

KEY POINTS

- Private companies must be valued when given as collateral in a “commercially reasonable manner”.
- What this means in law is untested, but it should be done using methods normal for such valuations.
- These methods yield a wide range of valuations.
- It is unclear whether the special value of the collateral – such as synergy benefits – should be taken into account when conducting the valuation.
- It is best to specify the valuation procedure at the outset of a collateralised lending transaction, if a dispute is to be avoided.

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What is collateral special value?

Shares in a private company must be valued when they are given as collateral for a loan and the borrower does not pay the interest and capital when due. Unlike for quoted companies, the subjectivity in valuing a private company results in a wide range of valuations. Even when standard methods are used, there are additional questions of whether the valuations should include, for example, synergy benefits which would accrue to a buyer of the shares – the so-called “special value”. The range of valuations and special value could be problematic, particularly for the borrower. In such transactions, disputes can be avoided if the valuation method and the parameters required by the model are agreed at inception.

INTRODUCTION

The recent judgement in *ABT Auto Investments Ltd v Aapico Investment Pte Ltd* [2022] EWHC 2839 (Comm) on the Financial Collateral Arrangements (No.2) Regulations 2003 shed light on valuing private shares held as collateral. ABT, having entered a joint venture with Aapico, granted shares in the JV subsidiary as collateral for a loan. ABT defaulted on its repayments. Subsequently, Aapico exercised its right to appropriate the collateral, placing a value of US\$27m. ABT disagreed with the valuation.

Aapico was obliged to value the shares in accordance with the terms of the loan and collateral agreement, and in any event, “in a commercially reasonable manner” (Financial Collateral Arrangements (No.2) Regulations 2003/3226, reg 18), and “no more, no less” (judgment at para 84.5). It is worth reviewing the regulation:

“18. (1) Where a collateral-taker [Aapico] exercises a power contained in a security financial collateral arrangement to appropriate the financial collateral the collateral-taker must value the financial collateral in accordance with the terms of the arrangement and in any event in a commercially reasonable manner.

(2) Where a collateral-taker exercises such a power and the value of the financial collateral appropriated differs from

the amount of the relevant financial obligations, then as the case may be, either –

- the collateral-taker must account to the collateral-provider [ABT] for the amount by which the value of the financial collateral exceeds the relevant financial obligations; or
- the collateral-provider will remain liable to the collateral-taker for any amount whereby the value of the financial collateral is less than the relevant financial obligations.” (Emphasis added)

The judge agreed with Aapico that the valuation was conducted in a commercially reasonable manner, but what does this mean in the context of valuing private companies? ABT argued that the valuation should have been greater, because the shares in the JV had a “special value” to Aapico (para 47 of the judgment)? What is “special value” and how might it be calculated?

“IN A COMMERCIALLY REASONABLE MANNER”

How is the value of a shareholding of a private company determined? There are two ways.

The first is to conduct a sale process for the shares by asking potential buyers to bid for them. This is time consuming, because buyers must be found and the nature of the company

must be explained – it takes months, and it is expensive. Though it yields the best estimate of the market value, it may not be appropriate in a time-sensitive process of determining the value of collateral for a loan.

The second is to calculate the value of the shares “in a commercially reasonable manner”, assuming the collateral agreement is silent on the method.

The objective of a lender is to be repaid the loan principal plus interest in a timely fashion and not a mechanism to buy the collateral (though this may well be the outcome). It follows that if the terms of the loan are not adhered to, the lender can sell the collateral in the market to recoup the amount owed. (For practical purposes it may need to buy the collateral in the first instance, then later to decide to keep it or to sell it.) If the lender is to sell the collateral in the market, then the valuation must be an estimate of what the market (potential buyers) would pay for the collateral.

The value of shares in a private company depends on the buyer. There is not a single value. It is not like a quoted company whose value at any time can be observed.

Calculating the value of shares depends on two things:

- the type of model used to conduct the calculation; and
- the input parameters that drive the model.

Of course, the collateral-taker (lender) cannot act arbitrarily or unreasonably when choosing the method of valuation or selecting the parameters. The models and parameters must be those generally used by the market for valuing such collateral. Two methods dominate the valuation of private companies: “Discounted Cash Flow” (DCF) and “comparables”, and both were considered in *ABT*.

