

Unit 1 Basis of Business valuation

Introduction:

Business valuation is a process used to estimate the economic value of business. Valuation is used by financial market. Valuation is used by financial market participants to determine price they are willing to pay or receive at the time of sale of business. Business valuation require working knowledge of varieties of factors and professional judgement. Valuation highly subjective calculations to determine a fair market value of a company. There are many common situations when valuation are required like Business recognition, employee share or stock option plan (ESOP), Mergers and acquisition and shareholder dispute. Business valuation examination conducted towards an estimate or opinion to the fair market value of business interest at a given point of time.

Sometimes, when a business owner is informed about the intrinsic value of business. Business valuation is worth the business. Like accounting, valuation is an art rather than science. Property conducted valuation is nothing more than opinion it is based on facts and judgement. Valuation are not precise due to which valuation estimates and opinion are generally stated range of values. Business valuation is no precise science. There is no Universal legal framework, which dictates action should be performed. Therefore, there is no right way to estimate a company's value.

When is valuation required?

Business valuation may be required at the time of
Shareholders dispute
Purchase and sale of business
Mergers and acquisitions
Damage claims
Buy or sell agreement etc.

Importance of Conducting a Business Valuation

Numerous business owners and entrepreneurs underestimate or simply are unaware of what the business valuation process entails and where it begins. This is a common scenario as the valuation process is a complex multistep process with different methods of approach. Independent of the valuation method you choose, valuating a company is a process where current value generating elements of the company are measured, as well as its competitive position within its sector and its future financial expectations. The type of valuation method used for analysis will then depend on factors such as the industry sector where the company operates, the size of the company, expected cash flow and the type of product or service it offers. For example, it is generally not advised to use the valuation method of comparable transactions if the sales volume or profits are 50% lower than that of the target company.

The valuation process is intrinsically technical; hence, it is vitally important that whoever is conducting the valuation acquire financial knowledge. The valuator should also be aware of the company's business model, its strategy, have a thorough understanding of the market where it operates, and the value-creating elements it acquires.

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The main objective of the valuation process is to identify the critical value-generating areas of the business. It is essential to consider which areas of your business may be of specific interest or value to the counterpart of the deal, as this will mostly determine the valuation results. For example, depending on the mind-set and objectives of the investor, their interest may not be as much the profitability of the business, but perhaps the market share, strategic positioning, or a specialized area of the company's value chain. The valuation result is then considered a significant estimation of a value range that will be a pivotal point in the negotiation of the final price paid for the deal. The valuation results are, therefore, important not only for identifying the key profit drivers of the business, but for also setting a pinpoint for upcoming deal negotiations.

Ultimately, the valuation process is a preliminary task to sell your company. It provides insight into the critical areas of a business, allowing owners to leverage the advantages and focus on improving vulnerabilities. Most importantly, this valuation provides an accurate estimation of the value range that both counterparts of the deal can use as the backbone of the deal negotiations. As discussed earlier, **there is no ultimate formula or perfect valuation method for each situation**. Still, by knowing the characteristics of the company and its corresponding environment, the best-fit method can be chosen from a variety. It is an essential process to be able to maximize the price of the company backed by logical reasoning and numerical arguments.

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Secondly, the valuation results act as a solid pivotal cornerstone of negotiations and don't bind to the final price of the deal. It is a rarity to see both buyers and sellers agree on the set price immediately, so the valuation, in a sense, brings the two sides of expectations to a middle ground.

Premises (Assumption) of Business valuation

- Going Concern – Value in continued use as an ongoing operating business enterprise.
- Assemblage of assets – value of assets in place but not used to conduct business operations.
- Orderly disposition – value of business assets in exchange, where the assets are to be disposed of individually and not used for business operations.
- Liquidation – value in exchange when business assets are to be disposed of in a forced liquidation.

