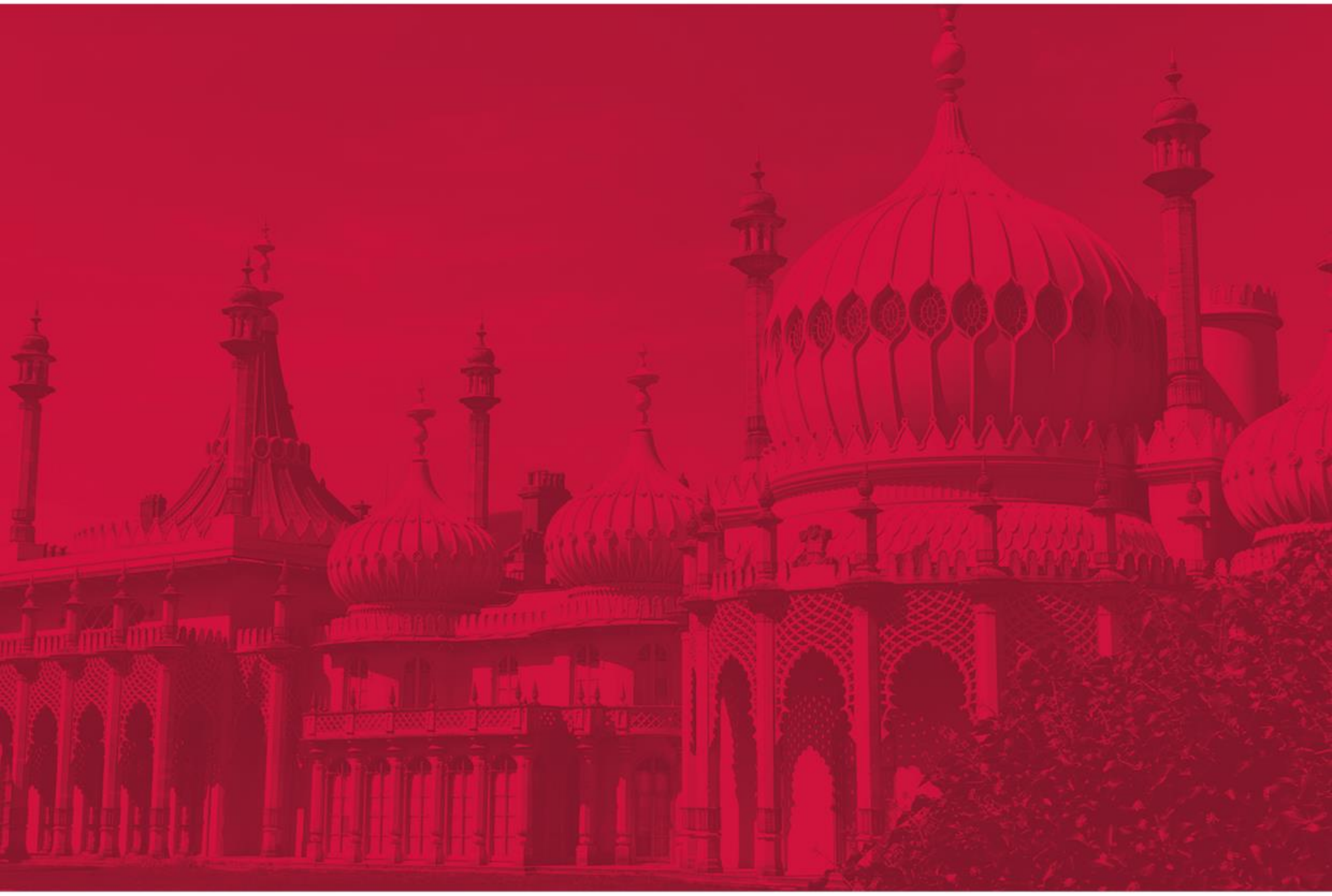
WESTGATE
CHAMBERS



Business Valuations.

Scott Sharp.

Introduction

Financial remedies proceedings are uniquely complicated in that they are unveiling the lives of often couple who have been intertwined for some time. Even short marriages can have multiple facets of assets that need unravelling.

So how is this managed when couple have business's between then and these need valuing, that is the big question! This guide aims to provide you with an overview and a guide on managing business valuation in financial remedies proceedings.

The Courts role is twofold:

i. To establish the value of the parties' interests in the business;

ii. To decide how that value should be reflected in the final financial distribution.

The below is a summary guide on when, how, and what is needed to consider business valuations, along with a review of recent case law highlighting the broad discretion the Court has when considering the same.

When to value a business?

1. One of the first questions practitioners will need to consider is when would a business valuation be needed. The short answer is there is no straight forward formula or blanket approach but you must consider the type of business.

