

Obtain Valuation for your Company

Knowing what your business is worth and what determines its value is a prerequisite for intelligent decision-making.

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WHAT IS BUSINESS VALUATION?

Business valuation is a process to estimate the economic worth of stakeholders' interest in a business. To determine the value of any business, the reasons for and circumstances surrounding the business valuation must be pre-ascertained.

These are formally known as the "standard of value" and "premise of value."

To be precise, the "standard of value" is the hypothetical condition under which the business is valued and the "premise of value" relates to the assumptions upon which the valuation is based.

KEY FACTS OF BUSINESS VALUATION:

Price is not the same as value

The value of a business is not the selling price of the business. As Warren Buffett says: "Price is what you pay; value is what you get."

Value varies with person, purpose and time

Value can have different connotations, meaning different things to different people. The result will not be the same, if the context/time changes.

BASIC REASONS TO GET VALUATION:

- ▶ Buying or selling business
- ▶ Going public

- ▶ Value enhancement
- ▶ Regulatory mandate
- ▶ Dispute resolution
- ▶ Mergers & Acquisitions
- ▶ Employee benefit plans
- ▶ Family successions
- ▶ Option compensation values
- ▶ Voluntary assessment

THE INDIAN PERSPECTIVE

Since there are no standards for business valuation in India, it lacks the uniformity and generally accepted global valuation practices. A number of business valuation models can be constructed that utilize various methods under the broad business valuation approaches.

In determining which of these approaches to use, a valuation professional must exercise discretion and care.

PRACTICALLY ACCEPTABLE METHODS OF VALUATION

1. Asset approach: Generally the Net Asset Value (NAV) reflected in books does not include intangible assets enjoyed by the business and are also impacted by accounting policies which may be discretionary at times. NAV is not perceived as a true indicator of the fair business value. However, it is used to evaluate the entry barrier that exists in a business and is considered viable for companies having reached the mature or declining growth cycle and also for property and investment companies having strong asset base.

▶ **Book Value Method:** It is based on the balance sheet review of assets and liabilities

▶ **Replacement Cost Method:** It is based on the current setup cost of plant of a similar age, size and capacity

▶ **Liquidation Value Method:** It is based on estimated realizable value of various assets

2. Income approach: Future distributable cash/profit generating ability of any business is widely regarded as the true determinant of its fair business value.

▶ **Discounted Free Cash Flow Method (DFCF):** The value is determined by calculating the net present value of the stream of benefits generated by the business discounted to the present using appropriate cost of capital. DFCF is the most widely-used standalone valuation model.

3. Relative approach: In this approach, value is determined by comparing the subject, company

or assets with its peers in the same industry of the same size and region. Most valuations in the stock markets are relative valuations.

▶ **Comparable Company Market Multiples:** The value is determined based on comparison of common variables such as earnings, sales, etc.

▶ **Comparable Transaction Multiples Method:** The value is determined based on the comparable transactions (M&A) reported in public.

4. Market value approach: The market value method is generally the most preferred method in case of frequently traded quoted shares of companies listed on stock exchanges.

5. Contingent claim approach: This approach uses the Option Pricing Model to estimate the value of assets, business and equity stake.

6. Price of recent investment approach: The recent investment in the business is often taken as the base value if there are no substantial changes since the last investment.

7. Rule of thumb approach: Although technically not a valuation method, a rule of thumb or benchmark indicator is used as a reasonableness check against the values determined by the use of other valuation approaches.

VALUER'S INSIGHT

Recent regulatory changes

▶ Institute of Chartered Accountants of India (ICAI) has recently developed and recommended Business Valuation Practice Standards to establish uniform principles, practices and procedures for valuers in India.

▶ The Companies Bill, 2009 has also provided a framework to enable fair valuation.

▶ It has been observed that different regulators in India have prescribed different and, in some cases, conflicting valuation methodologies creating practical difficulties.

CONCLUSION

Valuation is more of an art and not an exact science. Though the value of a business can be objectively determined employing valuation approaches, this value is still subjective, dependent on buyer and seller expectations and subsequent negotiations. Use of professional judgment is an essential component of estimating value. ■

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KEY TAKEAWAYS

- Minimize bias in valuation process;
- Evaluate the stage of business cycle;
- Match cash flows to discount rates;
- Do sanity check by multiple methods;
- Justify business model and key assumptions;
- Substantiate data