CHAPTER 1

The World of Value

INTRODUCTION

We have identified several underlying financial, economic, logical, and psychological principles that provide a solid basis for looking at what we can call the "World of Value." We refer to these as the *organizing principles of business valuation*, because the integration of the principles provides a logical and consistent framework within which to examine business valuation questions and issues. These principles also provide the qualitative framework within which to discuss the Integrated Theory of Business Valuation.

COMMON QUESTIONS

The discussion of the world of value in this chapter will help readers answer the following questions:

1. What are organizing principles that can help valuation analysts and market participants form reasonable valuation conclusions?
2. What is the relevance of market behavior for valuation conclusions?
3. Is a forecast necessary to derive a valuation conclusion?

4. What determines the level of return expected by investors?
5. What is the significance of present value concepts in valuation analysis?

THE WORLD OF VALUE

The world of value consists of all the various markets in which valuation and investment decisions are made by real investors, whether individuals, companies, institutions, or governments. This world includes (but is certainly not limited to) the public stock and bond markets, the private placement markets for debt and equity securities, and the private equity markets.

The world of value is the real world. If valuation analysts develop a solid understanding of the world of value, they are more likely to be able to develop reasonable valuation conclusions under the standards of value appropriate for specific valuation assignments, including fair market value, fair value, investment value, and others. So we begin with a general discussion of the world of value.

The goal of the world of value is to understand value. For purposes of this book, we are talking about the **value** of businesses, business ownership interests, securities, and intangible assets. These organizing principles provide the foundation for the Integrated Theory.

The world of value begins with **cash flow**. The underlying foundation for business value lies in expectations for future cash flow in the context of several organizing principles, including:

Principle of Expectations. Value is expectational (not historical) in nature.

Principle of Growth. Value today is influenced by expectations for future growth.

Principle of Risk and Reward. Value is impacted by the relationship between risk and reward.

Present Value Principle. Business value is based on the present value of expected future cash flows, discounted to the

present at a rate reflecting the risks of receiving those cash flows.

Principle of Alternative Investments. Businesses and business investments are valued in relationship to reasonable alternative and competing investments.

Principle of Rationality. The world of value is one of inherent rationality, sanity, and consistency.

The world of value is fascinating. The organizing principles lay the groundwork for the Integrated Theory and provide a basis for addressing nearly every business valuation issue. They describe the underlying behavior of public and private securities markets, which collectively form the (direct or indirect) reference point for valuing most businesses and business interests.

The principles also provide a framework for testing the reasonableness of valuation positions advanced by valuation analysts. We have used these principles actively for many years, both as an organizing tool for valuation thinking and as a review tool for work performed by Mercer Capital and other firms.

THE ORGANIZING PRINCIPLES

Others have surely discussed the meaning and implications of the organizing principles. We make no claim of originality here, other than in using them as a means of describing and discussing the world of value. In the following sections, we will discuss each of the organizing principles. At the conclusion of the chapter we will see that, while each principle stands on its own, it is by integrating them that we can better understand the world of value and business valuation.

1. The Principle of Expectations

The first organizing principle of the world of value is that value is based on expectations for the future. We refer to this as the Principle of Expectations.

Valuation analysts routinely examine a company's historical performance and develop estimates of earning power based on that

history. The earnings that are capitalized may be a simple average of recent years' earnings, or a weighted average of those earnings. In the alternative, a valuation analyst might capitalize the current year's earnings or annualize a partial year of earnings. A specific forecast of expected earnings for next year might be made. The purpose of all historical analysis, however, is to develop reasonable expectations for the future of a business.

History is the window through which valuation analysts look at the future. We should never forget, however, that visibility is not the same through all windows. Some windows have been cleaned recently and provide a good picture; others are shaded, tinted, or dirty. And the view through some windows is just blocked. Valuation analysts must make reasonable judgments about the expected future performance of subject companies. And those judgments can often be tested or evaluated in light of a company's recent history.

While it may appear to be obvious, the Principle of Expectations is one of the most difficult for beginning (and even experienced) valuation analysts to embrace in practice.

The efficient market hypothesis suggests that market information that is known about a company (which forms the basis for future expectations regarding its performance) is reflected in its stock price at any point in time. This information is considered, of course, in the context of expectations regarding the company's industry and economic conditions. In other words, the market evaluates the expected future performance in light of the consensus risk assessment for a security and moves the price of a stock to the level that equates that expected performance with its expected risk.

