VALUATION OF THE CORPORATE ENTERPRISE : PURPOSES AND METHODOLOGY pdf

1: Valuation Techniques Overview | Street Of Walls

EBITDA focuses on the operating decisions of a business because it looks at the business' profitability from core operations before the impact of capital structure. Formula, examples are the most common valuation method. The "comps" valuation method provides an observable value for the business, based on what companies are currently worth.

Valuation of a closely-held, family business is, at best, an inexact science, and can be a daunting challenge to the estate planner and family advisor. Valuation for Transfer Tax Purposes The vast majority of jurisprudence involving valuation of closely-held businesses are federal transfer tax cases, most of which are lodged in the United States Tax Court. When there are no recent sales, fair market value must be determined by an appraisal which must take into consideration a number of factors set forth in the Treasury Regulations and in Rev. These relevant factors include the following: The nature of the business and the history of the enterprise from its inception; The economic outlook in general and the condition and outlook of the specific industry in particular; The book value of the equity interest and the financial condition of the business; The earning capacity of the business; The dividend-paying capacity of the business; Whether the business has good will or other intangible value; Sales of equity interests and the size of the block of the interest to be valued; and The market price of stocks of corporations engaged in the same or a similar line of business which are actively traded on an open market. Valuation Methodology Although Rev. All of the facts and circumstances of each particular business must be carefully analyzed to determine value. A number of different methods may be utilized. Some of these methods include the following: Although commonly used for cost accounting purposes, the relationship between book value and fair market value is purely accidental. In those instances, the book value approach must be modified to reflect current fair market value by substituting the appraised value for the historical cost of the underlying assets and to reflect good will and other intangible assets such as any intellectual property owned. The net asset value approach is essentially a liquidation model. A projection is made of the future earnings capacity of the business based upon its current financial status, taking into consideration trends and past earnings which can result in different years earnings being given different weights. Under this valuation methodology, the dividend paying capacity rather than actual dividend payment history is studied and capitalized by multiplying such capacity by a factor derived from the dividend yields of comparable publically traded companies. Under this approach, overall profitability as well as the current future capital needs of the entity should be carefully examined. This approach assumes that the value of a closely-held, family business is analogous to similarly situated, publically traded companies in the same line of business. Furthermore, the market approach has long been accepted in the jurisprudence, although other approaches may more accurately reflect fair market value under the particular facts and circumstances. The earnings approach is also subject to a number of different variations. For example, one variation involves projecting future earnings from prior years and discounting the future expected earnings to present value using a reasonable discount rate which should equate to the rate of return that an investor would expect to receive from an investment in that business. Discounted cash flow methods also result in a residual value for the business at the end of the projected period of time which is then added back to the discounted expected future earnings to arrive at current fair market value. Another variation involves the capitalization of earnings. Under the market approach, comparable publically trade companies are selected based upon a number of factors which include the same line of business, similar markets, the position the company within the industry, company earnings, product lines and competition. Appropriate adjustments are then made between the price earnings ratios of the selected comparables to arrive at an accurate fair market value for the subject closely-held entity. Methodologies that compare the closely-held, family business to comparable publically traded companies require adjustment to reflect the fact that there is no ready market for the shares of a closely-held business. A closely-held family business, in all likelihood, has no reasonable prospect of going public. In most cases, the issue is not whether such an adjustment is appropriate but how deep the discount should be. Often analysis focuses on the difference between the value of stock both before and after a public stock offering as well as the loss in value of publically traded shares whose transferability is restricted because of federal and state securities laws. Recent Tax Court jurisprudence has not only looked to discounts for restricted stock and public stock offerings but also to a number of factors created by the Court, many of which are similar to the factors set forth in the Regulations and Rev. In most instances, particularly in community property states, the interest to be valued is a minority interest. The adjustment for a minority interest reflects the fact that a minority equity holder cannot force either current or liquidating dividends. As a result, a hypothetical willing buyer would take this into consideration and pay less for such an interest. These adjustments are appropriate even in a family setting when the only potential buyers are other family members. There is no family attribution for transfer tax valuation purposes. It is important to note that valuation methodologies utilizing comparisons to comparably traded public companies may already have a minority interest adjustment built into the calculation because stock quotes on established securities markets are of minority interests. Just as a willing buyer might pay more than the pro rata value of voting stock in order to achieve control, the same willing buyer would pay less for non-voting stock and, consequently, a valuation adjustment would be appropriate under the circumstances, in either direction. The appropriate adjustment will depend on the ratio of the outstanding shares of voting equity interests to non-voting interests. Loss of Key Person. The death of a key person, particularly the founding entrepreneur, can have a negative impact on value, particularly if that loss is not compensated for by key man life insurance. Under these circumstances, an adjustment is appropriate. Built in Capital Gain. For those entities that are either holding companies or whose assets are mainly investments rather than an active trade or business, the net asset value approach may require adjustment to take into consideration the fact that a willing buyer purchasing an interest in the entity will have to liquidate the entity in order to acquire its assets and will, thereby, incur federal and state income tax. If no entity existed, the willing buyer could purchase the same net assets on the open market directly without incurring those taxes. As a result, an adjustment for that tax liability is appropriate. Despite that position, the jurisprudence has acknowledged that a buy-sell agreement can fix the estate tax value of the interest, even if that value is lower than it otherwise would have been in the absence of an agreement, if: Importance of a Qualified Appraiser As can be readily seen from the foregoing, the appraisal of the fair market value of a closely- held, family business is an art and not a science. A number of subjective decisions need to be made in the valuation process including appropriate capitalization rates, the selection of comparable publically traded companies, the appropriateness and size of adjustments, etc. Clearly, no significant transaction should be entered into without the assistance of a competent, qualified appraiser. If the transaction involves a transfer subject to federal transfer tax requiring the filing a gift tax return, the Treasury Regulations concerning adequate disclosure to begin the running of the statute of limitations require a detailed description of the method used to determine fair market value of the property transferred, including any financial data that was used to determine the value of the interest, any restrictions on the transfer of property that were considered in determining the fair market value of the property and a description of any discounts claimed in valuing the property. Furthermore, if the value of the entity is determined based upon the net asset value method, a statement must be provided regarding the fair market value of the enterprise value determined without regard to any discounts. These requirements should be satisfied if a qualified appraisal prepared by a qualified appraiser is used and attached to the return. An appraisal also will assist the taxpayer in meeting the substantiation and record-keeping requirements for shifting the burden of proof to IRS. Since there is no judicially recognized appraiser-client privilege, it may be appropriate for the attorney handling the transaction to engage the appraiser directly in order to bring the discussions and work product of the appraiser within the attorney-client privilege. If the matter involved is headed for litigation, the qualifications of the appraiser are particularly important if he is to serve as an expert witness. Furthermore, in valuation cases in the Tax Court, appraisers are often required by the judge to submit reports critiquing the expert appraisal report of the opposing party. When an expert takes the stand in the Tax Court, his expert report is admitted into evidence without direct testimony. Consequently, the first impression made with the judge will be one of the expert under attack. The report should be complete and require no further explanation. Every prospective expert appraiser should be carefully reviewed and auditioned with these factors in mind. The issue of valuation can arise in many legal contexts, but most often for transfer tax purposes. A qualified business appraiser always should be utilized as an integral part of the process. Merrell Dow Pharmaceuticals, Inc.

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2: Enterprise Valuation - Scalar

Basically, these business valuation methods total up all the investments in the business. Asset-based business valuations can be done on a going concern or on a liquidation basis. A going concern asset-based approach lists the business's net balance sheet value of its assets and subtracts the value of its liabilities.

