, legal or equitable, vested in the defendants by the reason of their testator's membership in their company".

Example:
Shareholders in Company A invest £1m in 250,000 shares of £1 each (£3 premium) which is invested in a process to produce X number of Y goods per annum.

Shareholders in company B invest £¼m in 250,000 shares of £1 each. This company has a team of experienced process engineers who identify new methods of production which require an investment of £250,000 to produce X number of Y goods.

In all other respects: future profits etc. both companies are identical.

(a) Are shares in company A four times more valuable than company B? - on a net asset per share basis they are;

(b) Are shares in each company of equal value? - on a multiple of earnings they are, or

(c) are shares in company B more valuable? - less expenditure will be required on the replacement of plant which will result in higher cash flow to the shareholders in company B.

Which company would you invest in and why?

If you'd invest in company B you understand the fundamental principle of investment analysis; whether the holding being valued is a majority or minority shareholding, always remember cash is the real thing.

SPECIAL PURCHASERS
Many, if not most commercial purchases of unquoted shares are by special purchasers who for one reason or another are willing to pay in excess of the investment value of the shares.

In valuing shares for fiscal or tax purposes, it is established case law that the extra sum that could be obtained from a special purchaser is not an element in the open market or investment value of the shares and that value should not be increased by the extra sum, unless a special purchaser is known to exist and is likely to pay the extra sum.

SUMMARY
In summary the only thing of value to a shareholder is the right to a future flow of income. That value is determined solely by the amount of cash the investor anticipates, the timing of receipt and the related risks. That right to the future income may be disposed, however, the proceeds are determined solely by the purchaser's expectation of cash flow etc.