WHERE THEY GO WRONG

TRAPS IN SHARE VALUATIONS

by WAYNE LONERGAN

The recent shake-out in equities markets may have exposed some fundamental wrong-thinking in conventional approaches to share and company valuation — and the results could include damaging litigation.

The combination of (until recently) an excessively bullish equities market, frenzied takeover activity and highly publicised and expensive acquisitions in the media industry has set an interesting backdrop for an analysis of some significant errors which have occurred recently in valuation methodology.

Given the recent collapse in the equities market, it is my belief that there will be, at best, some very disappointed investors and boards of directors, and more probably some serious professional negligence writs against preparers of valuation reports in the recent equities market.

It is clear from the table of the average price-earnings ratio of industrial shares over the last 25 years that market multiples, prior to the recent collapse, were significantly higher than prevailed since the 1971 mining boom. My views on whether these halycon heights were ever justifiable (eg, by economic fundamentals, internationalisation of financial markets, weight of money arguments etc.) is outside the scope of this paper. Suffice it is to say the market was very high compared with the investment experience of the majority of "operators" and valuers in the Australian market.

Simply put, even if the correct valuation methodology is applied, considerable care must be taken with the application of high price-earnings multiples in an inflated equities market. All valuations should be clear as to the use to which they are put (eg, an asking price or value for loan purposes). They should also make it abundantly clear that if multiples are at a historic high point then such values may not be sustained for any prolonged period.

The valuation of a controlling shareholding is normally based on the capitalisation of future maintainable profits. Without digressing into the mechanics of the determination of either the capitalisation rate (ie, price-earnings ratio) or the assessment of future maintainable profits, this is the most common methodology used in practice. The asset backing in most companies is normally relevant only to an assessment of the apparent ability to maintain estimated levels of profit in the future, rather than the basis of valuing a company.

However, the controlling shareholder does have the ability to liquidate the company (or at least the underlying assets) so that the value of that shareholding is normally no less than that shareholder's proportion of the estimated realisable value of the net assets of the company. Accordingly, asset values can constitute the determinate of corporate wealth for a company holding real-estate or other assets which are surplus to operating requirements, or where, because of the stage of establishment of the business, or industry conditions, the outlook for a particular company's future

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earnings is either somewhat uncertain or the capitalised value of such earnings is less than the net realisable value of the assets employed.

In the case of conglomerates or companies with major divisible business segments, the appropriate valuation methodology is to examine each business segment. For those segments where the earnings basis approach is most appropriate, the future maintainable profits are capitalised at a rate appropriate to that business segment. Consideration is again given to the asset backing in order to form an assessment of the apparent ability to maintain the estimated levels of future maintainable profits of the segments. Appropriate adjustments also need to be made for any assets which are surplus to operating requirements.

For the purposes of most valuations it is not necessary to consider any extra value that might be paid by a "special purchaser". A special purchaser is one who as the result of potential economies of scale, reduction in competition, or other factors (not all of which may be commercially logical) is willing to pay a value over and above other purchasers. If the purpose of the valuation is to provide an opinion as to the fair market value to be attributed to shares in a company then it is not appropriate to include a premium which may or may not be paid by a special purchaser.

Similarly, care has to be taken in looking at comparable sales that these sale prices do not reflect special purchasers.

Having determined the value of the business as a whole, it is necessary to consider the components of that total value. The components are: (a) the net operating assets; (b) the identifiable intangibles and (c) a residual amount relating to unidentifiable assets, commonly referred to as goodwill.

Goodwill represents the future benefits of such factors as a superior management and operating team; established brand or company name; market penetration; effective advertising; good labour relations; and the synergistic benefits inherent in diversified and group enterprises.

It is the failure to identify the difference between goodwill and identifiable intangibles, eg, licences, mastheads, etc., that is the major conceptual weakness in many of the valuations currently being prepared.