2. The types of business you will likely see are;

   i. Limited companies, whether public or private;
   ii. Partnerships
   iii. Sole traders

   Whilst the difference in the business's above are technical, one would often expect to consider the size of the business and the necessity dependant on the complexity of the accounts.

3. There are some questions which can assist in deciding if a business should be valued, but the easiest approach would be to consider when a business valuation would be unnecessary.

4. It is unlikely to be needed if; the party is a sole trader, the business is a means of an income stream for the family, or a there is very minor holding of shares.

5. Further, is it a cash-based business? If so, the business valuation is unlikely to assist the Court as often paperwork does not reflect the nature and true assets available. Below are two examples of cases in which business valuations were of no benefit to the Court, or inappropriately considered such as double counting;

- *V v V (Financial Relief) [2005] 2 FLR 697*:

  Where there is no real value except as an income stream and there is no suggestion that there should be a clean break, to include a business's capital value runs the serious risk of double counting. The proper approach in such cases is for the Court to treat the business assets as primarily a secure income for the parties, from which there has to be a substantive and unlimited order for periodical payments.

- *Smith v Smith [2007] EWCA Civ 454:*

  An appeal where the district judge had divided the parties' assets equally, but had included the value of the business on the husband's side and had also ordered the husband to pay maintenance to the wife, equivalent to half his income generated from the business.

<u>How to value a business</u>

6. There are multiple methods to how to value a business within proceedings, all of which rely on expert evidence, and certain assumptions made. It is therefore critical when thinking of instructing experts, carefully consideration and review of the expert CV and the robustness of their approach is in mind as this may be critical in a client's case.

‘*A valuation is therefore no more than a guess, admittedly an educated and informed guess, about a hypothetical albeit proximate event'*
– Mr Justice Mostyn, E v L [2021] EWFC 60 (§54) -

a. Net Assets;

This method is a straight forward look at the book value and/or replacement value of tangible assets. This method alone is not typically acceptable for an ongoing business and there will be many variables which would be ruled out on such a basic approach.

However, this method would be used for business's which have little to no variable affect, such as a property investment company. Additionally, this approach could be adopted as a general consideration to provide a ‘floor' under any valuation.

b. Earnings

This is the most common technique used when valuing an ongoing trading company, which accounts for the business as a whole when the prospective purchaser would have access to the earning stream.

In short, the expert will need to identify the appropriate level of earnings which are representative of the business in the future and maintainable earnings, compare to similar business, and then apply suitable multipliers based on where the earning information has come from (historic, current, or future.

Dependant on the type of business the expert shall consider which of the three below to use to determine maintainable income;

i. **EBITDA** (earnings before interest, taxes, depreciation and amortisation)**.**

   Most valuations use EBITDA. This is because it is considered to be the level of profits closest to cash generated by the business and is not affected by the financing structure of the company, which provides greater confidence when considering multiples from comparators.

ii. **Profit after tax.**

   In some cases, profit after tax is used either because there is generally more information available on comparator companies, or the company being valued is considerably smaller than comparators available in the public domain and there are generally accepted ranges applied by expert accountants.

iii. **Turnover.**

   There are some specific industries where turnover is the most appropriate level of earnings to consider. These are generally professional practices, such as insurance brokers or accountants, where the income is generated by contacts and the cost structure can be varied by potential new owners.

Adjustments are the final step dependant on if the company is public, or private. If the latter, a discount to the multipliers is provided to account for these types of business being less saleable than those of recognised platforms.

Example:

£2000 pm EBITDA x 8.5 (average multiple prior to adjustment) = Enterprise value – net debt = Equity Value.

c. Discounted cash flow

This method is very rarely seen in FR. In the authors summary, this technique uses projected cash flow, discounted by the time value of the income. However, this technique carries inherent uncertainly as it raises questions of the accurate projections of future performance.

d. Dividend yield basis

This method would not typically be used to value a private business as a whole, and is more aimed at a small parcel of shares, where the shareholder has no, or very limited control over the company.

This method takes the value of the shares, along with the stream of dividends received from the shares in the yield period.

<u>Experts</u>

7. The above is of course a very whistle-stop summary of methods of valuations to assist the reader, but it is clear that experts will always be required when expert valuation becomes necessary.

8. However, it has always been accepted by the Court that values of business are a matter of opinion, and there are historic examples of experts within the same case have a wide opinion on the same business; *Miller v Miller [2006] UKHL 24*, there was a difference of £6,000,000.00 in the expert opinions provided to the Court!

9. In *H v H [2008] EWHC 935 (Fam)*, Moylan J found that seeking to base a financial award on a business valuation that is no more than a broad, or even very broad, guide, risks creating an award that is unsound and likely to be unfair.

10. In the two cases above the Court, despite criticism, did ascribe a value to the business using the expert evidence. However, in *Versteegh v Versteegh [2018] EWCA Civ 1050*, Singer J did not ascribe a value to the husband's business. Despite expert evidence, Singer J was unable to assign a value to the business, and transferred shares to the wife (in a *Wells* order), as there were few other options.