The Principle of Expectations suggests that participants in the world of value must deal with uncertainty. After all, we cannot know the future until it happens, so the future is always uncertain.

Sometimes expectations are binary. Either A will occur or B will occur. If A occurs, one level of pricing for a company is suggested. If B occurs, an entirely different level of pricing is indicated. Investors deal with the potential for binary (or multiple) future outcomes using various forms of probability analysis. In appropriate circumstances, valuation analysts may need to use probability analysis, as well.

Consider the following example: a real-world investor plans to invest in a company that expects to engage in an initial public offering (IPO) within a year or so. The stock is currently illiquid and is burdened by a right of first refusal flowing to the shareholders and the company. If the IPO does occur as expected, there will likely be a substantial boost in the overall value of the company and the subject shares.

However, if the IPO does not occur, growth prospects will be significantly lower than if it had (because the expected capital infusion will not occur). And the investor knows that one of the reasons that companies do not go public is because their emerging performance does not meet expectations. If the company does not have the IPO, the investor faces a potentially lengthy holding period before other opportunities for liquidity arise. In this case, the subject shares would be worth much less than if the IPO had occurred.

What does the investor do in this world of value we live in? He or she makes an informed judgment about the probabilities of the favorable and unfavorable outcomes. A decision is made at a value above the no-IPO scenario level, but below the IPO scenario. Why? *Because investors tend to be risk-averse, and, according to the Principle of Risk and Reward, may charge a high price for uncertainty*.

The investor in our hypothetical example makes a decision based on his probability-adjusted expected return, writes a check, and moves on. Either A (the IPO) or B (getting stuck) will occur, and the ultimate return on the investment will be determined over time.

Unlike the type of investors described above, who will take their licks or count their rewards based on the negotiated price, the business valuation analyst must write a report. In situations like this, the report's conclusion is almost certain to appear to be wrong at some point in the future with the benefit of hindsight. If the company goes public, the conclusion of value may appear to have been low in relationship to the ultimate IPO price. If the IPO is unsuccessful, the report's conclusion, which considered favorable aspects related to that potential, will appear to have been too high.

Business valuation analysts facing similar valuation situations must attempt to mirror the thinking of investors in the world of value and must reach conclusions and document them. We must solve valuation problems with reference to the appropriate organizing principles if our conclusions are to have credibility. A or B will occur, and the valuation report must withstand critical scrutiny regardless of which happens.

ASSESSING PROJECTIONS

A sidebar to this brief discussion of the role of expectations in valuation relates to the use of *unrealistic* expectations. One of the most frequent problems seen in appraisal reports today is the use of projected earnings that bear little or no resemblance to those of the past. These projections often lack any explanation of how the rose-colored glasses through which they view a business reflect realistic expectations for the future of a business. The projection phenomenon just described is so common that it has been given a name: "hockey-stick projections."

In a deposition a number of years ago, Mercer was asked how a bank with currently low earnings could possibly meet the projections found in bank management's own current capital plan for the next five years. The deposing attorney accused Mercer of unrealistically relying on the capital plan, which was prepared by his client for regulatory review in the normal course of business. How could any bank possibly achieve the results of such a "hockey-stick" set of projections?

Mercer referred the attorney to the exhibit in our report that compared the previous five years' performance with the earnings and returns of the capital plan. There, it was clear that the projected returns (on assets and equity) were within the levels achieved by the bank in the previous few years, and below the current level of the bank's peer group. Value today is a function of expectations for future performance – and the

expectations we used were in line with past performance, management's stated plans, management's business plan, and the performance of similar banks.

Valuation analysts should remember that every going-concern business appraisal reflects, implicitly or explicitly, a projection of expected future performance. If the expectations imbedded in the valuation are not realistic, the resulting conclusions will be flawed.

2. Principle of Growth

We live in a growing world. Change and growth are integral parts of nature, economies, and business. Investors look at the world, the economy, individual businesses, and specific investments with an eye toward growth prospects. There can, of course, be negative aspects to economic, industrial, or business growth. But we live in an economic world where growth is viewed, on balance, as good.

