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Price and value: companies’ evaluation under asymmetric stress

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Metro AG recently depreciated 450 million euros goodwill regarding the acquisition of Reals supermarkets. It shows how difficult the art of assessing a company may be.

Let us first have a glance at a communication trick commonly associated to such mishaps. Goodwill depreciation is merely an accounting entry. Bearing no cash issues it does not affect the company’s value. This is true. At the time of the acquisition, cash paid by the buyer is not lost: it is an investment. Also correct. So everything is just fine. Yet at one stage or another the buyer lost substance because of this investment!

Beyond these games, the price of M & A transactions raises a number of substantive issues. The first series is related to the methods, the second to information asymmetry and the third to the emotional.

A bunch of methods coexist served by a flowery language. Discounted cash Flows, EBITDA multiples, practitioners’ method ... As a matter of fact the approach behind all these methods should be unique: a financial asset is worth what it is going to bring. Whether liquid (listed security), medium liquid (real estate…) or illiquid, only the measurement tool may differ. One of the most complex case is the evaluation of non-listed companies. The appraiser will try to “refer to another case” by applying a multiple observed with listed companies. Does this solve the problem? Unfortunately not completely. It is impossible to find two companies whose performances are fully proportionate. Yet it is the implicit assumption behind the proxy. Indeed, a multiple is just (mathematically speaking) an expected return, associated to a growth rate and a discount rate. We are left with a “simple “calculation of discounted future cash flows. The formula is reassuring. It may lead to impressive calculations. The Scientific whiff of the process is soothing. But the devil is in the details. By the end of the day these may have grown to overwhelming proportions. Weak changes in financial assumptions easily lead to 30% deviations of the company's value. Adding the "business" dimension, the valuation sensitivity can become extreme. Yet another source of disturbances may worsen the issue: the appraiser’s own bias. For instance, would a low evaluation put one of his mandates at risk?

Risk assessment is a foremost ingredient for evaluations and transactions. Here lies another source of troubles poisoning communication between buyer and seller. The latter takes advantage of comprehensive risk mapping of the company. He will naturally tend to minimise risks with whom he lived for a long time. Conversely, the purchaser will have a more cautious approach. The audits would not always answer his question: "What is being hidden to me?”. The change in ownership may also result in a change of risk and therefore value. Customers and other stakeholders may have a different attitude towards a local or foreign shareholder, a small company or a subsidiary of a multinational group.

Emotions are always there and may take a decisive place in transactions involving family businesses. This topic has already been discussed in these columns. In essence, the sale’s price can be experienced by the transferor, not only as the outcome of a professional and impersonal calculation, but as his own assessment. Price is no longer just a matter of cash flow, but also the reward of years of involvement, personal and family sacrifices.

As we see, the gap between buyer and seller can be huge. Fortunately enough, some mechanisms may help aligning the interests of both parties. The governing idea is to link compensation to the seller and company's performance during a few years following the transaction. This will reassure the buyer for the best possible transmission. The seller will also have a strong incentive: the higher his involvement to turn the transmission into a success, the higher the sale price. And we expect the buyer to be happy to pay a higher price for an even better company than initially imagined (what the seller never doubted!).