Litigation Valuation analysts and IP professionals agree there are three standard methodologies to value IP: The historical cost to develop an asset is sometimes used to determine its value. However, the cost to develop an intellectual asset is rarely representative of its ultimate value. This approach is less useful for intellectual properties used with products that have reached the market and generated revenues. Generally, the cost approach is better suited to analysis of intellectual properties and products that have not yet been developed commercially, or that could be re-created quickly, as it reflects the cost a company could avoid by purchasing, rather than duplicating, a similar development effort. The income approach calculates the present value of future income streams specifically attributable to the intellectual property asset. This method utilizes forecasted financial results based on factors such as historical financial results, industry trends, and the competitive environment. The market approach values intellectual properties by comparing the subject asset to publicly available transactions involving similar assets with similar uses. Relief from Royalty Approach: The value is then calculated as the present value of the avoided hypothetical royalty charges. The decision of which approach to use is generally based on four factors: In addition to the traditional methods used to value intellectual property, several alternative methods are available. Some are modifications of the orthodox approaches with which most are familiar, but many other choices exist to value these complex assets. Below is a brief summary of these; a detailed explanation of each methodology could fill websites. Instead, this serves as a brief introduction to alternative intellectual property valuation approaches. Continuing Developments As part of a still developing discipline, there are at least 25 alternative valuation techniques to be employed. I would encourage an interested reader to continue doing research on the methods shown here, if the details provided below are insufficient. This article is intended to serve as a cover of alternative IP valuation methods and not meant to provide a detailed explanation or how-to manual for valuing intangible assets. The methods being explained below are frequently associated with a certain IP asset. Although it is similar to the income approach that utilizes a discount cash flow analysis DCF , it possesses two differentiating factors: We have broken them up into two groups: The contribution made by the brand may be separated from the profit contributed from other elements of the business in multiple ways: When using the Cost Approach to value an intellectual asset, two separate methods under the cost approach shall be considered: The Replacement Cost method aggregates the amount of money necessary to develop a replacement of the IP that provides the same functionality or utility, in the same stage of development as the IP being valued, as of the valuation date. Finally, calculating the cost of an IP using the Replacement Cost method excludes the costs associated with any failed or ineffectual models. The Replication Cost method is very similar to the Replacement Cost method, but differs slightly in that it measures the aggregate costs necessary to develop an exact duplicate of the IP being valued, in the same stage of development as the IP being valued, as of the valuation date. And unlike the Replacement Cost method, the Reproduction Cost method includes costs with associated prototypes. As the number of digital intangible assets rise, using The Technology Factor Method becomes all the more common because it is applicable only to technology. Although similar to the common DCF method, it is different in that a fixed, non-market based discount rate is used generally, a rate of between 40 to 60 percent used. Additionally, no specific adjustment is made to account for the probability of success e. The Concept of Relative Incremental Value: This methodology works when one is trying to represent some percentage of value of an individual asset that is associated with a larger trademark or patent portfolio. Decremental Cost Savings Valuation: If, in fact, the IP owner can quantify lower levels of capital or operating costs connected directly with the ownership of the IP; then those lower costs can be a direct measurement of the value of the specific IP. The value of the IP then would be the difference between the total business enterprise value and the business enterprise as calculated without the IP. A subset of traditional income approach methods, this imputed income analysis can be used quite effectively in valuing a domain name or sub brand attached to a trademark; or in valuing flanker patents for a core patent portfolio. In the case of a domain name, value is established by looking at the activity generated by the domain name and associated website assets, relative to the overall value of the core trademark and brand bundle. Therefore, one is able to estimate through imputation the relative value of a domain name to its parent trademark. Income Capitalization or Direct Capitalization Methodology: This is a method sometimes used to estimate the value for intellectual property that has no predetermined statutory expiration like trademarks and for which net income royalties or profit is not expected to vary greatly over time due to contractually-defined license fees, for example. This involves taking an estimate of expected annual royalty stream or profit and multiplying this amount by a factor known as the capitalization rate. This particular variation simply means that a company manufacturing and selling a product with a particularly strong trademark or unique technology will receive more income than a competitive company producing the same product but without the addition of the specific IP, such as the trademark or patent. Found most often in bankruptcy situations, as the name implies liquidation value for any piece of IP is the lowest price that the asset is virtually guaranteed to be sold in a distressed situation. Used almost solely in bankruptcy, other distressed situations or time critical contexts, litigation value scenarios arise most often in a Chapter 7 bankruptcy. Of all the variations to the income approach, this is perhaps the most easily understood â€" because the value of an asset is established by looking at the difference in the price that it can command in the market, typically at wholesale, compared to the average product in the market. The difference between these two prices is the price premium. This, then, is projected out on an annual basis and a net present value established. A form of the income approach, it can be tricky to apply accurately: Through this auction process, a market-based price of the IP would be determined through bidding. Not only does it require calculating the possible cash flows which might occur, DCF methods do not account for the various possibilities open to project managers for example, the levels of risk if a patent lapses or is abandoned at differing stages along the process. Assumptions can be built into the DCF model in an attempt to account for the possible outcomes as the result of management decisions. Using what is known as Decision Tree Analysis, a limited number of such managerial decision possibilities can be accounted for. It is important to note, however, that the Decision Tree Analysis should be based on an underlying DCF analysis of each branch. The recommended way to perform such analysis is to begin with the final decisions and work backwards in time, which will result in a present value. However, assumptions still need to be made regarding the discount rate as does the DCF method. It is important to use a discount rate appropriate with the level of risk involved at each stage of a managerial decision associated with the development of a brand or IP. In this methodology, a core value for the trademark is calculated, and then each of the individual other assets attached to the core asset have their values calculated. Therefore, the sum of the core brand value plus the incremental assets becomes a total brand value. Expressed in an equation it as follows: This technique is best used when the subject company has a complex portfolio of intellectual property and works on the supposition that the IP is giving its owner an advantage over its competitors because of proprietary patents, technology, trademarks, software or other intangibles. Monte Carlo Analysis of Value: This is a method to evaluate how possible future outcomes can affect the decision of whether or not to use a new piece of IP based on possible value â€" remember that this methodology is most useful in valuing early stage, non-commercialized technology; and, in particular, where there are many unknowns and numerous scenarios about the future development of the technology. Patent licensing shares at least one attribute with all other relevant business decisions: Where decisions involving financial risk are concerned, sound management principles suggest considering ways and vehicles to hedge that risk. Snapshots of Value Approach: This is similar in nature to the business enterprise value approach in that the snapshots value is based on establishing two different values for a company: Measuring the difference between the two snapshots establishes the value of the IP or intangible asset portfolio. Establishing the value of a company against another company by comparing them on a so-called benchmark basis is the premise of this method of value. In one instance, the benchmark value will be a company that owns a particular trademark or patent and the second value for a comparable company that does not have that same asset. A proprietary approach employed by our firm, it is a variation on the return on assets employed approach see above. ValCalc establishes the economic return that each intangible asset class should be earning. Calculations of adequate return are applied also to all classes of tangible assets within a company. Then the return for each intangible asset is calculated as a result. This proprietary system was developed by our firm more than two decades ago and employs a matrix of the twenty most important predictors of value for a trademark, patent or piece of software. The predictors for each of these types of IP are, of course, unique. They are used in a common manner, however: To score a given IP asset against its peers on a numerical scale. Value is therefore established relative to similar trademarks or patents. An important side note for the interested reader: This is especially true with intangible assets because active markets may not exist and assumptions need to be relied on in making valuation conclusions. Moreover, uncertainty may develop if one depends on a single methodology to value an IP asset especially a particularly complex family of technologies or brand assets. History has taught us that, as with any new practice, the evolution of methodologies will be ever-lasting. Conclusion Valuing and analyzing intellectual property is still at a premature stage, the field itself hardly more than a few decades old. As the process continues to evolve and experts refine a multitude of methodologies, the art of valuing IP will continue to witness developments, innovation, revision, and diligent progression of techniques to value intellectual property and intangible assets. In all probability, the techniques listed above will either be outdated or refined further to become industry standards. Take, for example, the notorious Georgia-Pacific factors. For a long time, these standards were implemented as a reliable damages quantification method in patent litigation. He currently serves as an active member of the International Licensing Executives Society board of delegates. The pages, articles and comments on IPWatchdog. Discuss this There are currently 6 Comments comments. Anon February 11, 8: Blair Carey February 12, 8: Thomas Walls February 12, I was not aware of many of the valuation approaches. Generally, I think placing a value on IP can be a shot in the dark if the IP is not being commercialized or otherwise licensed. With patents in particular, a patent is essentially valueless unless it is 1 being used to protect a commercialized product, 2 being asserted against infringers who seek to commercialize, or 3 licensed. The market usually sets the value for the patent owner. Anon February 13, 8: In some portfolio aspects, individual patents serve as simple stoppers to encroachment on other technology areas.

