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Decoding Valuation

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Knowing what exactly is the worth of a business and what determines its value has always been a prerequisite for intelligent investing and decision making.

Valuation of an enterprise or its equity shares is not an exact science and ultimately depends upon what it is worth to a serious investor or buyer who may be even prepared to pay goodwill. This exercise may be carried out using generally accepted methodologies, the relative emphasis of each often varying with the factors such as:

- Specific nature of the business.
- Whether the entity is listed on a stock exchange.
- Industry to which the Company belongs.
- Past track record of the business and the ease with which the growth rate in cash flows to perpetuity can be estimated.
- Extent to which industry and comparable company information is available.

Common terms for the value of an asset or liability are market value, fair value, and intrinsic value. The meanings of these terms differ. For instance, when an analyst believes a stock's intrinsic value is greater (less) than its market price, an analyst makes a "buy" ("sell") recommendation. Moreover, an asset's intrinsic value may be subject to personal opinion and vary among analysts.

> *"A valuation is an opinion on what something is worth and not the price what someone will actually pay for that in a commercial transaction"*
>
> *- Nucleus Advisors*

As most treatises and court decisions suggest to consider more than one method of valuation which must be reconciled with each other to arrive at value conclusion, but as of now there is not much guidance and standardization for business valuation in India specifically for unlisted and private companies.

Believe it or not, numerous conceptual controversies still remain, even amongst the most prominent valuation practitioners. Thereby, **Investment Banking wing of Nucleus Advisors**, Business Advisory firm, presents this article which gives its readers rich insights and adequate knowledge about key business valuation methods.

Value is an Economic concept whereby it's known to be an estimate of likely prices to be concluded by the buyer and seller of a good or service that is available for purchase. Hence, per se, valuation is the process of determining the "Economic Worth" of an Asset or Company under certain assumptions and limiting conditions and subject to the data available on the valuation date.

> *"Price is what you pay, value is what you get. They are not same."*
>
> *- Warren Buffett*

Did You Know?

- **Valuation Is an Art as Well As A Science:** Valuation is more of an art rather science. It involves high level of Professional Judgment. Mathematical certainty is neither determined nor indeed is it possible as use of professional judgment is an essential ingredient of estimating value.

- **Price and Value Is Not the Same:** The Value of a business obtained is not the selling price of the business. It is an economic figure based on certain data & assumptions. However, Price is what a Buyer is willing to pay by considering the Economic and Non-Economic factors which cannot be valued as such.

- **Valuation and Deal Price Is Not Always Same:** The valuation arrived is subjective and depends upon buyer and seller expectations and subsequent negotiations and the Deal concludes at negotiated price only.

Why Would We Need a Business Valuation?

Overall, there are many common reasons why business owners need to evaluate the worth of their company. Most prominent are stated below:

- As investors like to see where their money is going and how it is going to provide them with a return on the investment. One is more likely to gain the attention of a potential investor when they can see that their funds will carry the company to the next level, increase its value, and put more money back into their own products.

- Major corporations will attempt to acquire business or merge with it for as little money as possible. When you know what your business valuation really is, you are able to negotiate your way to the appraised valuation numbers provided by a well-known and reputable valuation determination service.

- When a new company goes for an Initial Public Offering (IPO), the Indian Stock Market follows a free pricing regime and thus the accurate pricing of an IPO is of immense importance.

- At times the management of the company voluntarily wants to know the true and fair value of the business for which they undertake the exercise of voluntary assessment for future decision making.

What are various Techniques of Valuation?

In respect of going concerns, certain valuation techniques have evolved over time and are commonly in vogue. These can be broadly categorized as follows:

- **Asset Based Valuation [Net Asset Value Method (NAV)]**

  The value arrived at under this approach is based on the audited financial statements of the business and may be defined as Shareholders' Funds or Net Assets owned by the business. The Net Asset Value is generally used as the minimum break-up value for the transaction since this methodology ignores the future return the assets can produce and is calculated using historical accounting data that does not reflect how much the business is worth to someone who may buy or invest in the business as a going concern.

- **Cash Based Valuation [Discounted Cash Flow Method (DCF)]**

  The DCF method uses the future free cash flows of the firm / equity holders discounted by the cost of capital/equity to arrive at the present value.
  In general, the DCF method is a widely accepted valuation tool, as it concentrates on cash generation potential of a business.

- **Market Based Valuation [Market Multiple Method]**

  Under this methodology, market multiples of comparable listed companies are computed and applied to the business being valued in order to arrive at a multiple based valuation. Under this method, the challenge is in the identification of publicly listed comparable companies and derivation of suitable multiples.

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So, what are Methods of Valuation?

With all of this in mind, let's explore some of the most common business valuation methods. Once again, depending on your specific situation, one approach may be more beneficial than another; however, you'll generally want to work with a professional like **Nucleus Advisors** to get the most objective assessment of what your company is worth.

