

Business Valuation in Emerging Market



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Nikolai Trifonov (27/06/1948) is the founder and the Chairman to the Belarusian Society of Valuers since 1996 and to the Belarusian Real Estate Guild since 1994. He works as Managing Director to the Council of Valuers' Associations of the C.I.S. since 2002 and as Chairman to the National Technical Committee for Standardization on Valuation, Minsk, Belarus since 2002.

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He studied mathematics in Belarusian State University, graduated in 1975 with Honour Diploma. Candidate of Science (PhD) degree in 1987. He was Director at Large – Responsible for Central and Eastern Europe Relations of the European Real Estate Society in 1998-2005. His career included positions as Professor in Valuation of Belarusian State University, Minsk, Co-Chairman of Minsk Exchange, Member of Council of Belarusbank, Minsk.

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He is married with two sons, grand-son and grand-daughter. His hobbies are tennis, alpine ski, sauna, collecting old books, and travelling including hill walking and mountaineering.

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BUSINESS VALUATION IN EMERGING MARKETS

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Abstract

Problems of peculiarities of business valuation techniques in emerging markets are discussed in the paper.

Keywords: appraisal techniques, business valuation, emerging markets.

INTRODUCTION

Changes in economic in second half of last century stimulated changes in world appraisal community. The system of the International Valuation Standards [1], IVS, has been generated and gradually began to find the increasing recognition both among appraisers of the various countries, and among representatives of adjacent trades, first of all bookkeepers. The main purpose of IVS was to fix uniform traditional approaches to appraisal, developed for centuries of activity in conditions of the stable developed economy, characteristic for the leading countries of the world during the preceded period.

At the same time it became gradually clear, that appraisal activity in conditions of transition economy has new, additional essential features [2-3] which were not noticed in traditional valuation manuals. The discussion which has developed after the report of the author [4], has confirmed an urgency of a problem for developing countries of Pacific Rim region.

Later it became understandable that during a valuation process we are not concern a whole economy but only a market, namely the market of subject of valuation. That is why it is more useful to speak on the features of valuation in emerging markets. But, as it was found out further, emerging markets are not specific elements of a transition economy, they appear in quite stable economically developed countries some time. At last, rather recent scandals in the USA with Enron company etc. have shown, among other, that an ignoring of emerging market features in an appraisal attracts sometimes to a catastrophic consequence. So-called «White document» let out in 2001, the comment to IVS devoted to a valuation in the emerging markets, draws attention to necessity of use of the standard of market value and describes difficulties of appraisal activity in these conditions, not giving recommendations on their overcoming. The purpose of the present paper is an attempt of more practical approach to business valuation in emerging markets.



MUTUAL FEATURES OF VALUATION TECHNIQUES

Some peculiarities of valuation techniques have a common character and are important not only for business valuation.

1. Necessity of definition of monetary unit of valuation.

In IVS a necessity of a definition of the valuation assignment prior to the beginning of the valuation is emphasized. It is spoken, that the purpose of a valuation and a kind of the defined value corresponding it together make so-called base of valuation. As to a monetary unit used in a valuation it is mentioned, that, as a rule, the valuation is made in local monetary units. It means, that is indifferent enough, the appraisal in local monetary unit or, for example, in one of world currencies (USD, EUR, JPY or others) is made. Really, in case of stable market, the difference between various exchange rates of any world currency in relation to local monetary unit in various bank establishments of the country is in the third-fourth significant figure, that obviously exceeds accuracy of an appraisal.

In a situation of emerging markets, rates of any world currency in relation to the local monetary unit, acting in various markets, can essentially differ (as far as several times). For example, buying a notebook for USD2000, and if it is necessarily to pay in local monetary unit the skilled buyer will ask: «At what rate?» And, for instance, in eastern Europe he will not be surprised, having heard the answer 20-30% higher than an average bank exchange rate. The similar increase in a rate occurs in other markets first of all connected with construction, that speaks some construction operations are paid “under the table”, in cash. It is also typical for business markets.

As consequence, in conditions of emerging market before manufacture of an appraisal is necessary, alongside with the purpose of a valuation and a kind of the defined value, to concretize monetary unit of an appraisal. Usually an appraiser must **choose the monetary unit adequate to the market of subject of valuation**. In our opinion, this element is so essential, and its absence can deform so result of an appraisal, that it should be included in the base of valuation together with the purpose of a valuation and a kind of the defined value corresponding it.

2. Necessity of accurate definition for subject of valuation.

In conditions of emerging markets there is a need for an appraisal enough non-conventional subjects of valuation. In the field of business valuation first of all it is necessary to note the incomplete construction (e.g. factory) and the contribution of a tenant to improvements of a real estate. For these appraisals special methods [5-6] are developed. The main and evident idea of income approach in these appraisals is a modeling future expenses and incomes.

Enough widespread there is a valuation of different obligations (for example, debts) and services. Obligations must be valued as a part of business valuation and separately.

Some situations are directly opposite usually observable in stable markets. As a vivid example the greater value of the partial property right (for example, the rights of long term lease of the real estate) in comparison with the full bundle of property rights can serve. It happens in a typical case when rent charge is less than the ground tax, and the risks connected with lease of a real estate are less than risks of the owner. In such markets businessmen prefer tenancy to land ownership. The situation in a number of the countries can cause braking of the privatization declared by the government.

Unequivocal identification of subject of valuation was necessary always, but in conditions of emerging markets it is necessary to pay special attention on it.