The correct or proper valuation of an identifiable intangible takes into account the following characteristics: (a) The value must relate to the realistic future profits to be generated from them; (b) They must be valued after taking into account the correct valuations of the other net operating assets; (c) They must be transferrable; and (d) They must be of an enduring nature.

In placing a value on (say) a television licence or masthead regard must also be had to the scarcity of licences and regulatory restrictions effecting their use, the cost of replacement or acquisition, their transferability, whether it is essential to the business and other related factors.

It is noticable in many valuations that future maintainable earnings after tax assume a lower than normal taxation rate. Such differences may be attributable to legitimate timing differrences (although in practice these are more often unfavourable than favourable given the cessation of investment allowances and the current tax regime), the benefit of carried-forward losses, etc. Whilst these items may legitimately result in a company being able to generate a lower-than-normal taxation charge, it is generally unlikely that such a reduced charge would persist over any prolonged period.

For example, a company with future maintainable profits (FMP) before tax of \$1 million, price-earnings ratio (PER) of 15 but a tax rate of only 20 percent should be valued using normal tax rates, with an appropriate allowance being made for the (temporarily) lower tax rate:

	\$M
FMP \$1m less tax 49% x (PER of 15)	7.65
Add net present value of low tax rates (49% less 20% x \$1m) say	.29
Value of company	7.94

It is clearly incorrect to value the company at \$12 million (FMP \$1m less 20 percent tax, ie, \$800,000 x PER of 15 equals \$12 million) unless the low tax rate will continue for 15 years.

Where the reduced taxation charge is attributable to taxation planning (particularly of a more adventurous sort) it is particularly difficult conceptually to believe that a smart taxation plan, which may or may not be subject to successful challenge, penalties, etc. by the Taxation Commissioner, could have a capital value represented by a price-earnings multiple (say 15-20x for many industrial companies) of the taxation saved in any one year.

For example, a company with future maintainable profits before tax of \$1 million, a PER of 15 and tax losses of \$1.5 million should be valued as

	\$M
FMP \$1M less tax 49% x PER of 15	7.65
Add net present value of tax losses (say)	1.30
Value of company	8.95

Perhaps the most common valuation methodology error made by valuers and boards of directors is to attribute the whole of the difference between the fair value of identifiable tangible assets employed in the business and the market value of that business as being attributable to the valuation of a specific identifiable (non-goodwill) item, eg, a licence.

Arguably, the most subjective and difficult part of the valuation of identifiable intangibles is the assessment of what portion of the total tangibles inherent in the value of a business undertaking should be related to identifiable intangibles (such as licences) and, as a consequence, the residual amount which remains to be classified as goodwill.

It follows that the valuation of goodwill is not a method of valuation per se, but rather a consequence of the valuation process representing the difference between the valuation of the whole of the business undertaking (or at least what was paid for it) and the fair value of the identifiable tangible and intangible net assets.

Clearly, in the valuation of any business to which relatively high multiples apply, appropriate adjustments need to be made to exclude the effect of any borrowings, interest payments and income from sources other than the core business. For example, if a television company has surplus assets of, say, $10 million on interest-bearing deposit earning 16 percent per annum then this would represent an earnings stream after tax of some $816,000. At a current price earnings ratio of, say, 20 times earnings, the valuation would, unless interest income is excluded from the level of earnings being capitalised, present a clearly incorrect answer. That is, $10 million cash on deposit would, unless interest income is excluded from earnings, have a value of some $16.3 million (being $816,000 after tax at an earnings multiple of 20 times).

Similarly appropriate adjustments have to be made to exclude interest expenses and to exclude income from non-core business activities. In other words, unless the valuation methodology presents an answer that: (i) the value of earnings from cash on deposit equals the amount of that cash; and (ii) the detrimental effect of excessive gearing is no more than the fair market value of the excessive debt; then one must question the methodology being used.

