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The curious case of the valueless valuation—the *Signia Wealth v Vector Trustees* ruling

On 8 May, the High Court in London issued a judgment on the *Signia Wealth v Vector Trustees Limited* case. Mr Justice Marcus Smith determined that the fair value of the 49% stake in Signia Wealth owned by Ms Nathalie Dauriac (represented by *Vector Trustees Limited*) was £790k—in sharp contrast to the £21m claimed by Ms Dauriac. This valuation decision provides an important precedent on the choice of the appropriate valuation method and the importance of taking into account relevant contractual terms in the valuation exercise

Oxera Partner, Dr Min Shi, CFA, was the valuation expert for Signia in this dispute. The article is based on information in the Signia Wealth -v- Vector Trustees *judgment.*

It is sometimes said that valuation is mostly science, and partly art. There are many approaches to valuing businesses, and subjective judgement is often required to arrive at a robust assessment. This was certainly the case in the recent *Signia Wealth v Vector Trustees Limited* dispute heard in the High Court of Justice in London.

A commonly used basis for valuing asset management companies is the amount of their assets under management (AUM). However, in this dispute, the judge, Mr Justice Marcus Smith, determined that 'a preconception that AUM automatically translates into value renders the AUM-based valuation more-or-less valueless.'[1]

The background to the dispute

Signia Wealth (Signia) is a London-based private wealth management company. It was founded at the end of 2009 by Ms Nathalie Dauriac and Mr John Caudwell with 49% and 51% shareholdings, respectively. Ms Dauriac was CEO of Signia until she left the company at the end of 2014, while Mr Caudwell (who also co-founded the business, Phones 4u, in the mid-1990s) was the cornerstone client of Signia, contributing more than half of Signia's AUM.

At the time of founding Signia, it was envisaged that the cornerstone status of Mr Caudwell, combined with the wealth management experience of Ms Dauriac, would attract a large amount of assets from other clients, and thereby make Signia a successful wealth management company. This, however, did not turn out to be the case. Instead, Signia did not deliver good returns on the assets that it was managing, and was unable to attract or retain significant assets from third-party clients. The business started with a small loss in 2010. It then earned small profits in the next three years. In 2014 it incurred a loss of around £3m, and was in breach of its regulatory capital requirements at the year end. Signia was able to continue as a going concern only with significant financial support from Mr Caudwell in 2015.

When Ms Dauriac left Signia following an internal investigation into her expenses, her 49% shareholding in Signia (the 'Dauriac Shares') was compulsorily transferred from her, as per the company's Articles of Association, for an amount of £2. Ms Dauriac contested that her shares were not appropriately valued in line with the Articles of Association, which made the fair value of the Dauriac Shares at the time of her departure the focus of the dispute.

Ms Dauriac's valuation expert estimated the fair value of the Dauriac Shares to be £21m. This was based on Signia's AUM of £1.5bn at the end of 2014, an enterprise value (EV) to AUM multiple of 2.9%, and Ms Dauriac's 49% shareholding in the company. Ms Dauriac's expert derived the EV/AUM multiple using data on asset management companies involved in private transactions or listed on stock exchanges, many of them mature and profitable.

In contrast, the expert for Mr Caudwell, Dr Min Shi of Oxera, estimated the fair value of the Dauriac Shares to be zero.[2] This was based on her findings that (i) Signia's normalised earnings before interest, taxes, depreciation and amortisation (EBITDA) were negative as at the end of 2014; (ii) a hypothetical buyer of Signia would have concluded that the company was not likely to be profitable going forward; and (iii) there were significant risks associated with the Dauriac Shares.

In May 2018, and following a three-week trial in November 2017, Mr Justice Smith issued a judgment containing a detailed assessment of the facts and economic evidence submitted in connection with the case. Mr Justice Smith adopted Dr Shi's approach and determined that the fair value of the Dauriac Shares was £790k. In reaching this valuation assessment, Mr Justice Smith considered the following three questions.

- What is the appropriate valuation method?
- What was the normalised EBITDA of Signia as at the end of 2014?
- What was the impact of other risk factors on the fair value of the Dauriac Shares?

The appropriate valuation method

Valuing private companies is challenging, as there are no market prices for their shares. Two commonly used valuation methods are the discounted cash flow method and the multiples method.

