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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) which applies 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; 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 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 an earnings multiple of 4 (or 4x). 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 it is implicit 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 the cap rate and the required RoR are taken to be the one and the same.

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For use when valuing privately-held businesses we have devised the 'Finverso Index' 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 (see www.finverso.com). After all, the investor is investing in a standalone business entity with unique financial performance characteristics; the investor is not investing in "the market".

The index scales the investor's required RoR (noting RoR equals the cap rate) for the assessed riskiness attached to the benefit streams that feed into profitability). Excellent quality of earnings, scored by the Finverso Index as 100/100, will equate to the required RoR. If scored <100, the required RoR will be scaled lower.

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.

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. 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 consequently the earnings multiple? Why not just accept what the industry is reporting in comparable transactions or what the vendor is asking? The short answer is all businesses are inherently different, so we seek to analyse the quality of the benefit streams that feed into profitability and scale 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 both the investor and 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. The implied earnings multiple (EM) is therefore ~6x (times) (i.e. 100/17).

- Finverso's financial performance assessment scaled the EM down to 4.01x because the quality of the entity's assessed benefit streams did not score 100/100; instead scoring 67/100.

- EM of 4.01 equates to a RoR of 24.9% (i.e. 100/4.01x100%). The investor initially required 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 inferred that all instances of scaling will yield a reduction.

Conclusion

This paper challenges the application of untested 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 financial performance characteristics can potentially misestimate risk.

Instead, we have put forward a systematic way of applying more rigour to allow for entity specific financial risk when determining an appropriate range of multiples from which to capitalise normalised earnings.

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