11. The Court of appeal has offered guidance that a value should be ascribed to a business where possible, but to make it mandatory would likely lead to unfairness.

<u>Recent approach - E v L [2021] EWFC 60</u>

12. There has been recent case law which offered a very good insight on how the Court can choose to handle business valuations within proceedings, alongside taking account of the impact of covid.

13. The above case is very useful as not only does it address previous issues, such as the division between income stream and capital assets, but highlights the real applicability of the Judge's discretion when considering business valuations.

14. In addressing the first point, Mr Justice Mostyn recalled the comments of Lord Justice Wilson from *Jones v Jones [2011] EWCA Civ 41; 'in truth the judge was placing a substantial capital value on the husband as a person I am convinced that such is no function of the divorce court",* along with the well-known principles of earning capacity not being a matrimonial asset.

15. Mr justice Mostyn concluded in that in his decision In E v L "*in my judgement this important principle must be firmly held in mind when considering evaluation based on capitalisation of future maintainable earnings the court must ask itself whether and to what extent the assessment of future earnings depends on the participation of the respondent. If the evidence is that future participation of the respondents is indispensable the court must ask itself whether the valuation is at least in part of the respondent as a person' (§68)*

16. Whilst in this case, the matter was stopped short of finding an income stream, it was an important factor in applying a discount to the business valuation provided to the Court.

17. The business was valued by several experts and the court found that the 'enterprise value' (the reasonably foreseeable future maintainable earnings multiplied by the estimate of how many years of earnings a notional purchaser would pay for) was $5,067,500 at the beginning of the relationship and $10,860,000 at the time of the trial, making the marital element $5,792,500.

18. Mr Justice Mostyn decided that the end value (i.e. $10,860,000) should be substantially discounted (by 45%) to $5,973,000 (thereby decreasing the marital element to

$906,000). That figure converted to sterling and net of tax was £518,000. The discount was applied for four main reasons:

i. The impact of Covid-19 (the business related to music performances and there was uncertainty around if and when revenue would start to resume and in what capacity;

ii. The husband's business partner would be hands-on in earning a proportion of the sale value and the product of his endeavour was not something which should be shared with the wife;

iii. The single joint expert confirmed that business owners work their hardest in the couple of years leading up to a sale of their company than at any other time. The valuation therefore must factor in that work having been done when in reality the husband would put in all that effort to keep the business performing at a high level throughout the lengthy due diligence process carried out by a potential buyer to ensure an 'orderly handover' and 'the preservation and promotion of the skills and reputation of the business' and ultimately achieve the sale price;

iv. The future maintainable earnings of the business (which form the basis of the expert's valuation) were linked to the husband's earning capacity and the future success of the business would to some extent depend on the husband's future work. Future income is treated differently to capital assets already accrued on divorce and spouses have no entitlement to share it, it is only a needs-based claim. The Judge felt that the business valuation included an element of capital value for the husband's ongoing work and attributes, which should not be shared on divorce.

The figure above was then appropriately added to the value of the company's surplus assets which was then divided equally between the parties.

19. The Court conducted a broad discretionary analysis of fairness, taking into account all the facts of the case, to arrive at this outcome. The case emphasises the inherent difficulties involved in the valuation of businesses, which the Court also discussed at great length, as highlighted in the earlier section to this handout.

20. Mostyn J went on to say that valuations should be based on facts and known events, that being the best way to achieve a fair outcome. His discount achieved that by factoring out of what would be shared, the value of the husband's work that was yet to be done.

21. Whilst a discount for Covid-related disruption is a temporary issue, the wider application of the other basis for the discount are significant and could apply to any business valuations used in divorce proceedings. The level of discount applied for each of the 4 reasons was not specified but we anticipate this will be a focus in many cases in the future.

Summary

22. It is clear that valuing a business, and the expert evidence behind the same, is treated with a broad brush by the Court, and the powers of the Judge's to consider, 're-interpret' or even outright ignore business valuations has been made clear in case law;

    Holman J described the business valuation evidence of the single joint expert in *Fields v Fields [2015] EWHC 1670 (Fam)* as '*inherently speculative, like many such valuation figures'* (*§ 41*).

23. As practitioners, we will need to be cautiously aware of the pitfalls and weaknesses in business valuations and how these are treated by the Courts as outlined above, but also that a post order change to the business valuation is unlikely to be a basis for challenging on the basis of a new event which invalidates the order (Barder event) - *Barder v Caluori [1988] AC 20*

24. The lessons to take away is as practitioners we will have to firmly advise, and warn clients irrespective of being the business owner or claimant, for caution on undue reliance on any claim to a portion of a business in financial proceeding when discussing settlement figures.