3. Necessity of use of all valuation approaches.

A valuation in conditions of emerging market is made by standard methodological approaches (by cost, income and comparative ones). We shall discuss features of their realization in concrete methods below, and now we shall point, that by virtue of unreliability of market data ***the appraisal should be executed by means of a maximum of accessible approaches, generally by all three.*** The nature of *data* unreliability in each approach differs, therefore application of all approaches for a valuation of the same subject compensates lacks of each of them.

As consequence, ***arises a problem of the reconciliation of approaches***, practically not mentioned in traditional appraisal textbooks (see, e.g. [7]). For this purpose various methods are applied [8]. Traditional ones are not changing results of separate approaches (method of weighted average, *multicriteria* ("matrix") method, hierarchy method, and method on the base of common approach). In business valuation also it is used modification of weighted average method, where weights for approaches change with life cycle of valuing business, as well as the method of self-reconciliation ("bootstrap"), using results of separate approaches in dynamics.

FEATURES OF SEPARATE APPROACHES TO BUSINESS VALUATION

Terminology in business valuation is not formed yet. But many business valuers prefer to use the same term system like in real estate valuation. In particular, valuation methods group in three methodological approaches. Sometimes cost approach is named asset-based approach, and comparative approach is named sales comparison or market approach. We will use uniformed terms. Below we shall consider features in application of separate valuation approaches.

1. Cost (or asset-based) approach.

In cost (asset-based) approach specificity of emerging markets is shown at accurate adjustment of book value of assets, first of all non-current assets. The situation when the **book value has become outdated** is typical. Especially it concerns to fixed assets, such as property, plant and equipment (PP&E). Typically a special **revaluation must be recommended**. In valuing enterprise very often there are **surplus assets** which have to **exclude** from financial statements.

Another characteristic problem is lack of intangible assets in financial statements. In any way, business valuer must pay a special attention to **goodwill (badwill) calculation**.

Of course, if we need to obtain a forced sale (liquidation) value of business, the same type of value have to estimate for all assets for further use.

2. Income approach.

In income approach in emerging markets it is necessary to consider, as a rule, significant inflation (sometimes up to 1000% and more) and great risks. Its force necessity to use the **variable rate** in discount procedure. Note, that terminal capitalization rate (reversion yield) differs from discount rate.

Return time for many investments is rather **short**. Because of that discount cash flow analysis is made for 3-4 years, seldom for 5 years.

Because lack of *data* and even lack of exchange, a popular capital asset pricing model (CAPM) for discount rate is not applicable. Cumulative model for discount rate can be used in simple four-link form:

$$R = R_0 + R_c + R_b + R_s,$$

where R_0 is a "risk-free" rate,

R_c is a country risk, *i.e.* specific risk of investment in the country of valuing subject (it depends on using currency),

R_b is a branch risk, *i.e.* specific risk of investment in the market of valuing subject,

R_s is a subject risk, *i.e.* specific risk of investment in valuing subject (incl. one because of management a.o.).

Note, if the monetary unit of valuation is local monetary unit, the country risk is absent.

3. Comparative (or sales comparison or market) approach.

In the comparative approach absence of the developed market cause complications in any used methods.

Capital market method is based on exchange *data* and typical lack of them usually forces impossibility of capital market method application. The same situation with branch ratio method,

in emerging markets there are no institution producing branch ratios such as professional societies and associations, analytical centres.

The markets are mobile enough that attracts necessity of their more careful monitoring. So, for example, the Belarusian Society of Valuers since summer of 2000 publishes *weekly* the BSV apartment *indices* according to the market of sale and purchase of flats in capital of Belarus the city of Minsk.

Sales method complicates with non-transparent market. It is important to note, that in many countries because of peculiarities of the taxation *the supply prices are more authentic*, than data of transactions of sale and purchase.

WHICH SHOULD BE STANDARDS FOR TRANSITION ECONOMIES?

Now in the world there is a complex system of professional standards of valuation. On top level there are the standards applying for a role of recognized world-wide. That is IVS which were created for such purpose, but also it is necessary to note national standards which by virtue of the international activity of the organizations supporting them also apply for a role recognized world-wide: the so-called Red Book of Royal Institution of Chartered Surveyors from Great Britain, the oldest and, apparently, the largest national organization of appraisers and Uniform Standards of Professional Appraisal Practice [USPAP] by Appraisal Foundation from the USA. For the sake of justice it is necessary to tell, that the International Valuation Standards Committee has much made for performance of IVS to above-mentioned mission. The important decision on co-operation with international organizations on financial reporting, and also on securities has been reached, that, in particular, has led to harmonization of IVS and International Standards of Financial Reporting.

At the bottom level there are national valuation standards which in many countries are absent or are insufficiently developed.

Last decade attempts of creation of standards of an intermediate, regional, level are observed. It corresponds to tendencies of regional economic cooperation. Such standards should reflect specificity of appraisal in conditions of economy of region, and, that is important, should be written in language of economy of region. All this it is impossible to reach, having translated, for example, IVS on language of local economy.

Therefore one of the important parties of activity of the international association Council of Valuers' Associations of the Commonwealth of Independent States, which headquarters is in Belarus, is a creation of Russian-speaking Valuation Standards of the CIS. This document should first of all include valuation standards, absent in IVS and reflecting features of valuation in transition economies.

Maybe such standards could be elaborated for Pacific Rim region. And its have to include all peculiarities of business valuation in emerging markets described above.

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