- The discounted cash flow method estimates the value of a company at a specific point in time as the present value of the company's expected cash flows in the future. It is commonly accepted to be a theoretically sound model, and is widely used by industry practitioners and academic researchers. However, implementing the method requires a reliable forecast of future cash flows, which was not available in this case. As a result, both experts agreed that it was impractical to rely on this method to value Signia and the Dauriac Shares.
- The multiples method is based on the idea that two comparable companies ought to have comparable valuations. It estimates the value of a company using valuation multiples (i.e. the ratio of the market value of an asset to an accounting measure of the asset) of comparable public companies or recent transactions (for which the transaction value is known). For wealth management companies, two types of valuation multiple are generally used: the EV/AUM multiple and the EV/EBITDA multiple, where EBITDA is often considered a good proxy for cash flows of the company.

While both experts relied on the multiples method to value Signia, they differed in their opinion regarding which valuation multiple was appropriate. As noted above, Ms Dauriac's expert valued Signia based on EV/AUM multiples of other asset management companies. He believed that 'a substantial AUM meant a substantial valuation,' and stated the following at the trial:[3]

> I really just can't conceive of any situation, especially with an asset management company with £1.5 billion of assets under management, how it cannot sell for valuable consideration…I actually find it quite inconceivable.

In contrast, Dr Shi argued that the EV/EBITDA multiple was the appropriate way of valuing Signia. This is because EBITDA reflects the difference between the revenue from and the cost of providing the services of a wealth management company, which both affect the valuation of the company.

Dr Shi noted that Signia's EBITDA margins (about 3% during 2011–13 and -60% in 2014) were significantly lower than those of most wealth management companies. The range of EBITDA margins of asset management companies was 20–60% in 2014/15, with an average of 36%.[4] She explained that, if all asset management companies were equally efficient in converting AUM to profit, there would be no real difference between the EBITDA multiple-based valuation and the AUM multiple-based valuation. This can be seen from an exchange between Dr Shi and Mr Justice Smith at the hearing, as shown in the table below.

Based on the above considerations, Mr Justice Smith concluded that the EV/EBITDA multiple 'represents the best starting point for the valuation process', while 'a

Table 1 AUM- vs EBITDA-based valuation

Q (Marcus Smith J.)	I mean, obviously, as you've just said, Dr. Shi, there's a nexus between AUM and profit, because it's assets under management for which you charge a fee, which leads to the profit. And I imagine if all asset management companies were equally efficient, then there would be very little difference between [the Dauriac Expert]'s approach and your approach?
A (Dr. Shi)	That is exactly right.
Q (Marcus Smith J.)	What you're saying is that where there is a difference in efficiency between firms operating in the same business, whilst they may have the same assets under management, because they are either forced to charge less or because their cost base is different, their profit varies, and that I think…
A (Dr. Shi)	That is exactly the point I wanted…
Q (Marcus Smith J.)	…is the difference between you and [the Dauriac Expert]?
A (Dr. Shi)	Yes. That is exactly the point I wanted to make, and that is the difference between [the Dauriac Expert] and I.

Source: *Signia Wealth -v- Vector Trustees*, para. 723.

preconception that AUM automatically translates into value renders the AUM-based valuation more-or-less valueless':[5]

> For the reasons I have given, I consider that Dr. Shi's approach represents the most reliable way of attributing a value to Signia's Ordinary Shares.

The appropriate EBITDA for applying the EV/EBITDA multiple

Having agreed that EV/EBITDA multiples were the most reliable way to value Signia, Mr Justice Smith considered what level of EBITDA should be used in the analysis. In principle, it is generally accepted that normalised 'steady state' EBITDA should be used to produce a robust estimate of value.

Signia had a negative EBITDA in 2014: -£3m. Mr Justice Smith made two types of adjustment to arrive at his estimate of Signia's steady-state EBITDA. The main one was to increase the fee rates paid by Mr Caudwell and Caudwell-related parties, such as his family. The second was to use a slightly greater AUM amount to account for potential growth.

Mr Caudwell had negotiated favourable fee rates with Signia for his and the Caudwell-related parties' AUM. Ms Dauriac's expert argued that Mr Caudwell's and related parties' fee rates were not on arm's-length terms because other clients were paying higher rates. In contrast, Dr Shi considered that Mr Caudwell's fee rates were on arm's-length terms due to the sheer size of his and the Caudwell-related parties' combined AUM and their bargaining power in negotiating with Signia as a start-up company.

