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Business Valuations

The Valuation of a business is a prerequisite for the acquisition of a share in it or its merging with another company (Mergers and Acquisitions (M&As)). The Valuation usually takes place for the benefit of the shareholders – current and prospective. The method of Valuation varies depending on the level of development of the business and the environment it operates in, necessitating the use of a different method depending on the circumstances.

The usual methods for business Valuations and the respective circumstances in which they are used, are the following:

The Cash Flow method

This is the only method accepted as valid by financial economics and is based on predicting the future cash flows of the business and discounting them to today's equivalent values.

Although the result of this method is just a number (in the form of X million of Euros), the accuracy of this result is based on assumptions that determine the estimations for the future cash flows and their discounting and, therefore, the Valuation. Therefore, before taking a decision based on such a Valuation, one has to examine carefully the underlying assumptions on the basis of which it has been made. Here is a list of the main assumptions one has to check:

- **The interest rate** used to **discount** future flows into today's values. If the rate is extremely high, the Valuation will be extremely low. If the rate is extremely low, the Valuation will be extremely high. The "correct" interest rate is based on

the general conditions existing in the financial and capital markets as well as the specific risks associated with the business.

- **The forecast of future incomes** and its relevance to reality. Special attention must be paid to the justifications for the expected market share of the business and the anticipated rate of development of the total market.
- **The forecast of future costs** and whether the anticipated cost structure corresponds to market norms. If not, can the (usually optimistic) divergence be justified? The most important parameter to check is Gross Profit, while Financial Costs have to be in line with anticipated borrowing and expected interest rates.
- **Credit given and taken** is particularly important when we are using the cash flow method as cash flows are, in general, different from profits. One of the main reasons behind this difference is credits given to the customers or taken from suppliers. It is not uncommon for fundamentally profitable operations to fail because of their lack of liquidity: credit given (which has to be financed from the business' liquid resources) exceeds by far credit received from suppliers (which in essence is an indirect form of financing the business). This factor becomes particularly important when we take into account the fact that business activity may depend to a much larger extent on expenses with a small credit limit (e.g. labor, energy etc.), than with an extended credit limit of 3 or more months (e.g. raw materials, spare parts etc.).
- **The investment programme** of the business and the proposed method of **financing** it. When analyzing these factors, particular attention has to be paid to the cost – including financial cost – of the construction period, which should also be financed before the investment starts paying off.

Benchmarking

This method uses benchmark ratios applied to specific values of the balance sheet and / or the P&L statement so as to determine the value of the business. For example, we often hear that the value of company X is 10 times its profits or 2 times its turnover. As we can see even from this simple example, we can use different types of benchmarks and derive different valuations.

These are "rule of thumb" type of methods and function best when there is an established capital market for the Valuation of businesses. Such a market is the Stock Market where businesses are Valued at their real value if, of course, the Stock Market functions properly. Following this thinking, the Price / Earnings (P/E) ratio of a listed share, can be applied to a company with similar characteristics about to be listed in the Stock Exchange with an IPO.

In cases where the stock market functions properly – and by implication so does the application of benchmarks – it has been proven that the use of the benchmarks can bring similar results with the prediction of cash flows. The reason is that in these cases the market valuation has assimilated the complicated calculations needed by the cash flow method and incorporated them in a benchmark. It can not be overemphasised, however, that in order to achieve this, the market has to function rationally. In other words, the application of benchmarks on the basis of fragmentary or unsubstantiated data from similar but different cases will, in all probability, lead to the wrong Valuation.

Net Worth

There are 2 cases:

- **Evaluating the Net Worth of a Going Concern**

  This method specifies the value of business at a certain moment in time as shown in its accounting books. The net worth of the business is based on the Valuation of its:

  - non-depreciated fixed assets

  plus

  - short-term assets

  minus

  - short-term and long-term liabilities.

  In other words, it is a snapshot of what the shareholders would take if they could convert into cash their financial property (fixed and short-term), and pay all their obligations (short- and long-term) in full.

This method is used as a “supportive” method for the specification of the minimum value of the shares of the company, and is called the "net worth" method.

- **Evaluating the company in case of liquidation**

  All the above-mentioned methods presuppose that the business is a going concern functioning now and in the future. For this reason none of the above is valid if the business stop functioning. In such a case, the value of the company results from:

  - converting the company's property into cash

  plus

  - collecting its receivables

  minus

  - paying its obligations

  Comparing this method with the net worth method, we note that they appear to come to the same result. However, this is highly unlikely as:

  - the conversion of a company’s assets into cash will earn an amount different from the amount of the non-depreciated value of the fixed assets;
  - the collection of the receivables is a painful and doubtful process for a company that has stopped its operations;
  - the usual reason that a company seizes operations is its inability to meet its obligations.

  Therefore, in reality, the two methods are very different and the liquidation method will produce a much smaller value.

<u>Intangible Factors</u>

Finally, it is extremely important to understand that any and all Valuations, hinge – in addition to the above – on the calculation of some intangible factors, like:

- the percentage share that someone buys into a company and whether it gives him/her some or total control of the company;
- the quality of management and labour in the company;

- the venue of the company and whether expected changes in infrastructure (airports, roads etc.) can impact on its operations and alternative uses of the site;
- expected changes in the legal environment of the business and their effect on its operations;
- how widely the company's customer base is spread and the resultant stability / predictability of its cash flows;
- the market share of the company, its position in the market and its potential to maintain them or strengthen them;
- the anticipated consequences from expected changes in technology.

Conclusion

In conclusion, a business Valuation is more of an art or a craft and less of a science. Like all arts and crafts, the result will depend greatly on the mastery of the person exercising it.