Premise of value for fair value Calculation

- In use – If the asset would provide maximum value to the market participants principally through its use in combination with other assets as a group.
- In Exchange – If the asset would provide maximum value to the market participants principally on a stand-alone basis.

Business valuation results can vary considerably depending upon the choice of both the standard and premise of value. In an actual business sale, it would be expected that the buyer and seller, each with an incentive to achieve an optimal outcome, would determine the fair market value of a business asset that would compete in the market for such an acquisition. If the synergies are specific to the company being valued, they may not be considered. Fair value also does not incorporate discounts for lack of control or marketability.

Note, however, that it is possible to achieve the fair market value for a business asset that is being liquidated in its secondary market. This underscores the difference between the standard and premise of value.

These assumptions might not, and probably do not, reflect the actual conditions of the market in which the subject business might be sold. However, these conditions are assumed because they yield a uniform standard of value, after applying generally accepted valuation techniques, which allows meaningful comparison between businesses, which are similarly situated.

Principles of valuation

Like finance, valuation is based on some foundations, which are called principles. The principle provides basic groundwork for the purpose of valuation and Different techniques of valuation the following are the principles of valuation.

1. Principle of substitution: It indicates that risk averse investor will not pay more for business desirable substitute exist by creating new or by buying. for example If one business is worth of 'X' amount and If similar business is available at a price less than 'X' amount Then business has worth less than 'X' amount. This principle is based on understanding of market and forced comparison, which will lead to flawed valuation.

2. Principle of Time value of money: business valuation is done based on time value of money. it suggests that value can be measured by calculating present value of future cash flow discounted at appropriate discount rate.

3. Principle of Expectation: Cash flows are based on expectations about the future performance of the company and not on the past. the difficult part is to determine the extent and direction of growth. These exemption we have significant impact on the valuation.

4. Principle of Risk and Return: investor is risk averse and investor would prefer a higher amount of wealth than lower one. The reason is higher wealth leads to possibility of higher consumption. Given to possible portfolios with similar risk, the one with higher expected return will be preferred.

5. Principle of Reasonableness and Reconciliation: Valuation require large number of uncertainties and we have to go for assumptions. this principle suggest how far are the assumptions are reasonable and it reconcile Different values of the under different approaches.

Valuation process.

Valuation process comprise of five steps.

1. **Understanding the business:** The first step towards business valuation is to understand the business that is evaluating industry prospects, competitive position of the In industry environment, corporate strategies its planning and execution, technological edge etc. These help the valuator in forming assumption and future prospects of the business.
2. **Forecasting company performance:** It is achieved by doing economic forecasting studying companies financial information. There are two approaches economic forecasting are Top down forecasting and bottom up forecasting. In top down forecasting analyst, use macroeconomic forecast to develop industry forecast and then make individual company forecast. in bottom up forecasting analysts aggregate individual company forecast with industry forecast and finally aggregated with macroeconomic forecasts.
3. **Selecting appropriate valuation model:** The most important step towards evaluation is to select appropriate valuation model the two broad types of valuation models are mission and relative valuation. Valuation model that specifies acid intrinsic value. This model specify the value of company point of time and it is compared with the existing market price for decision-making. Relative valuation model acid value relative to that of another acid and the basic notion of relative valuation model is that similar acid should sell at similar price.
4. **Converting forecast to valuation:** Analyst Play a vital role of Collecting, Analysing, Communicating and monitoring the corporate information, which they have used in valuation analysis.
5. **Communicating the information:** the final step towards business valuation the preparation of Research port. it is prepared on the basis of information collected and valuation based on models reported.

Value:

Value is the 'worth' it can also be defined as 'bundle of benefits' tangible or intangible. The value is also call desirability, utility of a thing.

It Is purchasing power and worth estimated.

Value is what each person gives a company depending on his profile and interests. It is the monetary measure of how useful the company is going to be for a person. Value is the monetary, material, or assessed worth of an asset, good, or service.

Who determines values?