The national and world economies have grown unevenly but steadily for hundreds of years. All valuation of businesses is considered in the context of growth of population, productivity, and inflation. Equity securities are purchased for their growth prospects.

Other things being equal, a growing business is more valuable than a similar business that is not growing. Why? The growing business will generate greater future cash flows than the one that is not growing. More future cash flows from the perspective of today, other things being equal, means more value today.

The Principle of Growth suggests, in nonmathematical terms, that there is an underlying relationship over time between growth and value. That relationship is indirectly reflected in Exhibit 1.1, which tracks the S&P 500 Index over the fifty years ending December 2019. The index has grown at a compound annual rate of 7.3% over the period, largely tracking the growth in underlying corporate earnings, supplemented by generally higher valuation multiples.

Valuation analysts addressing valuation questions need to focus on relevant aspects of growth, ranging from the world economy, to

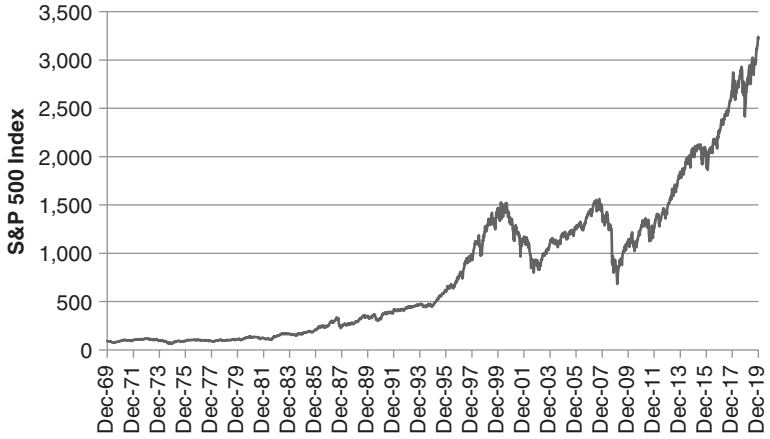

EXHIBIT 1.1 S&P 500 Index: December 1969 through December 2019.

the national economy, to the regional economy, to a local economy, to a particular industry, to a particular company, or to the facts and circumstances influencing the ownership of a particular business interest. As Exhibit 1.1 illustrates, while the long-term trend in asset values is upward, the rise is punctuated by reversals, or decreases in valuation. After all, when we value companies, we do so at particular points in time. The level and direction of movement of relevant markets will influence valuation decisions at any point in time.

The Principle of Growth is often linked, as we will see, to the Principle of Expectation and to the Present Value Principle. But they are not the same principles.

3. The Principle of Risk and Reward

In the world of value there are predictable relationships between expected future risks and rewards. The Principle of Risk and Reward can be summed up in the words of an immortal unknown: "No risk, no blue chips!" This principle is integrated with the Present Value Principle via the factor known as the discount rate, or

required rate of return. It is also embodied, implicitly or explicitly, when we employ the Principle of Alternative Investments.

The Principle of Risk and Reward suggests that an investor considering two possible investments, with one clearly riskier than the other, will require a greater expected reward for the riskier investment. If it were not so, there would be no incentive to purchase the riskier investment.

Return expectations or requirements are reflected in different discount rates, or required returns. Investments of relatively higher risk require relatively higher returns. We can see the Principle of Risk and Reward at work in Exhibit 1.2, which illustrates the general relationships between required returns (i.e., discount rates) and investments of generally increasing risk.

These return expectations influence value through the Present Value Principle, which is discussed next.

