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Scaling for Risk when Valuing Privately-Held Businesses

Risk is the degree of certainty or uncertainty associated with a given investment. Our mission has been to devise a systematic way of analysing, and then allowing for, financial risk in the subject entity. For this paper, subject entity refers to a privately-held business (non- public ownership) in any country which applies the GAAP (Generally Accepted Accounting Principles) framework.

In valuing privately-held businesses it is common for there to be a lack of reliable forecasts of future cash flows. When available, the more rigorous and indeed preferred valuation method is the Discounted Cash Flow (DCF) method. In the absence of cash flow forecasts the Valuer can resort to alternative income valuation approaches, of which the most common is the Capitalisation of Earnings method. The Valuer may sometimes use a Market approach and adopt what is known as the comparable transactions (market or industry) method. Under each method lies a common metric; the earnings multiple.

The earnings multiple is simply the inverse of the rate at which a normalised/stabilised single period income or benefit stream is capitalised. When applied as the divisor, the earnings multiple is the result. For example, a capitalisation (cap) rate of 25% is equivalent to earnings multiple of 4. The cap rate converts a representative single income stream, through division, to an estimate of present value. The rate applied is deemed to reflect the risk (degree of certainty or uncertainty) of the benefit stream.

Under the capitalisation of earnings and the comparable transactions methods, the reason for the use of which has been mentioned above, it is an implicit assumption that the expected level of earnings is constant in perpetuity. This is cited as a criticism of these methods, however a lack of robust forecast cash flows in the privately-held business sector can leave little other choice.

The level of risk perceived to be associated with an investment normally determines investors' required rate of return (RoR). This is the rate expected or demanded by an investor in order to attract capital to the subject investment after allowing for risk. It is not the same as the discount rate used in the DCF method. The DCF discount rate is the cost of capital.

Under the capitalisation of earnings method, and implicitly under the comparable transactions method, the cap rate and the required RoR are taken to be the one and the same.



The investor is investing in a standalone business entity with unique financial performance characteristics; the investor is not investing in "the market".

We have devised the 'Finverso Index' (see www.finverso.com) as a way of assessing the quality of income streams feeding into earnings and as a consequence, a measure of the financial risk for that particular business. The index scales the investor's required RoR (noting RoR equals the cap rate) without entity specific analysis to risk scaled (i.e. that based on entity specific analysis). Excellent quality of earnings, scored by the Finverso Index as 100/100, will equate to the required RoR.

If the investor does not specify a required RoR, Finverso defaults to 17%. This rate is based on market evidence (principle of substitution) that better performing privately-held businesses in Australia are currently selling at 6x EBIT.

However, it is the reality that there exists no identical or near identical businesses and a desired RoR is not necessarily what will be achieved. What one wants and what one gets can be very different.

Finverso scales the required RoR for the assessed riskiness attached to the benefit streams that feed into profitability (i.e. earnings). The benefit streams assessed and scored are cash flows (each of free cash flow-max.15 points, sustainable cash flow-max.10 points, cash gain/drain-max.25 points), margin of safety-max.30 points and return on net operating assets-max.20 points. Maximum 100 points.

Maximum points will equate the earnings multiple (EM) with the required rate of return and cap rate. Note again that under the capitalisation of earnings method, and implicitly under the comparable transactions method, the cap rate and the required RoR are taken to be the one and the same. Why is this? It is because of the implicit assumption the expected level of earnings is constant in perpetuity as no growth factor can be reliably substituted.

How does the EM equate?

Say the investor's required RoR is 25%, then the earnings multiple is the inverse of 25% at **4 times** (i.e. $100/25$). If Finverso scores actual and/or forecast financial performance as 100/100, then 100 points divided by (25% of 100) = **4**

Thus, for any given score at any given required RoR/cap rate, the earnings multiple will be calculated.

Why do we scale the rate of return and as a consequence, the earnings multiple? Why not just accept what the industry is reporting in supposedly comparable transactions or what the vendor is asking? The short answer is we are rigorously seeking to analyse the quality of the benefit streams that feed into profitability and scale the resultant earnings multiple accordingly. If the required RoR cannot be demonstrated as actually being achieved or likely to be achieved, the valuation of the business should be impacted accordingly. Why should a business be otherwise valued on a "wished for" return basis?



A comparison can be drawn on why we scale the business being valued to that of "the market", or indeed how we derive earnings multiples without any market indicator. A high school student (aka "the privately-held business") undertakes examinations and assessments together with other students from other schools (aka "the market").

Following is a comparative table, the underlying premise we believe supports, scaling student results (privately-held business) to a "scaled assessment".

STUDENT	FINVERSO's Privately-Held Business
Subjects studied and examined (e.g. Maths, English, Chemistry)	Benefit streams identified and analysed (e.g. Cash flows, Margin of Safety, RNOA)
School assessment mark submitted	Required rate of return submitted
External Examination undertaken	Business entity's benefit streams examined and scored
Final assessment - scaled assessment mark	Financial performance assessment - scaled earnings multiple (EM)

Scaling the **student's** school assessment mark up or down against the external examination mark has the effect of countering any assessment bias at the school level. If the external examination mark is lower than the student's school assessment mark, then the school assessment mark will be scaled lower (vis-a-vis a scaled assessment). The converse also holds true.

Scaling notional earnings' multiples up or down following Finverso's financial performance analysis has the effect of scaling expectation bias at the investor (or vendor) level. The lower is the scored performance, then at any given notional RoR, the lower will be the earnings multiple. The converse also holds true.

The scaled earnings multiple is entity specific and arguably better reflects the anticipated economic benefits from the subject entity. Scaling of financial performance (actual and/or forecast) in turn scales the earnings multiple and by resultant association, the effective RoR.

Let's now turn to an example.



Example

- Investor's required RoR is 17% based on what is believed is the market rate in which the business operates. This implies an earnings multiple of approx. 6x (times) (i.e. $100/17$).
- Finverso's financial performance assessment scaled the earnings multiple (EM) down to 4.01x because the quality of the entity's assessed benefit streams did not score 100/100; instead scored 67/100.
- EM of 4.01 equates to a RoR of 24.9% (i.e. $100/4.01 \times 100\%$). The investor's initially required, or notional RoR, was 17% however the assessed financial performance results are such that this RoR is unlikely. There is potentially higher risk attached in paying too much for the investment if the asking price is left unnegotiated downward.
- The capitalised value of the subject entity using the Finverso Index method adjusts an established market or industry RoR exclusively to that commensurate with the financial performance of the subject entity. Depending on performance, the RoR/EM may in fact equal a market rate. We most often find however the RoR needs to be higher (and commensurate EM lower) because of sub-optimal financial performance in one or more of the performance results we measure.
- It is worth noting that the example provided above shows a downward scaling, however it should not be implied that all instances of scaling will yield a reduction.

Conclusion

This paper challenges the application of untested and broad industry multiples being mechanically applied when valuing privately-held businesses. Striking an industry multiple can be representative of a highly diverse population. Applying without regard to a specific entity's embedded financial performance characteristics other than just EBIT, EBITDA or whatever profitability result, can potentially misestimate risk.

Instead, we put forward a systematic way of applying more rigour when analysing the financial performance of a privately-held business. We aim to allow for entity specific financial risk in determining an appropriate range of earnings multiples at which to capitalise sustainable earnings.

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May 2026