Valuation in Disputes: Navigating Uncertainty

‘Value’ is often understood as the sum of cash that would be exchanged for a particular asset in a hypothetical transaction. Value therefore depends not just on the characteristics of the asset, but on the assumptions about that transaction, including:

- The date of the transaction
- The identity and characteristics of the potential participants in the hypothetical transaction
- Their motivations
- Their knowledge of the subject matter of the valuation

Consequently, before embarking on the valuation of any asset, it is important to set the parameters of the valuation question, often referred to as the ‘basis of valuation or ‘valuation standard’. ‘Market value’ or ‘fair market value’ are two of the most frequently encountered valuation standards in disputes.

Valuation methods assess value by considering expectations of risk or growth, either explicitly through discounted cash flow analyses, or implicitly through observations of the prices at which comparable companies transact. In some situations, such methods can be challenging to apply. This might be because the asset has a limited track record, operates in an uncertain environment or lacks close comparators.

In such circumstances, the history of the company or asset may help a valuer navigate the uncertainty. Transactions in the subject asset at earlier dates, offers for the business, or attempts to market the business at a particular price can all provide indicators of value that help anchor the valuation, or provide directional guidance to its valuers.

Key Questions When Considering Valuation Issues

The value of a business, or other asset, depends on the expected future benefits from holding that asset and the uncertainty associated with those benefits. Valuers must often form opinions on value based on their assessment of future benefits and uncertainty at a given date. This is a challenging task in relation to many assets. It can sometimes be particularly challenging for expert valuers in the context of disputes.

How should experts, tribunals and courts approach valuation questions, given these challenges? What do we mean by value? How do we define the valuation question? What are the valuation standards frequently encountered in litigation and arbitration? What are some common valuation methods and how can a valuer seek to navigate the uncertainty that can exist in valuing businesses and other assets?

Defining Value

In investment treaty arbitration, the standard of compensation is often referred to in the relevant treaty, which provides clarity and certainty by setting the parameters for determining value and for assessing damages. In commercial arbitrations and litigation before national courts, the parameters for determining value may be less clear and can be contingent upon the governing law if not specified in the contract between the parties.

Before considering valuation in the context of arbitration and litigation, it is helpful to consider the meaning of the term 'value' in a broader context. Simply put, 'value' is often understood as the sum of cash that would be exchanged for a particular asset. That sum depends not just on the characteristics of the asset, but also, critically, on the assumed context.

As an illustration, the sum that an owner of an asset would accept in exchange for that asset if they were deprived of it could be quite different to the sum of cash that buyers might pay for that asset if the owner wanted to sell it on a given day. For instance, the owner may benefit from synergies that are not available to the buyers in the market for the asset in question, or there may not be many readily available buyers. This gives rise to the need to define the circumstances of the hypothetical exchange.

The International Valuation Standard Council ('IVSC'), states:

"Value is not a fact but an opinion of either: (a) the most probable price to be paid for an asset in an exchange, or (b) the economic benefits of owning an asset. A value in exchange is a hypothetical price and the hypothesis on which the value is estimated is determined by the purpose of the valuation. A value to the owner is an estimate of the benefits that would accrue to a particular owner from ownership."[1]

