

The value of business



To what extent do external economic factors impact the value of businesses when valued for the purpose of settling relationship property? Tony Weber explains

Expert valuers generally become involved in family law matters where the principal assets of a relationship include a business. These days, most business enterprises are operated within a company structure, so invariably the primary asset being valued is shares in a private company. Assuming we are engaged early on in the process, our initial instructions will be to value the parties' interests in the company at the date of separation.

The parties' interests in a family owned company will normally comprise:

- the shares in the company; and
- advances to or from the company.

Valuing these interests at the date of separation is not such a difficult task as financial information is more readily available, and it is unlikely that the business has, at separation, been affected by the proceedings that are on foot. However, as time passes, the task becomes more difficult as current relevant financial information becomes less readily available. Often, this results in extensive and forensic investigations being unnecessarily undertaken on behalf of an apparently disadvantaged party.

Sometimes, the property will be owned by a family trust or trusts. However, for present purposes, I will consider the asset to be *prima facie* relationship property.

The Property (Relationships) Act 1976

The *Property (Relationships) Act 1976* requires that "the value of any property to which an application under this Act relates is to be determined as at the date of the hearing of that application by the Court of first instance" (section 2G(1)). To assess value for settlement of relationship property at a later date is one of the more difficult tasks expert valuers have been asked to undertake and, unfortunately, the one

they have been most likely to get wrong.

In general terms, the value of a mature business operated by a company is unlikely to change significantly in the relatively short time between separation and the date of a hearing. What does change, sometimes quite dramatically, is the value of the company which operates the business. Of relevance is the fact that control of the company will likely vest with only one of the parties.

Relationship between the value of a business and the value of a company

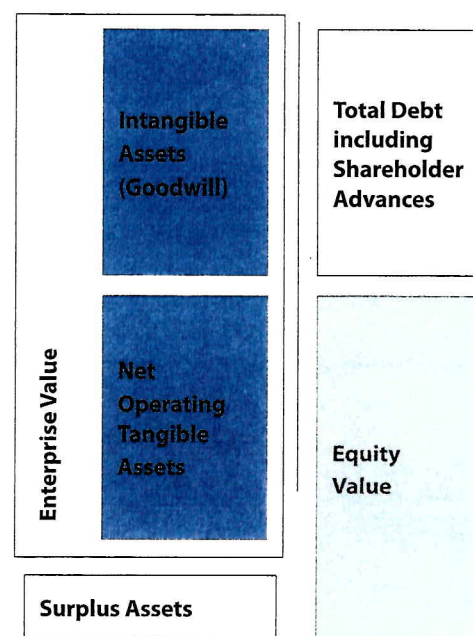
It is necessary to understand the difference between business value and company (share) value. One of the most widely used methods to value shares in a company (Equity Value) is to first value the business operated by the company (Enterprise Value) and then to add the value of non-operating assets and deduct the company's debt in order to assess the Equity Value.

The Enterprise Value comprises all of the tangible and intangible assets, including working capital, required to operate the business on a day-to-day basis along with the value of the goodwill (if any) of the business.

Non-operating assets (sometimes referred to as "surplus assets") are those assets owned by the company that exhibit a risk profile different to that of the business and which can be disposed of without affecting the day-to-day operations of the business. This might include surplus cash, land and buildings including bare land (held as an investment), other investments not related to the business such as shares in either listed or associated companies, high-priced motor vehicles, advances to shareholders or other related parties, artwork etcetera.

Debt includes third-party debt, advances to the company from its shareholders or related parties, liability for taxation, GST arrears etcetera.

The relationship between Enterprise Value and Equity Value may be depicted as follows:



This relationship is often not understood by legal practitioners nor by the parties themselves. In my experience, it is often not understood by practising accountants.

Movements in the value of a business over time

Although the value of a mature business will not necessarily change significantly in a relatively short time, there are factors which can affect value, particularly if the time from separation to the date of the hearing is extended.

Some of these factors and the impact they might have on the value of relationship property are noted in the table on the opposite page.

External economic influences

Of the above, changes in external economic conditions, such as the recent (and continuing) Global Financial Crisis (GFC), can have an apparent, but perhaps short-term, disastrous impact on business value, but it is sometimes difficult to assess the long-term impact.

Given that the Family Court is a court of equity, it does not seem fair that for relationship property purposes, valuers should necessarily take a short-term view of business value in such circumstances. The GFC has seen a substantial decline in transaction volume, with business owners preferring to 'sit out' the downturn in the expectation that improvement in economic conditions is imminent. This approach recognises the widely held belief that one should not sell at the bottom of the market.