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3: Valuation (finance) - Wikipedia

Enterprise Valuations specializes in the valuation of private company equity securities (typically common stock) for purposes of IRC Â§A and ASC Since our founding in we have completed hundreds of common stock valuations for a broad range of private companies.

The raw data used to compile the primary comparable data includes raw enterprise value , revenue and profit figures. A key part of a valuation model is to look at potential outliers and see if they need to be reconsidered or outright ignored. Both its gross and operating margins are above the industry average. Overall, the company looks reasonably valued, at least based on the above information. But, as detailed above, other considerations are still needed, such as a valuation by projecting growth and profit trends over the next couple of years, and really looking at the details of earnings, free cash flow and margins to make sure they are accurate and truly representative of the company. The same goes for each individual company that makes up the comparable universe. A final consideration is to look at market transactions. For instance, back in DuPont sold a large part of its chemical division, its performance coatings segment , to private equity giant Carlyle Group Nasdaq: This would indicate that Eastman is overvalued by this metric, but as explained in the next section, this may not be the case. Important Considerations It is important to note that it can be difficult to find truly comparable companies and transactions to value an equity. This is the most challenging part of a comparables analysis. For instance, Eastman Chemical acquired rival Solutia in in an effort to have less cyclicality in its operations. As detailed above, the free cash flow multiple for Air Products looks suspect in the analysis, meaning further work is needed to determine what adjustments should be made. Additionally, using trailing and forward multiples can make a big difference in an analysis. If a firm is growing rapidly, a historical valuation will not be overly accurate. What matters most in valuation is making a reasonable estimate of future market multiples. If profits are projected to grow faster than rivals, the value should be higher. It is also worth noting that, of the three primary valuation approaches, the comparable approach is the only relative model. Both the cost approach and discounted cash flow are absolute models and look solely at the company being valued, which could ignore important market factors. On the flip side, the stock market can become overvalued at times, which would make a comparable approach less meaningful, especially if comps are overvalued. For this reason, using all three approaches is the best idea. The Bottom Line Valuation is as much art as science. Instead of obsessing over what the true dollar figure of an equity might be, it is most valuable to come down to a valuation range. For instance, if a stock trades toward the lower end, or below the lower end of a determined range, it is likely a good value. The opposite may hold true at the high end and could indicate a shorting opportunity. Trading Center Want to learn how to invest? Get a free 10 week email series that will teach you how to start investing. Delivered twice a week, straight to your inbox.

4: Top 4 Business Valuation Methods with Examples

(ASC) Topic , Business Combinations, fair value accounting for business combinations. Either identification procedure may be appropri-ate depending on the purpose and objective of the goodwill analysis. This going-concern value may enhance the value. of the business entity's individual operating assets.

For example, it is commonly used to value industries that involve tremendous up-front capital expenditures and companies that have large amortization burdens. Cable TV companies like Time-Warner Cable and TeleCommunications have reported negative earnings for years due to the huge capital expense of building their cable networks, even though their cash flow has actually grown. This is because huge depreciation and amortization charges have masked their ability to generate cash. Sophisticated buyers of these properties use cash flow as one way of pricing an acquisition, thus it makes sense for investors to use it as well. It is also commonly used method in venture capital financings because it focuses on what the venture investor is actually buying, a piece of the future operations of the company. The premise of the discounted free cash flow method is that company value can be estimated by forecasting future performance of the business and measuring the surplus cash flow generated by the company. The surplus cash flows and cash flow shortfalls are discounted back to a present value and added together to arrive at a valuation. The discount factor used is adjusted for the financial risk of investing in the company. The mechanics of the method focus investors on the internal operations of the company and its future. The discounted cash flow method can be applied in six distinct steps. Since the method is based on forecasts, a good understanding of the business, its market and its past operations is a must. The steps in the discounted cash flow method are as follows: This is clearly the critical element in the valuation. The more closely the projections reflect a good understanding of the business and its realistic prospects, the more confident investors will be with the valuation its supports. Quantify positive and negative cash flow in each year of the projections. The cash flow being measured is the surplus cash generated by the business each year. In years when the company does not generate surplus cash, the cash shortfall is measured. So that borrowings will not distort the valuation, cash flow is calculated as if the company had no debt. In other words, interest charges are backed out of the projections before cash flows are measured. Estimate a terminal value for the last year of the projections. Since it is impractical to project company operations out beyond three to five years in most cases, some assumptions must be made to estimate how much value will be contributed to the company by the cash flows generated after the last year in the projections. Without making such assumptions, the value generated by the discounted cash flow method would approximate the value of the company as if it ceased operations at the end of the projection period. One common and conservative assumption is the perpetuity assumption. This assumption assumes that the cash flow of the last projected year will continue forever and then discounts that cash flow back to the last year of the projections. Determine the discount factor to be applied to the cash flows. One of the key elements affecting the valuation generated by this method is the discount factor chosen. The larger the factor is, the lower the valuation it will generate. This discount factor should reflect the business and investment risk involved. The less likely the company is to meet its projections, the higher the factor should be. Discount factors used most often are a compromise between the cost of borrowing and the cost of equity investment. Apply the discount factor to the cash flow surplus and shortfall of each year and to the terminal value. The following table illustrates the computations made in the discounted cash flow method.

5: Valuation of Closely Held Family Businesses - Baldwin Haspel Burke & Mayer

used with all premises of value including value-in-use as a going concern business enterprise. To summarize, the Adjusted Net Asset Method is a balance sheet-based approach to valuation that is relied upon most often for holding companies and companies generating losses (or only modest levels of.