On the basis that the most reliable indication of the value of an asset is what a person in arm's length transactions has paid for that asset, the most reliable source of valuation precedent would clearly be, in normal circumstances, such transactions. However, one of the main problems any valuer will face is the location of precedents for the valuation of intangibles, particularly valuations which are publicly available and for which public information reliably reflects the whole of the circumstances surrounding the transaction.

Intangibles by their very nature are integral with the business undertaking and therefore any sale of an intangible is almost invariably linked with the sale of other net assets of a business undertaking. The part of the total consideration attributable to the intangible is not normally separately or readily identifiable. The extent to which the value of intangible assets represents goodwill and the extent to which it is attributable to identifiable intangibles such as licences, etc, in many circumstances cannot be calculated with mathematical precision. It is nevertheless necessary to form a view on the reasonable allocation of the value of those elements of the business which might support their existence.

In the case of television and radio licences a significant proportion of this value is normally attributable to those items. However, it is equally clear that the whole of the value implicit in recent television acquisitions should not be attributable to the value of licences.

A simplistic example is in the case of capital-city radio licences in Sydney (or Melbourne) where there are upwards of 10 radio stations, each (with a few exceptions) broadcasting on adequate signal frequencies capable of reaching the majority of people in the metropolitan areas. In this market the value of a radio licence of a loss-making station should, if the value of the licence only is being considered, be equivalent to the value of an equivalent licence operated by any of the other Sydney or Melbourne radio stations.

Most boards of directors will not stand for a situation where book-keeping drives decisions. And even fewer boards will have their post-acquisition results distorted, as they see it, by writing-off goodwill.

Accounting standards

Many analysts have difficulty in understanding why the question of amortising goodwill has created so much heat and so little light. Clearly the amortisation of goodwill has no effect on the actual annual cashflow of a corporation. Despite what accountants may write into the books, investment analysts, smart investors and takeover merchants all over Australia will simply add back the amortisation of goodwill in their analysis, on the basis that it has no cash effect.

This notwithstanding, in recording the amount of goodwill and other identifiable intangible asset values in any set of accounts, due credence ought to be taken of the requirements of accounting standards and their impact on commercial thinking. That it is not is a reflection, partly, of directors' attitudes to the accounting treatment of goodwill, rather than to a recognition of the fact that goodwill is often not the asset it is purported to be, but really represents an overpayment in an overheated equities market.

Current Australian accounting standards require that goodwill, if recognised, has to be amortised over a period not exceeding 20 years.

This amortisation is a non-tax-deductible expense and, if correctly calculated in the first instance and correctly amortised in the second, would have such major impact on recorded results that many acquisitions just would not and could not take place.

Obviously, at board-of-directors levels, this is quite unacceptable. Most boards of directors will not stand for a situation where book-keeping drives decisions (a stance with which I have some sympathy).

And even fewer boards will have their post-acquisition results distorted, as they see it, by writing-off goodwill.

Accordingly, it is prevalent practice to get around the accounting standards in various ways. These include the writing-off of goodwill as an extraordinary item immediately upon acquisition.

Of more concern in the long term, is the increasingly prevalent practice of valuing other identifiable intangible assets. Regrettably such revaluations are often to relatively optimistic levels, perhaps occasioned by pressure from the boards who are paying for them, or by a misunderstanding of correct valuation methodology. In some cases they are also motivated by a desire to avoid reducing profits by writing-off goodwill.

Despite the objectives of the NCSC it is clearly marketplace practice that the value of the whole of the company is normally greater than the sum of the values attributable to the shares of that company based on transactions of minority shareholdings in the stockmarket on a day-to-day basis. This difference is often referred to as a "premium for control".

Clearly, in examining any prospectus, valuation, or equity-raising documents, due allowance needs to be made by investors and lenders for the fact that the value of their minority shareholding will, on a pro-rata basis, be less than the value attributable to the whole of the enterprise which is the valuation normally reflected in the accounts or prospectus document.