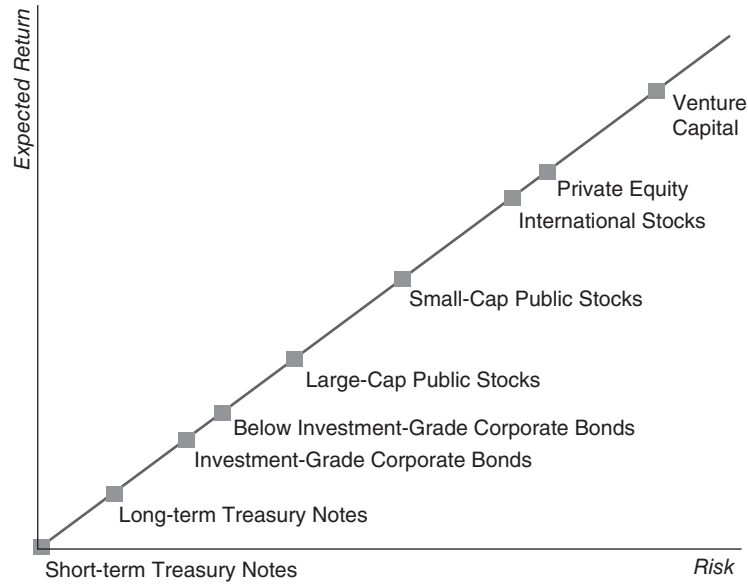

EXHIBIT 1.2 Relationship between Risk and Expected Return.

4. The Present Value Principle

Stated in its simplest form, the Present Value Principle says that a dollar today is worth more than a dollar tomorrow. Alternatively, a dollar tomorrow is worth less than a dollar today. Present value is really an intuitive concept that even children understand. Ask any child whether it is better to get a toy today or to get the same toy next week.

The Present Value Principle addresses four aspects of investments:

- *Equity Investments are expected to grow in value*. Recall the Principle of Growth.
- *Investments have cash flow characteristics*. Valuation analysts must understand the nature of the cash flows of a business over time, and the fact that the cash flows of the business may differ materially from the cash flows available to its minority shareholders.
- *Investments have duration*. They exist over time. Investors forgo consumption today (or make a choice among competing alternatives) in order to gain the benefit of the investment over its duration.
- *Investments have different risk characteristics*. Risk is the great leveling force in the world of present value via investors' required rates of return, or discount rates.

The Present Value Principle enables us to compare investments of differing durations, growth expectations, cash flows, and risks. We use present value calculations to express the value of different investments in terms of dollars today and, therefore, to provide a means to make investment or valuation decisions. Alternatively, we sometimes compare investments based on their expected values at dates in the future.

Exhibit 1.3 summarizes the fundamental valuation model.

This generalized model reflects a single-period income capitalization valuation method commonly employed by business valuation analysts. Assume that the net cash flow to equity of a

$$Value_0 = \frac{Cash\ Flow_1}{r - g} = Cash\ Flow_1 \times Multiple$$

EXHIBIT 1.3 The Fundamental Valuation Model.

business (for which earnings is often a suitable proxy) is $1.00 per share. Assume further that the appropriate discount rate (r) is 13% and that expected growth (g) (at a constant rate into the indefinite future) is 3%.

The expression (1 / (r – g)) converts to a multiple of 10.0x (1 / (13% – 3%). So capitalized value, today, is $10.00 per share, or $1.00 per share x 10.0. This method yields an identical conclusion of value to a discounted cash flow method under the same assumptions.

Both single-period capitalizations of earnings as illustrated above and the application of the discounted cash flow method, both of which are discussed in more detail in Chapter 4, are applications of the Present Value Principle. Both methods convert expected future cash flows into value today via the process of discounting them to the present at the selected discount rate or required return.

Normally, we use the fundamental valuation model to solve for the value of a business. However, the Principle of Present Value can also be used to facilitate comparing alternative investments. If we can estimate the future cash flows from a business (or a business strategy or investment), and we know what that business or strategy or investment costs today, we can solve for the implied internal rate of return. If we calculate the implied internal rates of return from similar investments and hold other risk factors constant, the investment with the higher internal rate of return is the preferable investment.

Whether a valuation analyst solves the DCF equation for its value conclusions, or a CFO of a company makes comparisons of investments based on their relative expected internal rates of return, both are applying the same principle.

Business valuation analysts and market participants must be intimately familiar with present value concepts and be able to articulate valuation facts and circumstances in a present value context.

5. The Principle of Alternative Investments

We live in an alternative investment world. The Principle of Alternative Investments suggests that investments are made in the context of choices between or among competing alternatives.

The Principle of Alternative Investments lies at the heart of business valuation theory and practice. When Revenue Ruling 59–60 directs valuation analysts to make comparisons of a subject enterprise with the securities of similar companies with active public markets, the Principle of Alternative Investments is being invoked. The public securities markets are massive and active and provide liquid investment alternatives to investments in many privately owned businesses. Business valuation analysts need to have a thorough, working knowledge of these markets in order to provide realistic appraisals of private business interests.

