The secret dream of company valuers

Bruno Husson and Henri Philippe

In recent years, business valuation has been central to many discussions that go beyond the small circle of financiers. The “fair value” of the IFRS accounting standards has led business leaders and auditors to look closely at valuation methods; given the high stakes in financial communications, this interest is particularly noticeable in the valuation of intangible assets on company balance sheets (in the wake of an external growth operation and subsequently as part of periodic impairment tests). Meanwhile, “independent financial valuations” have become an absolute must for many stock market transactions; a new chapter of the General Regulations of the *Autorité des Marchés Financiers* (AMF – The Financial Markets Authority), inserted during the transposition of the Fourth European directive on takeover bids, requires the involvement of an independent expert in any situation of a potential conflict of interest and defines the principles to be followed in carrying out valuation work. Paradoxically, financial valuation’s growing foray into business life did not come with a better understanding of what the very nature of valuation is, including within the admittedly very diverse community of valuers. Allow us to share a few thoughts on this topic, the fruits of our experience as teachers and consultants in corporate finance.

To define business valuation, let us begin by describing what it is not. Valuation does not mean implementing financial models to derive an average or a range of estimates. In other words, performing a business valuation does not in any way involve stringing together the results from the use of all available valuation methods and standards (including the most rudimentary or the least appropriate) and leaving the reader with the heavy burden of separating the wheat from the chaff. If business valuation were limited to that, software would have been developed long ago to do the work. We must instead come to terms with the fact that valuers cannot aspire to the comfortable position provided by the mechanical use of models or standard references, giving a false impression of objectivity. When they appraise, they must necessarily be involved. Any valuation is subjective, as it is always the expression of a point of view at a given time on the outlook of the appraised entity: valuations are done facing forward and not looking in a rear-view mirror, unless we assume that the past repeats itself exactly. However, subjectivity does not mean arbitrary, which means that the work of the valuer cannot escape from critical analysis. Lastly, despite the very frequent assimilation of the two verbs in valuation reports and even in the regulations governing independent valuation, valuing does not mean “valorising” either. Leave the valorisation of companies to their leaders, who have the burden of developing the portfolio of activities and creating value. Valuers do not participate in the company’s business activity. They therefore do not value it but only take a look at it from the outside. They are third persons who observe, trying to understand the company’s market, its strategy, and its future and transcribing this understanding into their own financial language.

To give a positive definition of business valuation now, let us say that assessing simply means giving an opinion on the value of an entity. It therefore involves taking a position, making arguments, convincing, etc. To do this, valuers have, of course, financial theory and the derived models. As such, valuers are primarily financial experts who have a mastery of financial models; with an understanding of the many academic discussions of financial theory, they know the issues and especially the limitations of these models, allowing them to avoid errors. And there is no shortage of pitfalls awaiting the apprentice valuer, whether it involves the impact of the financial structure on the value of assets (poorly understood in practice through the traditional calculation of the average cost of capital), integration of the cost of risk (through variable construction depending on the degree of asset diversification of the recipient of the valuation), consideration of liquidity (too quickly reduced in practice to the segmentation of assets listed/not listed on a stock exchange), or the benefit related to holding control (too often taken into account in a rudimentary way through a lump sum). Yet, valuers play a role that goes far beyond mastery of financial cuisine, however refined and sophisticated it may be. They are interpreters, listening to business leaders, understanding their strategy, and faithfully transcribing it in their models. They are teachers, explaining the procedure that they followed in a transparent manner. They are rhetoricians, aiming to convince their audience with arguments. Ultimately, the position of a valuer is rather uncomfortable. Facing an audience who, in more or less good faith, is always looking for "The Value" of the company (the True Value!), they can only offer an opinion on this value – their own opinion necessarily subject to criticism, discussion, and debate.

Far be it from us to want to close the debate on what business valuation is, as the area is complex and constantly evolving. More modestly, we would like to facilitate the emergence of a consensus on the fundamental nature of the profession by describing a dream situation – a dream where valuers would no longer string together series of more or less cryptic methods or formulas to provide tables of figures as evidence, where valuation reports would claim the subjectivity of their analyses without shame or pretence, where readers of these reports would no longer be naive or would no longer pretend to believe that the results of valuation work are intangible, universal "economic realities" just because the work is based on calculations and mathematical formulas. In short, a dream where business valuation would cease to be perceived as an exact science, where being a valuer would be considered a profession in itself and not just one of many practices of "number professionals" involving the use of a perfectly standardised set of techniques and formulas.