The concept of value is like beauty just as it is said that 'beauty lies in the eyes of the beholder' Value is determined by person who perceive Value in a thing. Value can also be estimated, determined by professional called 'Valuer'. The process of determining value is called 'Valuation'. Business valuation process of determining economic value of business. Valuation include

1. Value of Assets and liabilities to know the value of 'what we own' and 'what we owe'.
2. Asset will include both tangible and intangible asset.
3. Liabilities include both apparent and contingent.

Role of a Valuer

- Advisor
- Giving opinion to his client.
- Fair Market Value and Interest
- To take financial decision
- Advise on change in possible rental and capital value
- For investment suggestion on policy matter, sinking fund
- Land acquisition case - Date of valuation / Date of notification
- Estate management Maximum income and capital value Securing good maintenance – Increase or decrease in capital value – To check reasonableness of present rent and outgoings. – Provisions for reserve for future repairs.
- Must deliver own independent honest and conscious opinion.
- Not a advice tailored to suit what the client desires.

Types of Value

There are number of types of values.

Original value	Book value	Depreciated value
Sales value	Purchase value	Replacement value
Market value	Economic value	Residual value
Scrap value		

Price and Value

1. Price can be understood as the money or amount to be paid, to get something. And value implies the utility or worth of the commodity or service for an individual. Price is the amount of money paid by the buyer to the seller in exchange for any product and service. The amount charged by the seller for a product is known as its price, which includes cost and the profit margin. For example- If you buy a product for \$250, then it is the price of that product. Moreover, Value is the usefulness of any product to a customer. It can never be determined in terms of money and varies from customer to customer. For example- If you are going to a gym by spending 1000 bucks a month, the output seen is worth the expense, then it is the value that you create for a gym, regarding the service being offered there. Here the worth is its value.

2. Price is the amount you pay. Value is what the product or service pays you. This value could be measured in financial terms, emotional terms, physical conditions, or in any number of other ways.

3. The most important distinction between price and value is the fact that price is arbitrary and value is fundamental. For example, consider a person selling gold bars for \$5 a piece. The price of those gold bars is, in this instance, \$5. It's an arbitrary amount chosen by the seller for reasons known only to them. Yet, in spite of the fact that those gold bars are priced at \$5, their value is so much more.

4. Value represents the amount of money that you are *willing to pay* for anything. Price is the amount of money that you are *asked to pay* for it.

5. Price can be understood as the money or amount to be paid, to get something. Price is the amount of money paid by the buyer to the seller in exchange for any product and service. The **amount charged by the seller for a product is known as its price**, which includes cost and the profit margin. **For example-** If you buy a product for \$250, then it is the price of that product.

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Points	Price	Value
Meaning	Price is the amount of money paid by the buyer to the seller in exchange for any product and service.	<i>Value implies the utility or worth of the commodity of service for an individual.</i>
Ascertainment	Price is ascertained from the consumer's perspective.	Value is ascertained from the user's perspectives.
Estimation	Through Policy	Through opinion
Impact of market fluctuation	Prices increase or Decrease	Value remains unchanged
Unit of valuation	Price is calculated in terms of Money	It is not calculated in terms of Money
Example	If you buy a product for \$250, then it is the price of that product.	If you are going to a gym by spending 1000 bucks a month, the output seen is worth the expense, then it is the value that you create for a gym, regarding the service being offered there.

Purpose of Business Valuation

In real properties, valuation may be required for various purposes. It is essential to know exactly for what purpose the valuation is being prepared. Valuation is an art and professionals have to consider all pros and cons of the various factors affecting valuation. Broadly speaking, valuation may be required to be done for the following purposes.

1. Use of Valuation Reports in the Purchase/Sale of Property: If the owner of any property wishes to offer the same for sale, it is necessary first to find out what it would fetch him in monetary terms. Then only can he make a realistic decision on whether to accept or reject an offered price.