Knowing what an asset is worth and what determines that value is a pre-requisite for intelligent decision making -- in choosing investments for a portfolio, in deciding on the appropriate price to pay or receive in a takeover and in making investment, financing and dividend choices when running a business. The premise of valuation is that we can make reasonable estimates of value for most assets, and that the same fundamental principles determine the values of all types of assets, real as well as financial. Some assets are easier to value than others, the details of valuation vary from asset to asset, and the uncertainty associated with value estimates is different for different assets, but the core principles remain the same. This introduction lays out some general insights about the valuation process and outlines the role that valuation plays in portfolio management, acquisition analysis and in corporate finance. It also examines the three basic approaches that can be used to value an asset. A philosophical basis for valuation A postulate of sound investing is that an investor does not pay more for an asset than it is worth. This statement may seem logical and obvious, but it is forgotten and rediscovered at some time in every generation and in every market. There are those who are disingenuous enough to argue that value is in the eyes of the beholder, and that any price can be justified if there are other investors willing to pay that price. That is patently absurd. Perceptions may be all that matter when the asset is a painting or a sculpture, but we do not and should not buy most assets for aesthetic or emotional reasons; we buy financial assets for the cashflows we expect to receive from them. Consequently, perceptions of value have to be backed up by reality, which implies that the price we pay for any asset should reflect the cashflows it is expected to generate. Valuation models attempt to relate value to the level of, uncertainty about and expected growth in these cashflows. There are many aspects of valuation where we can agree to disagree, including estimates of true value and how long it will take for prices to adjust to that true value. But there is one point on which there can be no disagreement. Asset prices cannot be justified by merely using the argument that there will be other investors around who will pay a higher price in the future. That is the equivalent of playing a very expensive game of musical chairs, where every investor has to answer the question, "Where will I be when the music stops? The problem with investing with the expectation that there will be a bigger fool around to sell an asset to, when the time comes, is that you might end up being the biggest fool of all. Inside the Valuation Process There are two extreme views of the valuation process. At one end are those who believe that valuation, done right, is a hard science, where there is little room for analyst views or human error. At the other are those who feel that valuation is more of an art, where savvy analysts can manipulate the numbers to generate whatever result they want. The truth does lies somewhere in the middle and we will use this section to consider three components of the valuation process that do not get the attention they deserve â€” the bias that analysts bring to the process, the uncertainty that they have to grapple with and the complexity that modern technology and easy access to information have introduced into valuation. Value first, Valuation to follow: Bias in Valuation We almost never start valuing a company with a blank slate. All too often, our views on a company are formed before we start inputting the numbers into the models that we use and not surprisingly, our conclusions tend to reflect our biases. We will begin by considering the sources of bias in valuation and then move on to evaluate how bias manifests itself in most valuations. We will close with a discussion of how best to minimize or at least deal with bias in valuations. Sources of Bias The bias in valuation starts with the companies we choose to value. These choices are almost never random, and how we make them can start laying the foundation for bias. It may be that we have read something in the press good or bad about the company or heard from an expert that it was under or over valued. Thus, we already begin with a perception about the company that we are about to value. We add to the bias when we collect the information we need to value the firm. The annual report and other financial statements include not only the accounting numbers but also management discussions of performance, often putting the best possible spin on the numbers. With many larger companies, it is easy to access what other analysts following the stock think about these companies. Valuations that stray too far from this number make analysts uncomfortable, since they may reflect large valuation errors rather than market mistakes. In many valuations, there are institutional factors that add to this already substantial bias. For instance, it is an acknowledged fact that equity research analysts are more likely to issue buy rather than sell recommendations, i. The reward and punishment structure associated with finding companies to be under and over valued is also a contributor to bias. An analyst whose compensation is dependent upon whether she finds a firm is under or over valued will be biased in her conclusions. This should explain why acquisition valuations are so often biased upwards. One is to find that the deal is seriously over priced and recommend rejection, in which case the analyst receives the eternal gratitude of the stockholders of the acquiring firm but little else. The other is to find that the deal makes sense no matter what the price and to reap the ample financial windfall from getting the deal done. Manifestations of Bias There are three ways in which our views on a company and the biases we have can manifest themselves in value. The first is in the inputs that we use in the valuation. When we value companies, we constantly come to forks in the road where we have to make assumptions to move on. These assumptions can be optimistic or pessimistic. For a company with high operating margins now, we can either assume that competition will drive the margins down to industry averages very quickly pessimistic or that the company will be able to maintain its margins for an extended period optimistic. The path we choose will reflect our prior biases. It should come as no surprise then that the end value that we arrive at is reflective of the optimistic or pessimistic choices we made along the way. The second is in what we will call post-valuation tinkering, where analysts revisit assumptions after a valuation in an attempt to get a value closer to what they had expected to obtain starting off. The third is to leave the value as is but attribute the difference between the value we estimate and the value we think is the right one to a qualitative factor such as synergy or strategic considerations. This is a common device in acquisition valuation where analysts are often called upon to justify the unjustifiable. In fact, the use of premiums and discounts, where we augment or reduce estimated value, provides a window on the bias in the process. The use of premiums â€” control and synergy are good examples â€” is commonplace in acquisition valuations, where the bias is towards pushing value upwards to justify high acquisition prices. The use of discounts â€” illiquidity and minority discounts, for instance â€” are more typical in private company valuations for tax and divorce court, where the objective is often to report as low a value as possible for a company. What to do about bias Bias cannot be regulated or legislated out of existence. Analysts are human and bring their biases to the table. However, there are ways in which we can mitigate the effects of bias on valuation: As we noted earlier, a significant portion of bias can be attributed to institutional factors. Equity research analysts in the s, for instance, in addition to dealing with all of the standard sources of bias had to grapple with the demand from their employers that they bring in investment banking business. Institutions that want honest sell-side equity research should protect their equity research analysts who issue sell recommendations on companies, not only from irate companies but also from their own sales people and portfolio managers. Any valuation process where the reward or punishment is conditioned on the outcome of the valuation will result in biased valuations. In other words, if we want acquisition valuations to be unbiased, we have to separate the deal analysis from the deal making to reduce bias. Decision makers should avoid taking strong public positions on the value of a firm before the valuation is complete. In far too many cases, the decision on whether a firm is under or over valued precedes the actual valuation, leading to seriously biased analyses. The best antidote to bias is awareness. In Bayesian statistics, analysts are required to reveal their priors biases before they present their results from an analysis. Thus, an environmentalist will have to reveal that he or she strongly believes that there is a hole in the ozone layer before presenting empirical evidence to that effect. The person reviewing the study can then factor that bias in while looking at the conclusions. Valuations would be much more useful if analysts revealed their biases up front. While we cannot eliminate bias in valuations, we can try to minimize its impact by designing valuation processes that are more protected from overt outside influences and by report our biases with our estimated values. It is only an estimate: Imprecision and Uncertainty in Valuation Starting early in life, we are taught that if we do things right, we will get the right answers. In other words, the precision of the answer is used as a measure of the quality of the process that yielded the answer. While this may be appropriate in mathematics or physics, it is a poor measure of quality in valuation. Barring a very small subset of assets, there will always be uncertainty associated with valuations, and even the best valuations come with a substantial margin for error. In this section, we examine the sources of uncertainty and the consequences for valuation. Sources of Uncertainty Uncertainty is part and parcel of the valuation process, both at the point in time that we value a business and in how that value evolves over time as we get new information that impacts the valuation. That information can be specific to the firm being valued, more generally about the sector in which the firm operates or even be general market information about interest rates and the economy. When valuing an asset at any point in time, we make forecasts for the future. Since none of us possess crystal balls, we have to make our best estimates, given the information that we have at the time of the valuation. Our estimates of value can be wrong for a number of reasons, and we can categorize these reasons into three groups. Even if our information sources are impeccable, we have to convert raw information into inputs and use these inputs in models. Any mistakes or mis-assessments that we make at either stage of this process will cause estimation error. The path that we envision for a firm can prove to be hopelessly wrong. The firm may do much better or much worse than we expected it to perform, and the resulting earnings and cash flows will be very different from our estimates. Even if a firm evolves exactly the way we expected it to, the macro economic environment can change in unpredictable ways. Interest rates can go up or down and the economy can do much better or worse than expected. These macro economic changes will affect value. The contribution of each type of uncertainty to the overall uncertainty associated with a valuation can vary across companies. When valuing a mature cyclical or commodity company, it may be macroeconomic uncertainty that is the biggest factor causing actual numbers to deviate from expectations. Valuing a young technology company can expose analysts to far more estimation and firm-specific uncertainty. Note that the only source of uncertainty that can be clearly laid at the feet of the analyst is estimation uncertainty. Given the constant flow of information into financial markets, a valuation done on a firm ages quickly, and has to be updated to reflect current information. Thus, technology companies that were valued highly in late , on the assumption that the high growth from the nineties would continue into the future, would have been valued much less in early , as the prospects of future growth dimmed. With the benefit of hindsight, the valuations of these companies and the analyst recommendations made in can be criticized, but they may well have been reasonable, given the information available at that time. Responses of Uncertainty Analysts who value companies confront uncertainty at every turn in a valuation and they respond to it in both healthy and unhealthy ways. Among the healthy responses are the following: Building better valuation models that use more of the information that is available at the time of the valuation is one way of attacking the uncertainty problem. It should be noted, though, that even the best-constructed models may reduce estimation uncertainty but they cannot reduce or eliminate the very real uncertainties associated with the future Valuation Ranges:

VALUATION OF THE CORPORATE ENTERPRISE : PURPOSES AND METHODOLOGY pdf

6: Equity valuation: The comparables approach | Investopedia

The value of a firm's debt, for example, would need to be paid off by the buyer when taking over a company, thus, enterprise value provides a much more accurate takeover valuation because it.

Such discretion detracts from the objectivity of this approach, in the minds of some critics. Indeed, since the WACC captures the risk of the subject business itself, the existing or contemplated capital structures, rather than industry averages, are the appropriate choices for business valuation. Once the capitalization rate or discount rate is determined, it must be applied to an appropriate economic income stream: The result of this formula is the indicated value before discounts. Before moving on to calculate discounts, however, the valuation professional must consider the indicated value under the asset and market approaches. Careful matching of the discount rate to the appropriate measure of economic income is critical to the accuracy of the business valuation results. Net cash flow is a frequent choice in professionally conducted business appraisals. The rationale behind this choice is that this earnings basis corresponds to the equity discount rate derived from the Build-Up or CAPM models: At the same time, the discount rates are generally also derived from the public capital markets data. Build-Up Method[edit] The Build-Up Method is a widely recognized method of determining the after-tax net cash flow discount rate, which in turn yields the capitalization rate. The figures used in the Build-Up Method are derived from various sources. This method is called a "build-up" method because it is the sum of risks associated with various classes of assets. It is based on the principle that investors would require a greater return on classes of assets that are more risky. The first element of a Build-Up capitalization rate is the risk-free rate, which is the rate of return for long-term government bonds. Investors who buy large-cap equity stocks, which are inherently more risky than long-term government bonds, require a greater return, so the next element of the Build-Up method is the equity risk premium. The sum of the risk-free rate and the equity risk premium yields the long-term average market rate of return on large public company stocks. Similarly, investors who invest in small cap stocks, which are riskier than blue-chip stocks, require a greater return, called the "size premium. By adding the first three elements of a Build-Up discount rate, we can determine the rate of return that investors would require on their investments in small public company stocks. These three elements of the Build-Up discount rate are known collectively as the "systematic risks. It arises from external factors and affect every type of investment in the economy. As a result, investors taking systematic risk are rewarded by an additional premium. In addition to systematic risks, the discount rate must include "unsystematic risk" representing that portion of total investment risk that can be avoided through diversification. Public capital markets do not provide evidence of unsystematic risk since investors that fail to diversify cannot expect additional returns. Unsystematic risk falls into two categories. One of those categories is the "industry risk premium". It is also known as idiosyncratic risk and can be observed by studying the returns of a group of companies operating in the same industry sector. The other category of unsystematic risk is referred to as "company specific risk. However, as of late , new research has been able to quantify, or isolate, this risk for publicly traded stocks through the use of Total Beta calculations. Pinkerton have outlined a procedure which sets the following two equations together: While it is possible to isolate the company-specific risk premium as shown above, many appraisers just key in on the total cost of equity TCOE provided by the following equation: It is similar to using the market approach in the income approach instead of adding separate and potentially redundant measures of risk in the build-up approach. The use of total beta developed by Aswath Damodaran is a relatively new concept. It is, however, gaining acceptance in the business valuation community since it is based on modern portfolio theory. Total beta can help appraisers develop a cost of capital who were content to use their intuition alone when previously adding a purely subjective company-specific risk premium in the build-up approach. It is important to understand why this capitalization rate for small, privately held companies is significantly higher than the return that an investor might expect to receive from other common types of investments, such as money market accounts, mutual funds, or even real estate. Those investments involve substantially lower levels of risk than an investment in a closely held company. Depository accounts are insured by the federal government up to certain limits ; mutual funds are composed of publicly traded stocks, for which risk can be substantially minimized through portfolio diversification. Closely held companies , on the other hand, frequently fail for a variety of reasons too numerous to name. Examples of the risk can be witnessed in the storefronts on every Main Street in America. There are no federal guarantees. The risk of investing in a private company cannot be reduced through diversification, and most businesses do not own the type of hard assets that can ensure capital appreciation over time. This is why investors demand a much higher return on their investment in closely held businesses; such investments are inherently much more risky. This paragraph is biased, presuming that by the mere fact that a company is closely held, it is prone towards failure. Asset-based approaches[edit] The value of asset-based analysis of a business is equal to the sum of its parts. That is the theory underlying the asset-based approaches to business valuation. The asset approach to business valuation reported on the books of the subject company at their acquisition value, net of depreciation where applicable. These values must be adjusted to fair market value wherever possible. For this reason, the asset-based approach is not the most probative method of determining the value of going business concerns. In these cases, the asset-based approach yields a result that is probably lesser than the fair market value of the business. In considering an asset-based approach, the valuation professional must consider whether the shareholder whose interest is being valued would have any authority to access the value of the assets directly. Shareholders own shares in a corporation, but not its assets, which are owned by the corporation. A controlling shareholder may have the authority to direct the corporation to sell all or part of the assets it owns and to distribute the proceeds to the shareholder s. The non-controlling shareholder, however, lacks this authority and cannot access the value of the assets. The asset based approach is the entry barrier value and should preferably to be used in businesses having mature or declining growth cycle and is more suitable for capital intensive industry. Adjusted net book value may be the most relevant standard of value where liquidation is imminent or ongoing; where a company earnings or cash flow are nominal, negative or worth less than its assets; or where net book value is standard in the industry in which the company operates. The adjusted net book value may also be used as a "sanity check" when compared to other methods of valuation, such as the income and market approaches Valuation using multiples The market approach to business valuation is rooted in the economic principle of competition: Buyers would not pay more for the business, and the sellers will not accept less, than the price of a comparable business enterprise. The buyers and sellers are assumed to be equally well informed and acting in their own interests to conclude a transaction. It is similar in many respects to the "comparable sales" method that is commonly used in real estate appraisal. The market price of the stocks of publicly traded companies engaged in the same or a similar line of business, whose shares are actively traded in a free and open market, can be a valid indicator of value when the transactions in which stocks are traded are sufficiently similar to permit meaningful comparison. The difficulty lies in identifying public companies that are sufficiently comparable to the subject company for this purpose. Also, as for a private company , the equity is less liquid in other words its stocks are less easy to buy or sell than for a public company , its value is considered to be slightly lower than such a market-based valuation would give. When there is a lack of comparison with direct competition, a meaningful alternative could be a vertical value-chain approach where the subject company is compared with, for example, a known downstream industry to have a good feel of its value by building useful correlations with its downstream companies. Such comparison often reveals useful insights which help business analysts better understand performance relationship between the subject company and its downstream industry. For example, if a growing subject company is in an industry more concentrated than its downstream industry with a high degree of interdependence, one should logically expect the subject company performs better than the downstream industry in terms of growth, margins and risk. Guideline Public Company method[edit] Guideline Public Company method entails a comparison of the subject company to publicly traded companies. The public companies identified for comparison purposes should be similar to the subject company in terms of industry, product lines, market, growth, margins and risk. However, if the subject company is privately owned, its value must be adjusted for lack of marketability. This is usually represented by a discount, or a percentage reduction in the value of the company when compared to its publicly traded counterparts. This reflects the higher risk associated with holding stock in a private company. The difference in value can be quantified by applying a discount for lack of marketability. This discount is determined by studying prices paid for shares of ownership in private companies that eventually offer their stock in a public offering. Alternatively, the lack of marketability can be assessed by comparing the prices paid for restricted shares to fully marketable shares of stock of public companies. Option pricing approaches[edit] As above , in certain cases equity may be valued by applying the techniques and frameworks developed for financial options , via a real options framework. In general, equity may be viewed as a call option on the firm, [7] and this allows for the valuation of troubled firms which may otherwise be difficult to analyse. Of course, where firm value is greater than debt value, the shareholders would choose to repay i. Thus analogous to out the money options which nevertheless have value, equity will may have value even if the value of the firm falls well below the face value of the outstanding debtâ€”and this value can should be determined using the appropriate option valuation technique. A further application of this principle is the analysis of principalâ€”agent problems ; [4] see contract design under principalâ€”agent problem. Certain business situations, and the parent firms in those cases, are also logically analysed under an options framework; see "Applications" under the Real options valuation references. Just as a financial option gives its owner the right, but not the obligation, to buy or sell a security at a given price, companies that make strategic investments have the right, but not the obligation, to exploit opportunities in the future; management will of course only exercise where this makes economic sense. Thus, for companies facing uncertainty of this type, the stock price may should be seen as the sum of the value of existing businesses i. A common application is to natural resource investments. The value of the resource is then the difference between the value of the asset and the cost associated with developing the resource. Where positive " in the money " management will undertake the development, and will not do so otherwise, and a resource project is thus effectively a call option. A resource firm may should therefore also be analysed using the options approach. Specifically, the value of the firm comprises the value of already active projects determined via DCF valuation or other standard techniques and undeveloped reserves as analysed using the real options framework. Product patents may also be valued as options, and the value of firms holding these patents â€" typically firms in the bio-science , technology , and pharmaceutical sectors â€" can should similarly be viewed as the sum of the value of products in place and the portfolio of patents yet to be deployed. Similar analysis may be applied to options on films or other works of intellectual property and the valuation of film studios. Cultural valuation method[edit] Besides mathematical approaches for the valuation of companies a rather unknown method includes also the cultural aspect. The so-called Cultural valuation method Cultural Due Diligence seeks to combine existing knowledge, motivation and internal culture with the results of a net-asset-value method. Especially during a company takeover uncovering hidden problems is of high importance for a later success of the business venture. Discounts and premiums[edit] The valuation approaches yield the fair market value of the Company as a whole. In valuing a minority, non-controlling interest in a business, however, the valuation professional must consider the applicability of discounts that affect such interests. Discussions of discounts and premiums frequently begin with a review of the "levels of value". There are three common levels of value: The intermediate level, marketable minority interest, is less than the controlling interest level and higher than the non-marketable minority interest level. The marketable minority interest level represents the perceived value of equity interests that are freely traded without any restrictions. Some of the prerogatives of control include:

VALUATION OF THE CORPORATE ENTERPRISE : PURPOSES AND METHODOLOGY pdf

7: Business Valuation Methods | Valuation Approaches

The purpose of this document is to provide guidelines applicable to all IRS personnel engaged in valuation practice (herein referred to as "valuators") relating to the development, resolution and reporting of issues involving business valuations and similar valuation issues.

Business Valuation Methods by Armin Laidre Your business is your major asset and it is understandable that you want to know its value. Think the business valuation as a "subjective science". The science part is when valuing your business - you have to apply standard valuation methods. Its value will always be what you are willing to sell for and what the potential buyer is willing to pay. Nevertheless, there are a few frequently used valuation methods that can help you to start the negotiation process. The basic ideas are simple, but you need to understand the details to know the calculations. Profit Multiplier In profit multiplier, the value of the business is calculated by multiplying its profit. After four years they will get the full return on the investment. Compared to the bank or other investments this is a highly profitable return. Determine the multiple If pre-tax profit is used, commonly applied profit multiples for small businesses would be between 3 to 4 and occasionally 5. This is one of the main reasons why large corporations can acquire a smaller business and instantly revalue them at a higher price. Obviously, the multiple that you will use have a huge effect on the valuation of the company. A larger business with a track record of good profits and with several potential buyers is likely to value by a higher profit multiple. There are also a few more aspects for you to know. When the market-based salaries are taken into account, the profit is reduced to nothing. Even the established business owners generally take salaries below market rate to improve cash flow or for tax reasons. This is the reason adjusted profit is used. There may be other transactions that are exceptions, for example, you may work from home or own the business premises. Basically, the potential buyer wants to rest assure that the profit is accurate and the company will generate the same amount after you are no longer the owner of the business. Average or normalized profit If, say, last year was a good year for your company in terms of profit generation, you obviously want to highlight that period to the buyers, but professional buyers want the average profit calculation of the last few years. This is the adjusted profit that your company makes without the effect of tax and interest. The EBIT calculation is frequently used when a business is valued or sold based on any debts and surplus cash removed from the balance. The EBIT gives a demonstration of the earnings of the business without the destabilizing effect of debts or surplus cash balance. You may be thinking why are valuations calculated without any tax? The reason is that once the company is merged into a larger group or corporation, the tax position of the group as a whole may be different. But remember one thing, if they are based on pre-tax profit, the multiples used to calculate the value will be less. In addition, it explains that profit or adjusted profit is without the effect of any corrections due to the devaluation of assets or repayment of any business loans. A potential buyer gets interested and says he will buy the company based on a 5-time multiple valuations. It seems like an excellent offer, but you have to consider and clarify a few things before you can accept the offer. If the 5 times multiple is based on any or all of the following factors, it will be far less attractive. Talk to a professional business Appraiser near you. Comparables A common valuation method is to look at a comparable company that was sold recently or other similar businesses with known purchasing value. For example, office and home security companies typically trade at double the monitoring revenue, and accounting firms trade at one time gross recurring fees. You can ask around at your annual industry conference and find out what is the selling price of similar companies in your industry. The main problem with the comparables method is that it often leads to an apples-to-bananas comparison. For example, if you try to compare your company with similar fortune counterparts, you will be disappointed. Discounted cash flow method The discounted cash flow method is similar to the profit multiplier method. This method is based on projections of few year future cash flows in and out of your business. The main difference between discounted cash flow method from the profit multiplier method is that it takes inflation into consideration to calculate the present value. Which would be a better offer for you? However, you have to take inflation rate into consideration.

8: Enterprise Valuations | Business Valution Services

Enterprise value is a reection of the rms value as a functioning entity and it is helpful in that it facilitates the comparison of companies with varying levels of debt.