By combining the organizing principles, we begin to describe the workings of the world of value. For example, by combining the Principle of Risk and Reward and the Principle of Alternative Investments, investors make asset allocation decisions regarding their investments. In the public securities markets, investors ask questions like "Should we buy shares in Amazon or Alphabet? Should we buy large cap or small cap stocks? Should we buy stocks or bonds or real estate?"

The Principle of Alternative Investments suggests that there are many competing alternative investments. The mirror suggestion is that there are many alternative investors evaluating investments in different ways. This realization is causing valuation analysts to focus more frequently on the typical buyers for particular assets. For example, valuation analysts now generally recognize that there are different types of buyers for companies, including financial buyers and strategic or synergistic buyers. Strategic or synergistic buyers can often pay more for companies than financial buyers who may be substantially dependent upon a company's existing

cash flows for returns. Decisions by valuation analysts regarding who constitutes the "typical buyer" for an asset can significantly impact their conclusions of value.

The Principle of Alternative Investments also suggests the concept of *opportunity costs*. When resources are deployed to acquire one asset, they are not available to purchase another. When business assets are lost, destroyed, or diminished in value, valuation analysts and economic experts employ the organizing principles to estimate the magnitude of alleged damages.

The Principle of Alternative Investments confirms that business valuation analysts must be familiar with the public securities markets and capable of making objective comparisons between the public and private markets and drawing reasonable valuation inferences.

6. The Principle of Rationality

The Principle of Rationality assumes, for the most part, that markets are rational and consistent. When we speak to valuation analysts about the nature of the public securities markets, many are quick to point out many (apparent or real) exceptions to sane, rational, or consistent investment behavior. However, while the exceptions are always interesting, what we are discussing is the underlying rationality of the markets operating as a whole.

Many an unthinking investor has been taken to the proverbial cleaners by the investment pitch that "seemed almost too good to be true" and turned out to be. Lying beneath the surface of this comment are implicit comparisons with alternative investments that are sane, rational, or consistent with normal expectations.

Other valuation analysts are quick to point out that the markets sometimes behave abnormally or, seemingly, irrationally. We are using the comments of valuation analysts to illustrate that too many of us get caught up in the exceptions and miss the big picture that is played out in the public securities markets. If we can accept the underlying rationality or sanity of the markets, we then have a basis to explain or to try to understand the apparent exceptions.

The Principle of Rationality should be applied to valuation analysts as well as markets. Revenue Ruling 59–60, in the paragraph prior to the enumeration of the eight factors that are listed in nearly every appraisal report, suggests that valuation analysts employ three additional factors – common sense, informed judgment, and reasonableness. We call the eight factors the "Basic Eight" factors of valuation. We call the less well-known factors from Revenue Ruling 59–60 the "Critical Three" factors of valuation.

The Principle of Rationality suggests that valuation analysts need to study the markets they use as valuation reference points (comparables or guidelines). It also suggests that valuation conclusions should be sane, rational, consistent, and reasonable.

We employ tests of reasonableness in Mercer Capital valuation reports to compare our conclusions with relevant alternative investments or to explain why we believe our conclusions are reasonable. Other valuation analysts call the same process that of using sanity checks. Readers of appraisal reports should expect such "proof" of the rationality of the conclusions found in those reports as well as at key steps along the way as critical valuation decisions are made.

SUMMARY

The organizing principles provide an excellent framework within which to think about the world of value. Business value is determined by investors "out there" who either have or are seeking information about their potential investments. The various bits of information that are gathered are part of a mosaic. When the pieces are put together in an organized fashion, they form the knowledge that is necessary for decision-making about investments and their future performance in the face of uncertainty.

From the viewpoint of business valuation analysts and market participants, the organizing principles provide a number of avenues along which to seek and obtain the knowledge necessary to develop and support, and later, to defend valuation conclusions.

Valuation analysts and market participants who have a grasp on the organizing principles of business valuation have a leg up in the

process of developing reasonable valuation conclusions. Attorneys and other advisors to business owners who use these principles as a framework within which to discuss valuation questions can get to bottom-line issues more rapidly and effectively.

The importance of understanding the organizing principles of business valuation and being able to employ them in valuation assignments or investment decision-making should become clearer as this book progresses. The Integrated Theory presented in the next chapter relies heavily on these principles.