1. Berkus Method:

In the middle 1990's, Dave Berkus came up with a method of assessing the value of critical elements of a start-up without having to analyze the projected financials, except to the extent that the investor believes in the potential of a company to reach over 20 million in revenues by the fifth year of business. When business is at idea stage this is one of the best methods for Valuation Analysis

S. No	If Exists	Add to company value upto:
1.	Sound Idea (basic value, product risk)	$ 500K
2.	Prototype (reducing technology risk)	$ 500K
3.	Quality Management Team (reducing execution risk)	$ 500K
4.	Strategic relationships (reducing market risk and competitive risk)	$ 500K
5.	Product Rollout or Sales (reducing financial or production risk)	$ 500K

Note that these numbers are maximums that can be "earned" to form a valuation, allowing for a pre-revenue valuation of up to $ 2 million (or a post rollout value of up to $ 2.5 million), but certainly also allowing the investor to put much lower values into each test, resulting in valuations well below that amount.

2. Venture Capital Method:

The Venture Capital Method (VC Method) was first described by Professor Bill Sahlman at Harvard Business School in 1987 in a case study and has been revised since. It is one of the useful methods for establishing the pre-money valuation of pre-revenue and early stage business ventures. The concept is:

Terminal Value
Projected Net Income of Nth Year X Median Multiple

Using market multiples is the most common method of arriving at a terminal value, because a projection of future cash flow at that point would be excessively speculative. The parties will generally use a price to earnings ratio to calculate the terminal value

Post Money Value
Terminal Value / Anticipated ROI

Once a terminal value is calculated, the post-money value is calculated by discounting (dividing by a discount factor) that represents an investor's expected or required rate of return.

Return on Investment
Terminal Value / Post Money Value

The investor seeks a return based on some multiple of their initial investment. The required multiple is based upon the risk perceived by the investor. The higher the risk, the higher the return required.

3. Discounted Cash Flow (DCF) Valuation Method

Discounted cash flow (DCF) is one of the prominent income approaches to valuation and is used to estimate the attractiveness of any investment opportunity on the basis of future cash flow projections of business. The Discounted Cash Flow method expresses the present value of the business attributable to its stakeholders as a function of its future cash earnings capacity. This methodology works on the premise that the value of a business is measured in terms of future cash flow streams, discounted to the present time at an appropriate discount rate. Discounted Cash Flow can be used to derive the value of equity shareholders of company and also the value of the firm/company.

4. Public Company Comparable Method

The Public Company Comparable Method entails using valuation metrics from listed companies trading at stock exchanges, which are considered to be rightly similar to the subject entity. In most situations, direct comparability is hard to attain since a majority of public companies are not only larger but also more dissimilar to the subject.
Therefore, queries should be a little flexible so that public companies that have comparable business features are not excluded from giving guidance on the subject company's valuation.
Guideline companies are usually companies that have been traded publicly in a similar or equivalent industry as the subject company. They should also have a practical basis for comparison to the subject of evaluation because of resemblances in demand and supply factors, operational processes and financial composition.

5. Precedent Transactions Method

Precedent transaction method relies upon publicly available information to create a reasonable estimate of multiples or premiums that others have paid for a publicly-traded company.
One of the most important components of precedent transaction analysis is identifying the transactions that are the most relevant. First, companies should be chosen based on having similar financial characteristics being in the same industry. Second, the size of the transactions should be similar in size to the transaction that is being considered for the target company. Third, the type of transaction and the characteristics of the buyer should be similar. Transactions that occurred more recently are considered more valuable in terms of usefulness for analysis.

6. Net Asset Based Valuation Method

The Net Asset Value (NAV) is the easiest to understand. It is calculated simply as fair value of the assets of the business less the external liabilities owed. The key here is determining fair value, especially of assets since fair value may differ significantly from acquisition value (for non-depreciating assets) and recorded value (for depreciating assets).
Also, the true value of your company may be significantly higher than the simple addition of the net assets.

Concluding Thoughts:

As we all know, valuation is more on an art based on the professional experience of the valuer rather than a science based on empirical studies and logics. Valuation has been debated in India as an art or science and substantial part of the litigation in Mergers & Acquisitions (M&A) takes place on the issue of valuation as it involves an element of subjectivity that often gets challenged. More so, as in India, there are not much regulator prescribed standards for business valuation specifically for unlisted and private companies so in many cases the valuation lacks the uniformity and generally accepted global valuation practices. Even limited judicial guidance is available over the subject in India. Further, absence of any stringent course of action and non-regulation under any statute is also leading to lose ends. The Institute of Chartered Accountants of India (ICAI) has developed Valuation Standards aiming to establish uniformity in practices and procedures for valuers performing valuation services in India.
Keeping in view the growing relevance and importance of valuation in business and investment decisions as well as in regulatory compliance processes the development of practice of valuation as a discipline and profession in the present context has become a necessity because of imperatives of financial markets, emerging global economy, and changing framework of accounting and financial reporting.

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This article could not be this insightful without below mentioned contributions:

- Blog of insightfully CEO at Inc.com
- Corporate Valuations presentation: Insight of Valuation by Corporate Valuations
- Corporate Professionals presentation: Corporate Valuations: Techniques and Application
- Corporate Finance Institute blogs
- Will Kenton blog at Investopedia
- Ujval Nanavati blog at ET Contributors