Valuation overview[edit] Valuation of financial assets is done generally using one or more of the following approaches [2] ; but see also, generally, Outline of finance Valuation: These models take two general forms: These models rely on mathematics rather than price observation. See Discounted cash flow valuation. Option pricing models , in this context, are used to value specific balance-sheet items, or the asset itself, when these have option-like characteristics. Examples of the first type are warrants , employee stock options , and investments with embedded options such as callable bonds ; the second type are usually real options. The most common option pricing models employed here are the Blackâ€"Scholes - Merton models and lattice models. This approach is sometimes referred to as contingent claim valuation , in that the value will be contingent on some other asset; see Contingent claim valuation. Common terms for the value of an asset or liability are market value , fair value , and intrinsic value. The meanings of these terms differ. The International Valuation Standards include definitions for common bases of value and generally accepted practice procedures for valuing assets of all types. Usage[edit] In finance, valuation analysis is required for many reasons including tax assessment, wills and estates , divorce settlements , business analysis, and basic bookkeeping and accounting. Since the value of things fluctuates over time, valuations are as of a specific date like the end of the accounting quarter or year. They may alternatively be mark-to-market estimates of the current value of assets or liabilities as of this minute or this day for the purposes of managing portfolios and associated financial risk for example, within large financial firms including investment banks and stockbrokers. Some balance sheet items are much easier to value than others. Publicly traded stocks and bonds have prices that are quoted frequently and readily available. Other assets are harder to value. For instance, private firms that have no frequently quoted price. Additionally, financial instruments that have prices that are partly dependent on theoretical models of one kind or another are difficult to value. For example, options are generally valued using the Blackâ€"Scholes model while the liabilities of life assurance firms are valued using the theory of present value. Intangible business assets, like goodwill and intellectual property , are open to a wide range of value interpretations. It is possible and conventional for financial professionals to make their own estimates of the valuations of assets or liabilities that they are interested in. Their calculations are of various kinds including analyses of companies that focus on price-to-book, price-to-earnings, price-to-cash-flow and present value calculations, and analyses of bonds that focus on credit ratings, assessments of default risk , risk premia , and levels of real interest rates. All of these approaches may be thought of as creating estimates of value that compete for credibility with the prevailing share or bond prices, where applicable, and may or may not result in buying or selling by market participants. Where the valuation is for the purpose of a merger or acquisition the respective businesses make available further detailed financial information, usually on the completion of a non-disclosure agreement. It is important to note that valuation requires judgment and assumptions: There are different circumstances and purposes to value an asset e. Such differences can lead to different valuation methods or different interpretations of the method results All valuation models and methods have limitations e. Then they can weigh the degree of reliability of the result and make their decision. Business valuation[edit] Businesses or fractional interests in businesses may be valued for various purposes such as mergers and acquisitions , sale of securities , and taxable events. Alternatively, private firms do not have government oversightâ€"unless operating in a regulated industryâ€"and are usually not required to have their financial statements audited. Moreover, managers of private firms often prepare their financial statements to minimize profits and, therefore, taxes. Alternatively, managers of public firms tend to want higher profits to increase their stock price. Financial statements prepared in accordance with generally accepted accounting principles GAAP show many assets based on their historic costs rather than at their current market values. But under

GAAP requirements, a firm must show the fair values which usually approximates market value of some types of assets such as financial instruments that are held for sale rather than at their original cost. When a firm is required to show some of its assets at fair value, some call this process " mark-to-market ". But reporting asset values on financial statements at fair values gives managers ample opportunity to slant asset values upward to artificially increase profits and their stock prices. Managers may be motivated to alter earnings upward so they can earn bonuses. There are commonly three pillars to valuing business entities: Discounted cash flow method[edit] Main article: Valuation using discounted cash flows This method estimates the value of an asset based on its expected future cash flows, which are discounted to the present i. This concept of discounting future money is commonly known as the time value of money. The size of the discount is based on an opportunity cost of capital and it is expressed as a percentage or discount rate. In finance theory, the amount of the opportunity cost is based on a relation between the risk and return of some sort of investment. Classic economic theory maintains that people are rational and averse to risk. They, therefore, need an incentive to accept risk. The incentive in finance comes in the form of higher expected returns after buying a risky asset. In other words, the more risky the investment, the more return investors want from that investment. If given a choice between the two bonds, virtually all investors would buy the government bond rather than the small-firm bond because the first is less risky while paying the same interest rate as the riskier second bond. In this case, an investor has no incentive to buy the riskier second bond. Otherwise, no investor is likely to buy that bond and, therefore, the firm will be unable to raise capital. For a valuation using the discounted cash flow method, one first estimates the future cash flows from the investment and then estimates a reasonable discount rate after considering the riskiness of those cash flows and interest rates in the capital markets. Next, one makes a calculation to compute the present value of the future cash flows. Guideline companies method[edit] Main article: Comparable company analysis This method determines the value of a firm by observing the prices of similar companies called "guideline companies" that sold in the market. Those sales could be shares of stock or sales of entire firms. The observed prices serve as valuation benchmarks. From the prices, one calculates price multiples such as the price-to-earnings or price-to-book ratiosâ€”one or more of which used to value the firm. Many price multiples can be calculated. Net asset value method[edit] The third-most common method of estimating the value of a company looks to the assets and liabilities of the business. At a minimum, a solvent company could shut down operations, sell off the assets, and pay the creditors. Any cash that would remain establishes a floor value for the company. This method is known as the net asset value or cost method. In general the discounted cash flows of a well-performing company exceed this floor value. Some companies, however, are worth more "dead than alive", like weakly performing companies that own many tangible assets. This method can also be used to value heterogeneous portfolios of investments, as well as nonprofits , for which discounted cash flow analysis is not relevant. The valuation premise normally used is that of an orderly liquidation of the assets, although some valuation scenarios e. An alternative approach to the net asset value method is the excess earnings method. This method was first described in ARM34,[further explanation needed] and later refined by the U. The excess earnings method has the appraiser identify the value of tangible assets, estimate an appropriate return on those tangible assets, and subtract that return from the total return for the business, leaving the "excess" return, which is presumed to come from the intangible assets. An appropriate capitalization rate is applied to the excess return, resulting in the value of those intangible assets. That value is added to the value of the tangible assets and any non-operating assets, and the total is the value estimate for the business as a whole. In the below cases, depending on context, Real options valuation techniques are also sometimes employed, if not preferred; for further discussion here see Business valuation Option pricing approaches , Corporate finance Valuing flexibility. Valuation of a suffering company[edit] When valuing " distressed securities ", in many cases the company in question is valued using real options analysis - see Business valuation Option pricing approaches. This value serves to complement or sometimes replace the more standard techniques. When these latter are applied, various adjustments are typically made to the valuation result; this would be true whether market-, income-, or asset-based. The price reflects what investors, for the most part venture capital firms, are willing to pay for a share of the firm. They are not listed on any stock market, nor is the valuation based on their assets or profits, but on their potential for success, growth, and eventually, possible profits. The professional investors who fund startups are experts, but hardly infallible, see Dot-com bubble. Patent valuation Option-based method. Valuation models can be used to value intangible assets such as for patent valuation , but also in copyrights , software , trade secrets , and customer relationships. Since few sales of benchmark intangible assets can ever be observed, one often values these sorts of assets using either a present value model or estimating the costs to recreate it. Regardless of the method, the process is often time-consuming and costly. Valuations of intangible assets are often necessary for financial reporting and intellectual property transactions. It can be reckoned as the difference between its market capitalisation and its book value by including only hard assets in it. Valuation of mining projects[edit] In mining , valuation is the process of determining the value or worth of a mining property. Mining valuations are sometimes required for IPOs , fairness opinions , litigation, mergers and acquisitions, and shareholder-related matters. In valuation of a mining project or mining property, fair market value is the standard of value to be used. The standards [6] stress the use of the cost approach , market approach , and the income approach , depending on the stage of development of the mining property or project.

VALUATION OF THE CORPORATE ENTERPRISE : PURPOSES AND METHODOLOGY pdf

9: Enterprise Value (EV) | Investopedia

Business valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to effect a sale of a business.

