Semester III(PG)

Subject: Business Valuation

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Lecture Note 1

VALUE: MEANING

Value is the 'worth' of a thing. It can also be defined as 'a bundle of benefits' expected from it. It can be tangible or intangible.

Value is defined as:

a. The worth, desirability, or utility of a thing, or the qualities on which these depend

b. Worth as estimated

c. The amount for which a thing can be exchanged in the market

d. Purchasing power

e. Estimate the value of, appraise (professionally)

Valuation is defined as:

• Estimation (esp. by professional valuer) of a thing is worth

• Worth so estimated

• Price set on a thing

What has Value?

Everything under the sun has value. There is nothing in God's creation that does not have value. This applies to all physical things. If something has not been assigned any value, it can only be said that its value or utility has not yet been explored or discovered yet.

Who wants to Value?

The following entities may require valuation to be carried out:

1. A buyer or a seller

2. A lender

3. An intermediary like an agent, a broker

4. Regulatory authorities such as tax authorities, revenue authorities

5. General public

Reasons for a Valuation

♣ Buying/selling all or a partial interest of a business

♣ Mergers

♣ Organizational recapitalization or restructuring

♣ Estate planning

♣ Financial reporting

♣ General information purposes

♣ Assist in settlement of shareholder disputes

♣ Corporate or partnership dissolution

♣ Dissenting shareholder oppression suits

Business Valuation:

1. The objective of any management today is to maximize corporate value and shareholder wealth. This is considered their most important task. A company is considered valuable not for its past performance, but for what it is and its ability to create value to its various stakeholders in future.

2. Therefore, in analysing a company, it is not sufficient just to study its past performance. We must understand the environment – economic, industrial, social and so on – and its internal resources and intellectual capital in order to gauge its future earning capabilities.

3. It is therefore essential to understand that business valuation is important in determining the present status as well as the prospects of a company, which in turn is important to understand how to maximize the value of a company. The creation and development of corporate value is the single most important long – term measure of the performance of a company's management. Further, this is the only common goal all shareholders agree on.

4. Business Valuation is a fascinating topic, as it requires an understanding of financial analysis techniques in order to estimate value, and for acquisitions, it also requires good negotiating and tactical skills needed to fix the price to be paid.

Misconceptions about Valuation:

There are several misconceptions about valuation and some of them are given below:

Myth 1: A valuation is an objective search for "true" value.

Truth 1.1: All valuations are biased. The only questions are how much and in which direction.

Truth 1.2: The direction and magnitude of the bias in your valuation is directly proportional to who pays you and how much you are paid.

Myth 2: A good valuation provides a precise estimate of value.

Truth 2.1: There are no precise valuations.

Truth 2.2: The payoff to valuation is greatest when valuation is least precise.

Myth 3: The more quantitative a model, the better the valuation.

Truth 3.1: One's understanding of a valuation model is inversely proportional to the number of inputs required for the model.

Truth 3.2: Simpler valuation models do much better than complex ones.

Myth 4: Valuing a private business should only be done when the business is ready to be sold or a lender requires a valuation as part of its due diligence process.

Truth 4.1: Although the above situations require valuations to be carried out, effective planning for ownership transition requires a regular valuation of the business.

Myth 5: Businesses in an industry always sell for x times the annual revenue (the revenue multiple). So why should valuation of the business be done by an external valuer?

Truth 5.1: While median multiple values are commonly used as a rule of thumb, they do not represent the revenue multiple for any actual transaction.

Myth 6: The business should be at least worth equivalent to what a competitor sold his business for recently.

Truth 6.1: What happened a few months ago is not relevant to what something is worth today.
Truth 6.2: What a business is worth today depends on three factors:

1) how much cash it generates today;

2) expected growth in cash in the foreseeable future; and

3) the return buyers require on their investment in the business. Therefore, unless a firm's cash flows and growth prospects are remarkably similar to the competitor firm, that firm's revenue multiple is irrelevant to valuing the firm. Also, the current value of the business is likely to be different than a few months ago because economic conditions may have changed.

Myth 7: How much a business is worth depends on what the valuation is used for.

Truth 7.1: The value of a business is its fair market value, i.e., what a willing buyer will pay a willing seller when each is fully informed and under no pressure to transact.

Myth 8: The business loses money, so it is not worth much.

Truth 8.1: While most private businesses may appear to lose money, the cash a business generates determines the value of the business. Quantifying the size of discretionary expenses is often a critical determinant of the firm's value.