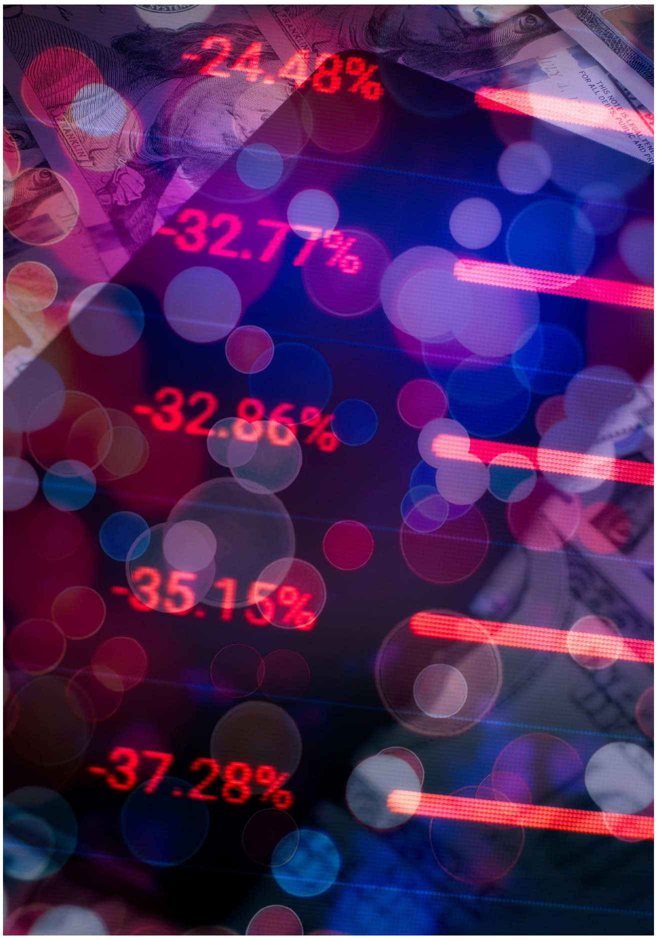
This introduces two connected measures of value. The first, 'value in exchange', relates value to the hypothetical price that would be agreed upon for an asset in an exchange between a buyer and a seller. The second, 'value to the owner', relates value to the benefits that would accrue to the owner of the asset.

In some circumstances, these two measures will be the same. An owner of an asset would not voluntarily accept a price in exchange that is lower than their estimate of the value that would accrue to them from continuing to hold the asset. Conversely, a potential buyer of the asset would not pay a price that is higher than their estimate of the value that would accrue to them from holding the asset following the exchange. Providing the benefits of ownership are the same for both parties in the hypothetical exchange underlying the 'value in exchange' estimate, and those benefits are also the same for the owner of the asset in the 'value to the owner' estimate, then the two measures of value should in theory be the same.

Though this will not always be the case. The 'value in exchange' might be estimated on the basis of a hypothetical buyer and seller, neither of whom generates any synergies through ownership of the asset. By contrast, the 'value to the owner' might be estimated on the basis of an owner who generates significant synergy benefits through ownership of the asset that are particular to him or her. In those circumstances the 'value to the owner' would be higher than the 'value in exchange'.

Where value is linked to a price in a hypothetical transaction, the fundamental assumptions about that hypothetical transaction and its circumstances affect the resulting estimate of value. Those fundamental assumptions are usually about:

- The date of the transaction
- The identity and characteristics of the potential participants in the hypothetical transaction
- Their motivations
- Their knowledge of the subject matter of the valuation



The Valuation Question

Different sets of assumptions can lead to different valuations for the same asset. For example, the sale of an asset in an orderly transaction, between two knowledgeable parties who conduct adequate due diligence, where neither party is under financial duress, will yield a particular estimate of the price that would be agreed upon. That price would differ if instead, it was assumed that, for the same asset, the transaction took place on a 'fire sale' basis, with the vendor in financial distress – a circumstance in which the due diligence conducted by the potential purchaser of the asset might be much reduced. Similarly, an estimate of 'value to the owner' will depend upon the characteristics of the owner of the asset, and the benefits that he or she would therefore enjoy from its ownership.

Consequently, before embarking on the valuation of any asset, it is important to set the parameters of the valuation question. Does the valuation relate to 'value in exchange' or 'value to the owner'? What are the other assumptions underlying the valuation? The answer to those questions will ultimately depend on the purpose of the valuation, and on the choice of parameters, which is often referred to as the 'basis of valuation'. Valuation standards provide a framework for common bases of valuation.