First, investment banks act as intermediaries between those entities that demand capital e. This is mainly facilitated through debt and equity offerings by companies. In providing these services, an investment bank must determine the value of a company. How does an investment bank determine what a company is worth? In this guide you will find a detailed overview of the valuation techniques used by investment bankers to facilitate these services that they provide. In this chapter we will cover two primary topic areas: How do bankers determine how much a company is worthâ€"in other words, what valuation techniques are typically used? What are the advantages and disadvantages of each valuation technique, and when should which technique be used? Overview While there are many different possible techniques to arrive at the value of a companyâ€"a lot of which are company, industry, or situation-specificâ€"there is a relatively small subset of generally accepted valuation techniques that come into play quite frequently, in many different scenarios. We will describe these methods in greater detail later in this training course: Comparable Company Analysis Public Comps: Valuing a company by projecting its future cash flows and then using the Net Present Value NPV method to value the firm. Different parts of the investment bank will use these core techniques for different needs in different circumstances. Equity Capital Markets ECM bankers underwrite company shares in the public equity markets in advance of an initial public offering IPO or secondary offering, and thus rely heavily on Comparables valuation. Financial sponsors and leveraged finance groups will almost always value a company based upon leveraged buyout LBO transaction assumptions, but will also look at others. Also, in many cases, all of these groups will employ some degree of DCF valuation analysis. These different divisions of an investment bank may come up with similar valuation ranges using some subset of the techniques given, but will approach this process often with entirely different goals in mind. Thus all of these techniques are used routinely by investment banks, and for a banking analyst, at least some degree of familiarity with all of these techniques must be achieved in order for that analyst to be considered proficient at his or her job. When To Use Each Valuation Technique All of the valuation techniques listed earlier should be practiced by a junior banker, but some may be more applicable than others, given the group, the client, and the exact situation. Comparable Company Analysis The Comparable Company valuation technique is generally the easiest to perform. It requires that the comparable companies have publicly traded securities, so that the value of the comparable companies can be estimated properly. We will detail the calculation process for Comparable Company analysis later in this guide. The analysis is best used when a minority small, or non-controlling stake in a company is being acquired or a new issuance of equity is being considered this also does not cause a change in control. In these cases there is no control premium, i. With no change of control occurring, Comparable Company analysis is usually the most relied-upon technique. In this respect, DCF is the most theoretically correct of all of the valuation methods because it is the most precise. However, this level of preciseness can be tricky. What DCFs gain in precision giving an exact estimate based on theory and computation , they often lose in accuracy giving a true indicator of the exact value of the company. DCFs are exceedingly difficult to get right in practice, because they involve predicting future cash flows and the value of them, as determined by the discount rate , and all such predictions require assumptions. The farther into the future we predict, the more difficult these projections become. Any number of assumptions made in a DCF valuation can swing the value of the companyâ€"sometimes quite significantly. Therefore, DCF valuations are typically most useful and reliable in a company with highly stable and predictable cash flows, such as an established Utility company. Precedent Transaction Analysis The Precedent Transaction valuation technique is also generally fairly easy to perform. If the buyer acquires a majority stake in a company or similarly, when a controlling stake in a business is divested , a Precedent Transaction analysis is almost always the theoretically correct Comparable Company analysis to perform. Why do we use Precedent Transactions analysis in this scenario? Because when a majority stake is purchased, the buyer assumes control of the acquired entity. By having control over the business, the buyer has more flexibility and more options about how to create value for the business, with less interference from other stakeholders. Therefore, when control is transferred, a control premium is typically paid. Precedent Transactions are designed to attempt to ascertain the difference between the value of the comparable companies acquired in the past before the transaction vs. In other words, the analyst determines the difference between the market value of the company before the transaction is announced vs. This difference represents the premium paid to acquire the controlling interest in the business. Thus when a change of control is occurring, Precedent Transaction analysis should typically be one of the valuation methods used. We will detail the calculation process for Precedent Transaction analysis later in this guide. In order to maximize returns from these investments, LBO firms generally try to use as much borrowed capital debt financing as possible to fund the acquisition of the company, thereby minimizing the amount of equity capital that the sponsor itself must invest equity financing. There are three possible approaches to take in running an LBO analysis for a target company: Usually the first analysis is performed by investment bankers. Bankers will often use LBO analysis to determine whether a higher valuation from private equity investors is possible, again using the first analysis. LBO analysis can be quite complex to perform, especially as the model gets more and more detailed. For example, different assumptions about the capital structure can be made, with increasing layers of refinement, to the point where each individual component of the capital structure is being modeled over time with a host of tranche-specific assumptions and features. That said, a simple, standard LBO model with generic, high-level assumptions can be put together fairly easily. Unfortunately, LBO valuations can be highly subject to market conditions. Hence LBO investing is highly cyclical depending upon market forces. Valuation Technique Advantages and Disadvantages Each valuation method naturally has its own set of advantages and disadvantages. Some are more reliable and accurate, while others are easier to perform, for example. Additionally, some valuation methods are specifically indicated in certain circumstances. Here are the main Pros and Cons of each method: Comparable Company Analysis Pro: Market efficiency ensures that trading values for comparable companies serve as a reasonably good indicator of value for the company being evaluated, provided that the comparables are chosen wisely. These comparables should reflect industry trends, business risk, market growth, etc. Values obtained tend to be most reliable as an indicator of value of the company whenever a non-controlling minority investment scenario is being considered. No two companies are perfectly alike, and as such, their valuations generally should not be identical either. Thus comparable valuation ratios are often an inexact match. Also, for some companies, finding a decent sample of comparables or any at all! Illiquid comparable stocks that are thinly traded or have a relatively small percentage of floated stock might have a price that does not reflect the fundamental value of that company. DCF method is not heavily influenced by temporary market conditions or non-economic factors. Valuation obtained is very sensitive to modeling assumptionsâ€”particularly growth rate, profit margin, and discount rate assumptionsâ€”and as a result, different DCF analyses can lead to wildly different valuations. Generally regarded as the best valuation tool for control-transferring transactions because the previous transaction has validated the valuation in other words, a precedent has been established, whereby a previous buyer has actually paid the amount specified in the precedent transaction. The valuation multiples found in prior transactions typically include control premium and synergy assumptions, which are not public knowledge and are often transaction-specific. These assumptions are not always achievable by other market participants conducting a new transaction. Precedent Transaction valuations are easily influenced by temporary market conditions, which fluctuate over time. For example, a prior transaction might have been conducted in a more favorable environment for debt or equity issuance. LBO valuation is realistic, as it does not require synergies to achieve financial buyers usually do not have synergy opportunities. Ignoring synergies could result in an underestimated valuation, particularly for a well-fitting strategic buyer. The valuation obtained is very sensitive to operating assumptions growth rate, operating working capital assumptions, profit margins, etc. Company Value In order to use the valuation techniques described above, it is important to understand a few core building blocks of valuation. These concepts will be used in much more detail in later chapters of this training course, wherein we will walk you through how to conduct these valuations in explicit detail. It is calculated by multiplying shares outstanding by the current stock price. The accounting valuation of the equity. This generally assumes, of course, that the company will be ceasing operations. What is the difference been Book Value and Market Value? Market Value is almost always larger then Book Value for three primary reasons: Market Value includes future growth expectations while Book Value does not. Market Value includes brand value and company intangible assets. Market Value includes value accrued by the company historically through wise managerial decision making, while Book Value generally does not. How do you calculate Market Value and Enterprise Value? Why is Cash subtracted out? Cash is subtracted out of Enterprise Value because excess Cash is considered a non-operating asset. When should Enterprise Value be used? Here are a couple of simple examples of how to calculate Enterprise Value based on information available for a company: Solving for Enterprise Value, Example 1:

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