For example, if a television company with 100 million shares on issue has the following assets:

	$M
Fixed and current assets	30
Licence	60
Goodwill	10
Shareholder's funds	100

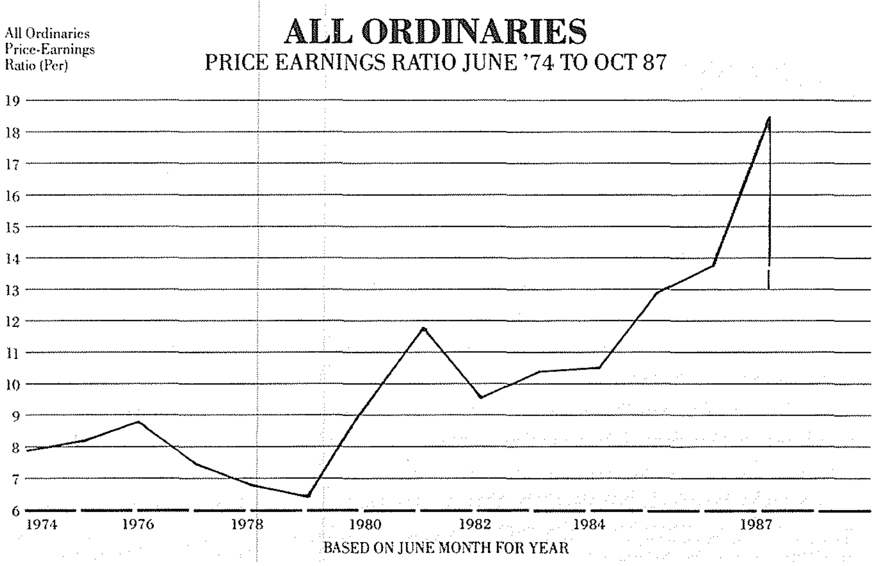
then it is unlikely that a parcel of one thousand shares will have a market value of one thousand dollars. In practice, the market value will be determined by earnings per share and dividend policy. For the sake of demonstrating the principle of the difference between minority and majority parcels, the value of a minority shareholding of 1,000 shares could be as low as, say, $650, calculated as follows:

	$M
Value of Whole	100
Less discount for minority interest (or sometimes called premium for control) say*	35
	65

Divided by 100 million shares:

$$\frac{65}{100} = 65¢ \text{ per share}$$

** I have used 35% for demonstration purposes only. The essential point is that the value of the whole of a company is normally greater than the sum of the number of shares multiplied by the daily share price determined in the absence of a takeover bid.*



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Despite its apparent simplicity, the valuation of shares and businesses is much more of a science than many people (including some who purport to practice the art) believe. I have very briefly set out above some of the conceptual errors commonly made in valuations.

No doubt as the equities market returns to sanity there will be a series of legal actions occasioned by over-optimistic boards of directors seeking scapegoats and angry shareholders and even creditors seeking redress for losses sustained.

I base this belief on the following:

- The equities market has recently risen to, and fallen dramatically from historically high levels;
- Valuation methodology is misunderstood by many valuers and investors;
- Due allowance needs to be made for the impact on the market of special purchasers;
- Special taxation gains are unlikely to persist in the long term;
- The component elements of intangibles are not being clearly distinguished;
- The problems in valuing intangibles are not properly understood;
- The effect of interest income and expense needs to be eliminated from the earnings being capitalised;
- Different sorts of income should be capitalised at different capitalisation rates;
- A desire to avoid the requirements of accounting standards has resulted in the proliferation of the valuation and sometimes overvaluation of other intangible assets;
- Adequate allowance is not being made for the difference between the valuation of the whole of an enterprise and the valuation of minority interests.

One of the first places that litigants will look to for redress will be the "expert" reports prepared by "independent" valuers. It is my belief that, even if everything else is correct, many valuations will be found wanting because of simple errors in their basic logic. □