While the GFC may also have impacted real estate values, it is likely that this has not been as severe as it has been on business value. There is evidence to suggest that market-derived multiples used to value business may have fallen by more than 15 per cent from 2007 to the fourth quarter of 2008 (*KeyBank Capital Markets: Mergers and Acquisitions Market Update* (2008 year end Review)). In a situation where the parties to the relationship had separated in, say, 2006 or 2007 and the hearing was in early 2009, the valuer would be faced with a possible double impact with both revenues down and a lower multiple being

applied. In such circumstances, I would suggest that a prudent valuer might take a longer-term view of market multiples.

Admittedly, events such as the GFC, although lingering like a bad cold, do not come along that often. In fact, the most recent KeyBanc update suggests that multiples evident from recent mergers and acquisitions are at their highest point since 2009 (*KeyBanc Capital Markets: Mergers and Acquisitions Market Update* (First Quarter 2011)).

Movement in the value of a company's equity

Although the value of a business conducted by a company may not change significantly in the short-term, the value of the shares in the company can change significantly as a result of the direct actions of a controlling party. Disregarding external abnormal events, the value of the parties' equity interest in a company which is a component of the relationship pool will increase over time by the quantum of net after tax paid profits, assuming always that:

- all expenses including salaries for working shareholders continue to be paid at market rates;
- the company does not declare dividends; and
- the company does not incur abnormal expenses inconsistent with historic normalised levels.

Post-separation, even if it were possible to obtain all of the financial information required to enable a formal valuation opinion to be assessed at the date of the hearing, the valuer would still likely be faced with the task of adjusting for abnormal transactions. Therefore, it seems that valuing a company or interest in a business at the date of a hearing has little relevance when settling relationship property if control is in the hands of only one of the parties.

M v B – Court of Appeal

In the absence of reliable financial information, it would seem that the defining decisions of Court of Appeal President Justice William Young, and Justices Hammond and Robertson in the case of *M v B* (Court of Appeal CA13/05, 22 March 2006) may well be applied. Not only did *M v B* provide a solution to the difficult question of how to value a partnership interest in no-goodwill professional practices (which confirmed an earlier valuation approach adopted in *Z v Z* (No 2) [1997] 2 NZLR 258), but it provided a possible solution to overcome the difficulty of valuing a company at the date of the hearing, or, for that matter, at any other date post-separation.

The Court of Appeal in *M v B* made two significant awards that can, in my opinion, be relied upon in future by experts called on to provide valuation opinions for relationship property settlement purposes in situations where current financial information is difficult to obtain, namely:

- B's share of the partnership was relationship property which should be valued by assuming it could be transferred to a prospective, but hypothetical, buyer at market price: and
- M, the wife, was entitled to a share of the tax-paid super-profits from the date of separation to the date of the hearing calculated on the basis of the assessed future maintainable super-profits that existed at the date of separation.

Further, the Court noted that any enhanced profitability post-separation was not relationship property but the separate property of B. It seems to follow from this decision that any decline in profitability post-separation as a direct result of the activities of the controlling party represents a decline in the value of separate property and not a decline in the value of relationship property.

However, the significance of the second bullet point above has to a large extent been lost on both the legal and accounting professions. While the legal consequences of both *Z v Z* and *M v B* have been largely dealt with, I am not sure that the implications from a valuation perspective have been sufficiently analysed. The decision to recognise post-separation tax-paid profits as relationship property is in effect a proxy to valuing the company or business interest at the date of a hearing and provides a solution to determining a notional value for the shares in a company or interest in a partnership, post-separation, in the absence of financial information. It also eliminates the requirement for extensive and expensive post-separation discovery and, in some instances, detailed forensic investigation.

While I have seen instructions from barristers requiring consideration be given to *M v B* when valuing for relationship property settlement purposes, I have not seen any experts extend the principle to assess a notional value at the date of the hearing. Rather, the approach has been to stay with the separation value and note that the applicant is also entitled to a share of profits post-separation pursuant to *M v B*. This approach fails to give full recognition to the intentions of the Act, which is to

Factor	Separate or Relationship Property
• Inflationary growth	No impact on "Real" value
• Organic real growth of a continuing nature	Relationship Property
• Increase in profits as a result of investments or planned expansion made by the company pre-separation	Relationship Property
• One-off catastrophic event (such as loss of single customer or supplier)	Relationship Property
• Enhanced value or decline in value arising from the efforts (or lack of effort) of only one of the parties	Separate Property
• External economic influences (such as the recent GFC)	Relationship Property

value the asset at the date of the hearing.

However, by giving consideration to growth and other factors that may impinge on value, there is no reason why the relatively simplistic approach I am suggesting cannot be applied and relied on by the Family Court. After all, valuation relies on opinion and whether the expert is able to defend his/her position by using a methodology based on a sound theoretical yet practical approach.

Another benefit arising from the decisions in *M v B* and *Z v Z* is that the concept of a "Bundle of Rights" attached to a partnership share in a no-goodwill professional partnership being worth more than market value (assuming it could be sold) may have been laid to rest.

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