Feature

It is worth emphasising that when a private company is being bought and sold, the goal is to negotiate a price which the counterparties can agree on. The various technical methods of calculation provide the basis for a discussion. In *ABT*, on the other hand, the purpose was to calculate the margin or sale price without negotiations. This makes it crucial that the method of valuation is agreed on in detail at the outset, if the risk of adverse outcomes are to be minimised.

DISCOUNTED CASH FLOW

The risk of an upfront investment in a company is offset by the benefit of a future flow of dividends. The value of the future dividends in today's terms can be calculated if the dividends can be estimated.

To be comparable, the value of each of the future dividends must be adjusted to reflect the difference in value between a payment today and a payment in the future; that is how the present value of the future cash flows is calculated. \$1m today is worth more than \$1m in a year's time. This is because \$1m today can be deposited and earn interest: the interest would be \$50,000 if the interest rate was 5% ($\$1m \times 5\% \times 1 \text{ year}$). It follows that \$1,050,000 in one year is equivalent to \$1m today; in other words, the present value of \$1,050,000 is \$1m. In this way, the present value of all future dividends can be calculated. Their sum is equal to the value of the company.

Denoting the calculation of the present value as *PV*, then,

$$\text{Value of a company} = PV(D_1) + PV(D_2) + PV(D_3) + \dots + PV(D_\infty)$$

Here, D_1 represents the first dividend, D_2 , the second dividend and so on. For example, if the first dividend is estimated to be \$1,050,000 payable in one year, then its present value is \$1m (as calculated above). $PV(D_1)$ then equals \$1m. Similarly, the present value of each of the future dividends is calculated and added together.

This leaves two issues:

- the first is estimating the future dividends (for ever, represented in the equation above with infinity (∞)); and

- the second is deciding the appropriate rate of interest to use to calculate the present values.

Both are difficult, but the dividends more so.

To estimate the dividends, the management must construct a full financial model for several years into the future (five years is a common timeframe) comprising: forecast sales, costs, capital investments etc. Judging the financial state of a company in a year is difficult enough, let alone over the next five years, leaving aside that the dividend forecasts are needed for ever (there is a cheat method – a gross approximation – to cover eternity!) The reliability of management's forecasts can be evinced by comparing previous forecasts to actual results. They should not be expected to match, but the extent of the mismatch is a good indicator of reliability. Sometimes the forecasts are simply not available.

In the case of *ABT* a discounted cash flow method was not used because the forecasts were found to be unreliable and, in any case, they were not sufficiently detailed to allow the calculations to be conducted (para 96.4 of the judgment). There was no choice but to use the "comparables" method.

COMPARABLES

The "comparables" method of company valuation has advantages: the principle is straightforward, and its application is easy. Unfortunately, more often than not, the method produces a large range of valuations.

Suppose one needs to value a house. It would be normal to consider the value of a house in the neighbourhood that has been sold recently. Calculating the value of the sold house on a dollar per square foot basis and multiplying it by the area of the house to be valued would provide a good estimate. Suppose a thousand square feet house had been sold for \$750,000. The value of the house then was \$750 per square foot ($750,000 \div 1,000$). If the area of the new house is 1,250 square feet, then, by this measure, its value is \$937,500 ($750 \times 1,250$).

A similar process can be applied when valuing private companies. What is needed

is a measure of a company akin to the \$ per square foot measure used in real estate. Several such measures are often used, such as the Price-Earnings Ratio (PER). A company's PER is equal to its share price divided by its earnings per share. The PER is reported in most financial newspapers. The PERs of companies in the same sector are not the same. For example, the range of PERs of construction companies which are included in the FTSE 100 index is 9 to 38 (this and all other share price information is from the *Financial Times* newspaper, 24 February 2023). In other words, the highest rated company is 4.2 times ($38 \div 9$) more valuable than the lowest rated company. This is a large variation. Other sectors have a higher variation. Continuing with the real estate analogy, the house that has been sold could have been on a more desirable road and so worth more, thus over-estimating the value of other houses. Similarly, some companies, though they are in the same sector, will have different management teams, growth prospects, a different mix of products, profitability, international reach, and so on.

These differences give rise to vastly different PERs (or any other measure that might be used). Take for example two companies in the same sector which are direct competitors in food retail in the UK: Tesco plc (PER 12.68) and J Sainsbury plc (PER 22.15). Tesco's share price was 249p, but it would have been 435p ($22.15 \times 249 \div 12.68$) if it were valued based on Sainsbury's PER; incorrect by +175%.

