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Question 1: Do you agree with the current categorisation and timings of the topics contained in the gap analysis and if not why?

I appreciate the gap analysis, but would like to recommend to reconsider the allocation of Discounts and Premiums to Guidance Notes. Guidance Notes „*provide further information on the practical implementation of IVS and are set at a more detailed level and often incorporate local legislation and mandatory practices. Guidance Notes incorporate material and information on good practice appropriate for particular circumstances.*“ (p. 15) In my opinion Discounts and Premiums need a more substantial discussion and evaluation. A Discussion Paper would be the right place for it.

ad Discounts and Premiums

IVS 105 para. 30.17 concentrates on Discounts for Lack of Marketability (DLOM), Discounts for Lack of Control (DLOC) and Blockage Discounts. I am aware that they are used in many valuations by well-respected valuers, but they stem from real or hypothetical transaction prices. The critical question is, what prices (especially hypothetical ones like market capitalization) can tell about values. The answer is none: A realized price is the observable result of a market transaction. Value is a non-observable financial dimension of utility that is attributed to a good or service by an actual or potential market participant. Rational market participants with financial interests deviate in their valuations from prices. The deviation causes their transactions. Value equals price only by chance or in often used but nevertheless unrealistic settings like the Capital Asset Pricing Model in its basic version, where all fictive market participants have identical probability estimations of one-period returns of the capital assets by assumption.

The market approach using DLOM and/or DLOC suffers from

- (i) theoretical deficiencies because of its confusion between value and price,
- (ii) empirical deficiencies when hypothetical instead of real prices are measured (market cap),
- (iii) empirical deficiencies when transactions are dated far back or stem from markets that differ substantially from those of the valuation object,
- (iv) legal deficiencies, when jurisdictions do not accept shortcuts in order to avoid a more in-depth and detailed analysis.

There are many well-reasoned objections against premiums and discounts in theory and practice because of the following:

- (i) Control does not have value in itself, it does only have value for the buyer by reference to synergy or to greater cash flows or reduced risks which the buyer can obtain by implementing change, cf. Strickland 2015, p. 4.¹
- (ii) The premium represents normal market forces of supply and demand at work, cf. Strickland 2015, p. 8.

¹ Strickland, Andrew (2015), Control Premiums in Business Valuation (2015), A Scrutton Bland Guide, Colchester, September 2015, http://www.scruttonbland.co.uk/sites/www.scruttonbland.co.uk/files/u1736/control_premiums_in_business_valuation_-_updated_2015.pdf.

(iii) „Use of the average acquisition premium in other transactions is a flawed approach. Since the average premium includes the prices paid for companies that buyers viewed as attractive undervalued targets and excludes companies that acquirers considered overpriced or fairly priced in the marketplace, the average premium paid in acquisitions is biased upward. Only a small portion of publicly traded companies are acquired in any particular year.“ (Strickland 2015, p. 8, citing Gil Matthews.)

(iv) Empirical studies of DLOC reveal a wide spread which makes the computation of means or medians meaningless and implies the necessity to search for peers that creates a lot of discretion. DLOC are unstable over time and are often based on only a few observations. Empirical evidence might be found, e.g. in FactSet Mergerstat, Control Premium Studies.

(v) DLOM-Studies disclose similar deficiencies. Evidence might be found cited in Hitchner 2017.²

(vi) The use of discounts and premiums strongly enhances the risk of double counting in the evaluation of cash flows and their risk. It is perhaps – beside (hidden) pursuit of interests – only irrelevant intuition and institutional as well as personal inertia that secures the survival of premiums and discounts.

ad Price vs. Value

According to IVSC a Discussion Paper shall be developed for this topic. That makes sense with respect to the before mentioned objections against premiums and discounts. Alternatively, the issue could be addressed directly through improvements of IVS 2017.

Price and value are not the same

„In October 2015 the IVSC published its Purpose and Strategy Document which stated that the priority of the IVSC is to expand the quality and depth of International Valuations Standards (IVS) and ensure they are fit for purpose and provide much needed clarity and market efficiency.“ (Introduction to Exposure Draft, p. 4)

I will take this sentence as a starting point, since it mentions the quality and clarity of IVS as desiderata. To reach both, price and value must not be confused. In case of confusion, IVS will not contribute to reach their purposes.

As mentioned above, price is the observable result of a market transaction. Value is a non-observable financial dimension of utility that is attributed to a good or service by an actual or potential market participant. Rational market participants with financial interests deviate in their valuation from prices. The deviation causes their transactions. Value equals price only by chance or in unrealistic settings like the CAPM in its basic version, where all fictive market participants have identical probability estimations of one-period returns of the capital assets by assumption.

In reality, there might be good reasons to estimate future prices, and standards might serve this purpose. Nevertheless, price estimation is not the same as valuation.