2. Valuation for Central Government Taxation under Direct Tax Laws: Valuation of property is required under various direct tax laws administered by the Central Board of Direct Taxes, Ministry of Finance. These include the Wealth Tax Act, Capital Gains Tax, etc. These valuations are normally required to be done under the particular act for a specific purpose as of a specific date.

3. Valuation for the Purpose of Forecasting Earnings: Any property owner would like to receive a return on his investment that is in conformity with return on other investments. Expected outgoings can forecast the earning capacity of the property.

4. Valuation in Connection with Mortgages: Many institutional lenders such as banks and state financial corporations are bound by law to have pledged real estate valued and not to lend more than a certain fixed percentage of this valuation.

5. Valuation for Partition of Properties: The distribution of property under a family settlement or a will or on dissolution of a partnership between various claimants warrants valuation of the property. Such valuations form the basis of the settlement or they may be used in any legal proceedings.

6. Valuation for Mergers/Take-overs/Acquisition by Companies: In case two or more businesses or enterprises come together, it is necessary to place a value on each so that stocks or shares of the new merged corporation can be apportioned between shareholders. Also when properties are exchanged each asset should be valued.

7. Valuation for Liquidation: Very often, it happens that a Company has become sick or is not operating for any of several reasons. There may be

creditors of the Company who have gone to court for affecting liquidation. The official liquidator will require an inventory of items and the value or minimum price at which the assets are to be sold. Here also valuation will be required for the liquidation proceedings.

8. Valuation Requirement in Probate Matters: The grant of probate, i.e., for the successors to get the property transferred to their name, is a state subject in India. A valuation for this purpose is necessary as all state governments collect stamp duty under their own laws.

9. Valuation Reports to Study Alternate Investment Opportunities and Economic Feasibility: Very often, an investor is faced with a choice between alternative investments. Again, in each investment proposal there are several questions likely to arise, i.e., the cost of actual acquisition, the market value of the property, the likely return on investment, etc.

10. Valuation for Accounting Purposes (Asset Valuation): Very often, large companies or other organizations revalue their assets and bring up-to-date the 'historical value' in their books of accounts and balance sheet. This concept is popular in western countries and is gaining ground all over the world whereby the concept of 'current cost accounting' has been introduced.

Valuation Bias:

Valuation is never started with blank slate. Valuation is shaped by your prior views of company in question. The more you know about the company, the more likely it is that you will be biased, while valuing company. In practice, people often decided what to pay and do the valuation afterwards. The following are different sources of Bias.

1. **Closer:** The more you get the closer with management/owners of the company, the more biased your valuation of the company become. In principle you should do your valuation first before you decide how much to pay for an asset.
2. **Choice:** The biased starts with the matter of choice for the company as choices are almost never random, and how we make the choice will start laying the foundation for bias.
3. **Perception:** When we read something about the company in NEWS or in public (good or bad) about the company or heard from expert valuer start making perception or create image about the company, which leads to bias. The information collected for valuation also added to bias.

4. **Institutional Factor:** Many a time biased is created due to dependency on institutional or company support and suggestions. Information, opinion and supportive documentation leads to biased in valuation. The use of annual report and other financial statements may include best possible spin of numbers.
5. **Rewards and Punishments:** The reward and punishment structure associated with finding companies to be under or overvalued is also a contributor to bias. An analyst whose compensation is depend upon whether he finds a firm under a overvalued will be bias on his conclusion.

What to do about bias:

Bias cannot be regulated or legislated out of existence. An analyst or valuer are human and bring their biases on the table. However, there are ways to mitigate the effects of bias on valuation.