The share price (equity value) takes into account the indebtedness of a firm, but it is better to use the enterprise value of a company (EV) – as though it were debt free. EV is equal to the equity value (market capitalisation of a quoted company) plus net debt. If debt is to be excluded when valuing a company, then the costs of servicing the debt must also be removed when calculating the firm's profitability. The ratio that is most often used is EV divided by the EBITDA (Earnings before interest, tax, depreciation and amortisation). This was the measure used in *ABT*. Whilst using EV/EBITDA is preferable to PER, the other shortcomings

Biog box

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remain, ie different companies in the same sector have different prospects and so may not be directly comparable. In *ABT*, one of the companies (Sakthi Global Auto Holdings Limited) was valued at \$42m to \$69m, a 64% range (at para 94 of the judgment).

Another issue is that two identical companies, one listed and the other unlisted, will not have the same valuations. Nor should they. An owner of the listed company's shares could sell them if they needed to whereas this is far less straightforward, perhaps impossible, for shares in a private company. The greater liquidity of listed companies brings with it a higher valuation.

"SPECIAL VALUE"

One type of "special value" arises from synergy benefits from an acquisition.

Not all buyers will view a company's prospects, and, therefore, its value to them in the same way. One key issue is one of synergy. Take two companies which are identical and equal in size. Each has no debt, a revenue of \$50m and costs of \$40m leaving a profit of \$10m. Suppose the "comparables" method of calculating such companies' values is that it should be 10 times the profit. This values each company at \$100m. Further suppose that on one company acquiring the other, the synergy benefits are such that the total cost can be reduced by \$10m from a total of \$80m (\$40m for each company) to \$70m. The revenue for the combined company is \$100m (\$50m per company) leaving a profit of \$30. The combined company is now worth \$300m (10 x \$30m) rather than \$200m separately. \$100m of extra value has been created by the acquisition as a result of the synergy benefits by the acquirer's action. Other bidders for the same company may not be able to extract the same extent of synergy, or perhaps none.

In a situation of a sale process, the bidding companies will have to decide how much of the synergy benefits that they will bring about should be given up to the vendor in order to ensure success in the auction.

Should some or all the synergy benefits be included in the context of valuing the collateral? In the absence of actual bidders,

though the synergy benefits to the lender (the collateral-taker) can be estimated, it cannot be known what proportion of that might have been given as consideration for the purchase.

Indeed, if there were no other bidders (as sometimes happens), then, presumably, none of the synergy benefits would have been sacrificed by the buyer. The judgment (at para 45) refers to this possibility,

"The second of these problems is the difficulty of valuing the charged shares in circumstances where there is either no or a very limited third-party market for them and/or where they may nevertheless have a special value to the collateral taker."

The judgment (at para 47) states,

"... neither the FCD nor the FCARs contains any description of what constitutes a 'commercially reasonable manner' of realisation or valuation. Nor is there any express indication in either the FCD or the FCARs about whether a 'commercially reasonable manner' of valuation should reflect any special value of the collateral to the collateral taker."

Nor did the judge need to comment on whether special value should be included, and so it remains an open question.

It is likely that the question will arise again.

CONCLUSION

Calculating a theoretical value of a private company for the purpose of evaluating the collateral requires the use of models and parameters. Two models are often used:

- the DCF; and
- "Comparables".

Both produce a very wide range of valuations. The key is that the methods employed are market standard even though their results may be quite different to a price achieved in an organised auction process. As Longmore LJ (*Barclays Bank plc v Unicredit Bank AG* [2014] EWCA Civ 302) said:

"It is the manner of the determination which must be commercially reasonable; it does not follow that the outcome has to be commercially reasonable ..." (repeated at para 74 of the judgment).

It is an open question whether "special value" such as synergy benefits should be included in the valuation and, if so, how this may be done.

Given these uncertainties it is critical to have a detailed methodology agreed in the loan and collateral agreements at the outset of the transaction. ■

Disclaimer: this article is not advice, and the author accepts no liability for reliance upon any of the facts or matters stated. Financial and legal advice on the issues discussed should be sought in the ordinary way.

Further Reading:

- Appropriation of financial collateral under English law security financial collateral arrangements (2023) 2 JIBFL 79.
- A calculated risk: some dangers of taking shares in private companies as collateral (2011) 11 JIBFL 673.
- Lexis+® UK: Share incentives: Practice Note: Creating a market for shares in a private company.