Misleading terminology in IVS 104 and 105 and its implications

I detect no clear differentiation between value and price in IVS 104 Bases of Value. Market Value, Market Rent, Equitable Value and Liquidation Value are each defined as a hypothetical price in a hypothetical market transaction. Even if one accepts this misleading terminology because of its

² Hitchner, James R. (2017), Financial Valuation: Applications and Models, Fourth Edition, Hoboken, New Jersey.

popularity, this terminology differs from Investment Value and Synergistic Value in two ways. First, there is no transaction mentioned. Second, in cases where a transaction would be realised with this kind of value it would be unfavourable to the actual or potential owner. I would favour clarifying remarks concerning this differentiation.

It is not only a question of terminology but also one of valuation approaches and methods, since the market approach methods lead to price estimations whereas the DCF methods lead to valuations. Again, this difference is not described in IVS 105 Valuation Approaches and Methods.

In a comment letter to the draft of IVS 104 by Valuology one could read: „Synergistic Value ... is not a basis of value but is the description of an element of value that can arise in valuations undertaken on a number of different bases.” The same was mentioned in different words by Duff & Phelps. I totally agree and cannot see what the category of Synergistic Value is good for. Even the definition of Equitable Value mentions „certain elements of Synergistic Value“ (50.3) as a reason why Equitable Value differs from Market Value.

IVS 104, para. 30.2 explains Market Value with the sentence: „It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer.“ In my opinion, it cannot be the best for both parties in the same transaction. A potential buyer who attributes a positive value to a good would like to pay nothing (or even get some money in order to take the good). A potential seller normally would like to get a price which is higher than the actual one. The actual price will not be the best to both parties.

The missing differentiation between value and price could also be the reason for the following sentence in IVS 105, para. 10.8: „Although no one approach or method is applicable in all circumstances, price information from an active market is generally considered to be the strongest evidence of value.“

To repeat: Price is the result of market transactions. Rational market participants with financial interests deviate in their valuation from prices. The deviation causes their transactions.

Price information may help to estimate Market Value, but cannot help to calculate Investment Value!

Additional remarks to IVS 105

There are deficiencies in the description of the Income Method:

- i. The weight of the Income Method seems to be dominated by market comparables in 40.2(b) without giving a convincing reason. That might make sense for assets like cars or buildings, but not for businesses.
- ii. 40.1 defines the value of an asset as a value of income, cash flow or cost savings, whereas 50.1 tells us, that methods of this approach are variations of the DCF method. There is a contradiction, since income does not equal cash flow.
- iii. 50.5(a) mentions: „Cash flow to the whole asset is most commonly used because an asset should theoretically have a single value that is independent of how it is financed or whether income is paid as dividends or reinvested.“

The question arises whether it is of interest what is most common, or not. More important: Theoretically the asset value might be independent of capital structure and dividend policy because of the world of Modigliani-Miller 1958 without taxes and Miller-Modigliani 1961 with taxes. But the next

question arises, why firms do have different capital structures and different dividend policies. For me, it's an unnecessary digression.

iv. 50.9.(c) and 50.10 have remarks to „a stabilised level of growth and profits“ without explaining what is growing and why profits are mentioned. I would expect that cash flows are growing.

v. 50.23 is not correct: „The constant growth model assumes that the asset grows (or declines) at a constant rate into perpetuity.“ An asset, besides farming, cannot grow. The value of an asset is growing, if the future cash flows, generated by the asset, are expected to grow.

vi. 50.17 is not correct: „For example, probability-weighted expected cash flows incorporate expectations regarding all possible outcomes and are not dependent on any particular conditions or events (note that when a probability-weighted expected cash flow is used, it is not always necessary for valuers to take into account distributions of all possible cash flows using complex models and techniques.“

First, it is impossible to take into account all possible cash flows. Second, there is a contradiction: all, but not always all. Third, all future outcomes are dependent on particular conditions or events.

vii. 50.17 is imprecise: „A single most likely set of cash flows may be conditional on certain future events and therefore could reflect different risks and warrant a different discount rate.“ Different to what?

viii. 50.20 says: „Where the asset is expected to continue beyond the explicit forecast period, valuers must estimate the value of the asset at the end of that period. The terminal value is then discounted back to the valuation date, normally using the same discount rate as applied to the forecast cash flow.“

First, is it of interest what is normally done? Second, would it make sense, if capital structure changes over time?

ix. What is a „future growth potential for the asset“ and an „expected risk level of the asset“, mentioned in 50.21(b) and (d)?

x. In 50.30 it is not clear what „the observed or inferred rates/yields“ are and what the basis of the mentioned IRR is.

xi. What are „rates implicit in transactions“? Should it be „rates implicit in transaction prices“?

xii. Maybe there is a contradiction between 40.5 „Generally, investors can only expect to be compensated for systematic risk ...“ and 50.30(f) the build-up method. In my understanding the build-up method captures also unsystematic risks.

xiii. According to pre-tax and post-tax cash flows and discount rates it should be stated more powerfully, that for business valuation the post-tax concept should be used. This is mentioned in IVS 105 50.6 and I suggest to repeat this point because of its importance in IVS 200 60.3.

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