1. **Reduce institutional pressure:** Significant portion of bias can be attributed to institutional factor. For instance in addition to dealing with all of the standard sources of bias had to grapple with the demand from their employee that they bring in investments banking business.
2. **De-link valuation from reward/punishment:** Any valuation process where the reward or punishment is conditioned on the outcome of the valuation will result in biased valuation. In other words if we want acquisition valuation to be unbiased. We have to separate the deal analysis from the deal making to reduce bias.
3. **No pre-commitments:** Decision makers should avoid taking strong public position on the value of a firm before the valuation is complete. An acquiring firm that comes up with price prior to valuation of target firm has put analysts in an untenable position, where they are called upon to justify this price.
4. **Self- Awareness:** The best antidote to bias is awareness. An analyst who is aware of biases brings to the valuation process can either actively try to confront these biases when making input choices or open the process up to more objective points of view about company's future.
5. **Honest reporting:** The reporting of valuation must be honest i.e. analyst are required to reveal their biases before thy present their results from analysis. The person reviewing the study can factor that bias in while looking at conclusion.

We cannot eliminate bias in valuation, we can try to minimise its impact by designing valuation process that are more protected from overt outside influences and by report our biases with our estimated value.

Uncertainties in Valuation

Starting early in life we are thought that if we do things right, we will get right answers. In other words, the precision of answer is used as measures of quality of process that yield the answer. While this may be appropriate in maths or physics, it is a poor measure of quality in valuation.

There will be always uncertainty associated with valuation, even the best valuation come with a substantial margin of error.

Sources of Uncertainty

Uncertainty is a part and parcel of valuation process both at the point in time when we value the business and in how value evolves overtime as we obtain new information that impacts the valuation when we valuing an asset at any point in time we make forecast you the future. Since none of us possess crystal ball we have to make our best estimates every time given the information that we have at the time of valuation. Our estimate value can be wrong for a number of reasons likes-

- Estimate of uncertainty: - Even if our info sources are impeccable (without fault) we have to convert raw information into input and use this input into models. Any mistake will cause estimation error.
- Firm specific uncertainty: - The path that we envision for a firm can prove to be Hopelessly wrong. The firm may do much better or much worse that we expected.
- Macro economic uncertainty:- Even if a firm evolves exactly the way we expected it, the macro economic environment can change in unpredictable ways.

The contribution to each type of uncertainty to the overall uncertainty associated with valuation can vary across company. When valuing a mature cyclical or commodity company it may be macro-economic uncertainty i.e. the biggest factor causing actual number to deviate from the expectation. Valuing a young tech company can expose analyst to for more estimation and firm specific uncertainty.

RESPONSES TO UNCERTAINTIES

Analyst to value the company confront Uncertainty at every turn in the valuation and they respond to it in both healthy and unhealthy ways. Among the healthy ways, responses are:-

- Better valuation models

Building better valuation models that use more of information that is available at the time of valuation is one way of attacking uncertainty problem. It should be noted that even the best constructive model they reduce estimation uncertainty is but they cannot reduce or eliminate the very real uncertainty is also with future.

- Valuation range

A few analyst recognise that value they obtain for business is an estimate and try to quantify a range of the estimate some uses simulation and other devices best case and worst case of estimates of value.

- Probabilistic statements

Some analyst couch their evaluation in probabilistic terms to reflect the uncertainty they that they feel thus analyst who estimate a value of \$30 for a stock which is trading at \$25 will state that there is a 60-70% probability that the stock is undervalued rather than make the categorical statement that is undervalued.

In general, healthy responses are open about its existence and provide information on its magnitude to those using the valuation. Unfortunately not all analyst deal with uncertainty in ways that lead to better decision.

The unhealthy responses to uncertainty includes

- Passing the back

Some analyst try to pass on responsibility for the estimate by using other people numbers in valuation for example analyst will often use the growth rate estimated by other analyst valuing other company as there estimate of growth.

- Giving up on fundamentals

A significant number of analyst give up especially on full-fledged evaluation model unable to confront uncertainty and deal with it. Open the fall back on more simplicity ways of valuing the companies.

It is a natural to feel uncomfortable when valuing equity in a company we are after all trying to make our best judgement about and uncertainty in future. The discomfort will increase as we move from valuing stable companies to valuing growth companies from valuing major companies to valuing young companies.

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