Fair Market Value

'Market value' (also often used interchangeably with the term 'fair market value') is one of the most frequently encountered bases of valuation in disputes. Ultimately, it is the price, expressed in cash or cash equivalents, that a willing and able buyer would pay a willing and able seller, acting at arm's length, in an open and unrestricted market, where each party had reasonable knowledge of relevant facts, each desired to maximise their financial gain, and neither party was under compulsion to buy or sell.[2]

The consequences of this definition are important for the valuer and should always be borne in mind when considering the available valuation evidence. Whenever we are seeking to determine the (fair) market value of an asset, we are estimating a price: the price that would be agreed upon between a willing buyer and a willing seller.

Factors Affecting Price

It is therefore important to understand what factors affect the prices that a willing buyer and willing seller would be prepared to pay or accept. The factors affecting the price agreed upon for an asset depend on the specific asset and the motivations of the parties to the transaction. For some assets, the motivation for acquiring the asset is the utility of the asset itself. For example, the price paid for a work of art might reflect the utility, in the form of the pleasure of ownership that the owner of the art will receive. However, for the assets that we typically consider in a dispute context, the principal motivations of buyers and sellers are financial. In particular, the motivation relates to the economic benefits, in terms of the cash generated, that can be obtained from ownership of the asset.

When the purpose of ownership is to generate economic benefits from the asset, there are three fundamental factors that affect the price that an asset transacts for.

— ***Expected cash flows:*** The expected cash flows that the asset will generate. This is linked to the current cash flows being generated by the asset, and to the expected growth in those cash flows. The higher the cash flows generated, and the greater the expected growth in those cash flows then the higher the value of the asset.

— **Uncertainty:** The level of uncertainty, or risk, around the expectations of cash flow growth. Investors are generally risk-averse, and therefore the greater the uncertainty around the expected cash flows then the lower the value of the asset.

— **Availability of alternatives:** The availability of other assets. Buyers and sellers do not consider prices of assets in a vacuum. They will compare them with other assets that are in a market with similar characteristics, in terms of risk and growth, and the prices of those assets.

Assumptions made, either implicitly or explicitly, about the growth and risk of the cash flows generated by an asset affect all valuations. Consequently, the price that two parties agree for an asset is linked to expectations about the economic prospects, in terms of growth and risk, that a buyer and seller have regarding the asset in question.

The price that any party would be willing to pay for an asset, or for which it would agree to sell it, depends on the expectations of that party. Different investors can have very different expectations. Even if those expectations are informed by a common set of information that is available to them, two investors might interpret the information differently – whether about the asset, the market it operates in, and the overall economy. In other words, in the same way that macro-economists have a wide range of views about the prospects of the economy, investors are likely to have an equally wide range of views about the prospects of a business.

This leads to an important conclusion — outside well-functioning and liquid markets, assets do not have a single, objective value. Value is a function of price, and price is a function of expectations. Different investors can have different expectations. Expectations change over time as new information becomes available and conditions change. Value is not a constant, immutable fact. Perspectives on value can differ from person to person and over time.

Uncertainty And Value

The role of the valuer in arbitration and litigation is usually to estimate what price would have been agreed upon for an asset (the ‘subject asset’) between a buyer and seller at a particular point in time (the ‘valuation date’). This means that the valuer must consider what expectations a hypothetical investor would have held at the valuation date regarding the economic prospects – in terms of both growth and risk – of the asset that is the subject of the valuation, and how a price would have been derived from those expectations.

There is a degree of uncertainty inherent in many valuations. However, the extent of that uncertainty depends on the available evidence. In circumstances where there are transactions involving the subject asset on the valuation date, a valuer can identify prices at which parties were agreeing to buy and sell the subject asset with certainty.

If there are no transactions in the subject asset on the valuation date, but there are transactions involving the subject asset that were carried out prior to the valuation date, then the challenge starts to increase. The valuer must assess how expectations have changed over time and how that would affect value. If there are no transactions involving the subject asset prior to the valuation date, then the challenge increases even further. The valuer must consider the extent to which expectations about growth and risk can be inferred from transactions in other assets. Either by looking at transactions in the same industry, or alternatively build up their own view about the growth and risk prospects of the subject asset and consider the price that an investor would pay in light of those views.

