Uncertainty in business valuations

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On the occasion of a valuation, the objective business value (an often debated question) changes into a proposed value which becomes the decisive criterion for an M&A deal. In view of the differing interests of buyer and seller, it is almost impossible to state an objective value for a business. It is only possible to ascertain subjective maximum or minimum prices on the basis of each party's point of view.

If the focus is also on the subjective valuation in an M&A process, then it must be stressed that the subjective value can only be determined on an objective basis.

Despite objective fundamentals, it is difficult to eliminate uncertainty.

The appropriate commercial value for a business is, in principle, based on the future earnings which the owner will receive.

Using the potential earnings method, the future earnings are discounted at a capitalisation rate. If the planned earnings are one uncertain factor, the determination of the capitalisation rate is even more important. Since, according to the theoretical approach, the capitalised value of potential earnings is the most meaningful factor, the rate of capitalisation is crucial.

Although low-risk government bonds offer low rates of interest, riskier investments give a higher return. And often there is pointless discussion of possible trade restrictions on the investments, which again pushes up the rate of interest.

The sole focus of attention should be: what risk relating solely to the business can be expressed in interest rate percentages.

Deducing the capitalisation rate via the financial structure is probably too simplistic, leaving far too many loopholes. Borrowings can significantly reduce the capital costs and therefore influence a "standard calculation".

In a negotiating process, it is the future market situation – alongside all the ratios – that decides the price (business value). If an accurate definition can be arrived at via the risk, that will have a decisive influence on the negotiations concerning the value of the business.

Only listed companies really have a market value. M&A advisors therefore have the task of collating all the information from the sector into a coding and expressing it accordingly in a risk mark-up.

The "theoretical" capitalised value of potential earnings method is thus derived from an "external" approach, and will be similar to a calculation using multiples.

The following are key points of uncertainty which need to be clarified and eliminated:

- The uniqueness of the business
- The reliability of the fundamentals
- Correct use of multiples
- Stock market values compared to the transaction value.

Apart from skill and experience, it therefore also requires creativity to state the market risk or the risk in general by using interest rates.

A challenge that will entail sensitive involvement to guarantee both negotiating partners the subjective success that will be achieved if the valuation arguments are carefully prepared.

The future must belong to the exact coded rate of interest for market risk, rather than the WACC (Weighted Average Cost of Capital) which is affected by leverage.

A new debate – a key element in successful dealing.

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