Mr Justice Smith accepted the arguments put forward by Dr Shi, but noted that they did not fully explain the mismatch between the fees paid by Mr Caudwell and the related parties on the one hand, and those paid by third parties on the other hand. He concluded that 'part of the mismatch derives from the fact that Mr Caudwell was an investor in, majority shareholder of, and lender to, Signia.'[6] As a result, in normalising Signia's EBITDA, Mr Justice Smith used higher fee rates for Mr Caudwell's and the related parties' AUM. This increased the normalised EBITDA to £925k.

Other factors affecting the fair value of the Dauriac Shares

To estimate the fair value of the Dauriac Shares, Mr Justice Smith applied an EV/EBITDA multiple of 5 (the lower end of Dr Shi's estimate for a small wealth management company with poor historical performance) to account for the fact 'that Signia was a start-up and moreover a start-up that was enormously dependent on Mr Caudwell and the Caudwell-related parties staying with Signia'.[7]

Even though the Dauriac Shares represented minority ownership in Signia, the Articles of Association implied that the fair value assessment of these shares should not include a discount for lack of control.[8] Nevertheless, Mr Justice Smith assessed whether there were other considerations that could affect the value of the Dauriac Shares. He found two to be of particular importance.

First, there was no obligation for Mr Caudwell and the related parties to have their assets managed by Signia; they were free to move their AUM away from Signia with no advance notice. Mr Justice Smith considered that 'the hypothetical buyer would take this factor extremely seriously, and it would cause the price that the hypothetical buyer would be prepared to pay to be materially reduced'.[9] At the same time, he noted that Mr Caudwell was also a large shareholder in Signia, and that moving away his AUM would diminish the value of his own shares. Therefore, the negative impact of the concentrated AUM may have been less pronounced.

Second, the exit provisions of the Articles of Association implied that the holder of the Dauriac Shares would not receive 49% of Signia's equity value upon exit, unless Signia reached the target exit valuation of £175m. In fact, if Signia did not reach the minimum exit valuation of £75m, the holder of the Dauriac Shares would receive only 20% of Signia's equity value. Mr Justice Smith considered that 'this would be a very material, negative, factor bearing on the mind of the hypothetical buyer.'[10]

As a result of these considerations, Mr Justice Smith determined that the price that a willing buyer would be prepared to pay for the Dauriac Shares would be half of what was implied based on the EV/EBITDA multiple—i.e. £790,000.[11]

Lessons for valuation experts

This case offers several important lessons for valuation experts. The first is that the valuation of a company derives from its ability to generate cash, which is affected by the asset count or head count of the company, but not determined by them. Companies that are not efficient in converting their assets to cash are much less valuable than companies that are efficient. For valuation experts, this means that caution is warranted when using valuation measures that are not based on cash flows of the company, as these can lead to unreliable estimates.

Second, when using a multiples-based approach to value a private company, it is important to identify companies that are truly comparable to the company being valued. In the dispute at hand, the specific situation of Signia at the end of 2014 meant that it was not appropriate to use valuation multiples of established and profitable asset management companies to value Signia.

Finally, when valuing shares in a company, it is important to take into account contractual terms that relate to the shares, such as the exit provisions in this case. Failure to do so would lead to an inappropriate estimate.

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[1] *Signia Wealth -v- Vector Trustees*, www.judiciary.gov.uk/judgments/signia-wealth-v-vector-trustees/, paras 724 and 750.

[2] Dr Min Shi, CFA, of Oxera was instructed by Mishcon de Reya, solicitor of Signia and Mr Caudwell.

[3] *Signia Wealth -v- Vector Trustees*, para. 748.

[4] William Blair (2015), 'Investments Services Industry Insights', June, p. 8.

[5] *Signia Wealth -v- Vector Trustees*, paras 724, 750 and 734.

[6] *Signia Wealth -v- Vector Trustees*, para. 706.

[7] *Signia Wealth -v- Vector Trustees*, para. 742.

[8] *Signia Wealth -v- Vector Trustees*, p. 3 'Fair Value'.

[9] *Signia Wealth -v- Vector Trustees*, para. 744 (2).

[10] *Signia Wealth -v- Vector Trustees*, para. 744 (4).

[11] *Signia Wealth -v- Vector Trustees*, para. 746. Separately, Mr Justice Smith also determined that Ms Dauriac was a 'bad leaver' as per Signia's Articles of Association. By applying the formula set out in the Articles of Association for calculating the transfer value for bad leavers, he determined that the compulsory transfer value of the Dauriac Shares was £511,510. *Signia Wealth -v- Vector Trustees*, para. 753.