The uncertainty may be magnified in circumstances where assets have characteristics that make them either difficult to compare to other assets, or which make it difficult to formulate reliable expectations about their future performance. For instance, this may occur when an asset is relatively new, or operates in a market that is undergoing rapid change.

Sometimes the uncertainty in a valuation leads to the view that valuation is ‘more of an art than a science’. In our view that is an unhelpful perspective. While there are many definitions of ‘art’ and ‘science’, ‘art’ is associated with fundamentally creative processes. ‘Science’, in contrast, is associated with a disciplined study of the world – observing facts and developing hypotheses and predictions that can be tested. In our view, approaches that are likely to be associated with ‘science’ are much closer to good valuation practice. The uncertainty present in many valuations is the reason a valuer should do all they can to study the available evidence, derive theories about value and test those theories carefully. Labelling valuation as an ‘art’ can be used as justification for paying insufficient attention to these principles.

Valuation Methods

In some circumstances, the valuer has access to clear observable market data, such as transactions in the shares of the subject asset on a well-functioning and liquid stock market in a mature country. These types of data are likely to provide the best evidence of the price that would be agreed upon between a willing buyer and a willing seller. This is because such transactions reflect actual buyers' and sellers' assessments of the future benefits of holding the asset and the uncertainty in those assessments. However, in most circumstances in litigation and arbitration, such data is not available and the valuer needs to rely on other evidence.

Market Multiples

Where there is insufficient or no reliable data on transactions in the subject asset, an alternative method can be used based on market multiples. These can be calculated based on the observed prices of transactions in comparable assets.

Examples of market multiples are 'P/E multiples', which are the ratio of price per share to earnings per share; 'EV/EBIT multiples', which are the ratio of enterprise value ('EV') to earnings before interest and tax ('EBIT'); and 'EV/EBITDA' multiples, which are the ratio of enterprise value to earnings before interest, depreciation and amortisation ('EBITDA'). The various ratios that are calculated from observed prices of transactions are reviewed, analysed and adjusted, and a representative multiple, or often a range of multiples, is thereby determined. That multiple, or range of multiples, is then applied to an appropriate corresponding measure of profitability of the company that is the subject of the valuation.

To apply market multiples, it is necessary to identify transactions in the shares of comparable companies. For this purpose, one must select companies that share economically relevant characteristics with the company that is the subject of the valuation. These are characteristics that determine the growth prospects and risk of the company and can include the industry in which it participates and its geographic location.

Discounted Cash Flow Analysis

Discounted cash flow ('DCF') analysis involves determining the present value of future cash flows by discounting these cash flows back to the date of valuation at an appropriate discount rate. In practice, DCF analysis involves the valuer making a series of assumptions in respect of forecasted cash flows and the discount rate, with growth and risk also taken into account.

Both the DCF and the market multiples valuation methods rely on market data. A market multiples valuation method relies on market data directly through the use of data on the price and financial performance of comparable companies. A DCF analysis relies on market data indirectly, since the performance of comparable companies is often used as the basis for the growth forecasts and market data provides the inputs to the discount rate — for instance, estimates of the equity risk premium, a key input in most discount rates, are based on observed stock market returns. As the level of uncertainty associated with the prospects of the company at issue increases, such as for a start-up business, it may become more difficult to develop appropriate assumptions for these inputs.

The key challenge when applying market multiples is determining which companies are truly comparable. The key challenges when applying DCF analysis are identifying appropriate assumptions for the expected growth of the cash flows, as well as the level of risk that ought to be reflected in the discount rate.

A Route Through Valuation Challenges

Assessing the value of a business may be more challenging when the business has a limited track record of financial performance, making it difficult to use historical data as a basis for assessing expectations of future financial performance. Similarly, where the market environment in which the business operates is volatile, this makes it difficult to form reliable expectations of future financial performance. Both of these situations make it challenging to apply the DCF valuation method.

On the other hand, it can be difficult to apply the market multiples method where there are few, if any, comparable businesses with similar economically relevant characteristics, operating in similar environments.

Where available, evidence of indicators of value can provide a route through the uncertainty that these challenges create. This might include transactions in the asset or company under consideration at an earlier date than the valuation date, offers for the business or potential sales, or unsuccessful funding rounds or bids for the business that were not completed.

For example, suppose a DCF analysis yields an estimate of the value of a business of $100 million at a particular date, say 1 January 2012, and a market multiples analysis yields an estimate of value of $85 million. Based on this analysis, an expert valuer might arrive at a valuation that lies in the range between the two estimates. However, the characteristics of the asset might mean there is considerable uncertainty around that range.

Suppose also that the business was acquired three years earlier, on 1 January 2009, for a price of $50 million. That transaction represents the price a willing buyer and willing seller agreed upon for the asset, albeit three years prior to the valuation date.

By explaining the ways in which the characteristics of the business, and the environment in which it operates, have changed between 2009 and 2012, and understanding the associated changes in expectations of growth and risk, a valuer may be able to test the conclusions drawn from the DCF and market multiples analysis.

If it can be shown that over that period the prospects of the company have improved significantly, for example through changes in commodity prices, an improved political environment or other macro-economic factors, that may increase a court or tribunal's confidence in a valuation in the range of $85 million to $100 million. Such analysis can be enhanced by also examining how the value of comparable companies has shifted over time.

Conversely, if the conditions in which the business operates have deteriorated between 2009 and 2012, that potentially helps demonstrate that the DCF and market multiples analyses are unlikely to be reliable.

This kind of analysis can be particularly beneficial in circumstances where courts and tribunals are faced with experts positing very different valuation conclusions. In some circumstances two competing DCF models may have been presented by two different experts: one yielding a very large value and one a small value. The models are sensitive to changes in the input assumptions, and there is no middle ground between the experts. There may also be no reliable data to calculate market multiples based on comparable companies.

The history of the company or asset may help address this divergence. The available facts may 'anchor' the value or provide directional guidance such that it is clear that one of the asserted values is too low or too high. In our experience, experts can sometimes overlook or underplay the importance of such evidence and instead focus too much on DCF models and arguments over the appropriate inputs to their respective models.

Final Thoughts

Valuation methods assess value by considering expectations of risk or growth, either explicitly through discounted cash flow analyses, or implicitly through observations of the prices at which comparable companies transact. In some dispute contexts, such methods can be challenging to apply. This might be because the asset has a limited track record, operates in an uncertain environment or lacks close comparators.

In those situations, the scope increases for two experts to present very different views of the value of an asset. That might be because they make different assumptions in connection with a discounted cash flow analysis, or they have different views about comparable companies.

The history of the company or asset may help the expert, and ultimately the court or tribunal, navigate between those competing views. Transactions in the subject asset at earlier dates, offers for the business, or attempts to market the business at a particular price can all provide indicators of value that help anchor the valuation, or provide directional guidance to its valuers. These indicators can cut through disagreements about specific parameters in a valuation methodology by providing overall cross checks or guidance to the valuation.

Reproduced with permission from Law Business Research Ltd. A previous version of this article was published in April 2016 and can be found here: https://globalarbitrationreview.com/review/the-middle-eastern-and-african-arbitration-review/2016/article/valuation-in-international-arbitration

Endnotes

1 International Valuation Standards Council – Framework and Requirements, at paragraph 8.

2 Canadian Institute of Chartered Business Valuator's International Glossary of Business Valuation Terms – Practice Bulletin 2

NOEL MATTHEWS
Senior Managing Director
+44 20 3727 1353
noel.matthews@fticonsulting.com

ANDREW WYNN
Senior Managing Director
+44 20 3727 1540
andrew.wynn@fticonsulting.com