Magic Workbooks

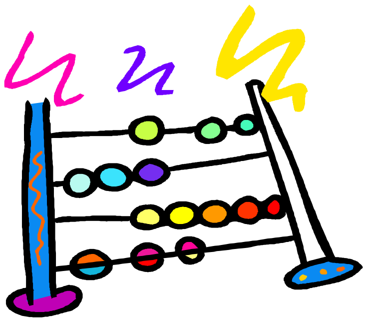
Business Survival Manual

COMPANY VALUATION

OR

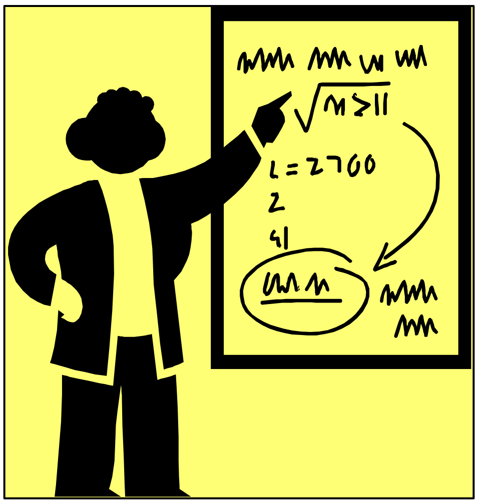
Count Your Assets...

Much has been written on the subject of how to properly establish the value of a company. And most of that is only helpful if you need to pass an economics exam.



Practical applicability: forget it, zip, *nada*, none.

So, we will set out to dissect the problem in our usual primitive business survival manner.



This will undoubtedly drive all those practitioners of economics up the wall who believe that complexity is preferable to practicability – probably because the more complex the formulas are, the less likely they are to be contradicted.

But let's leave academic vanities behind and concentrate on the essentials. We can distinguish three completely different approaches to company valuation:

The income approach — value is determined by future income

The philosophy behind this approach: the company is regarded as a cash-generating machine/organism in which every asset and every process is an integral and inseparable part of the overall purpose of producing income.

The asset approach — value is determined by the assets the company holds

The philosophy behind this approach: the company is a hard-to-evaluate intangible, therefore valuation concentrates on the substantial assets the company holds e.g. real estate, buildings, machines and so on.

The benchmark approach — value is determined by the price of similar companies

The philosophy behind this approach: before we make a fool of ourselves, let's find out what companies like this are presently being sold / bought for.

Each of these basic approaches has fanned out into a number of separate methods and quite often combinations of these approaches are used and averaged up.

But let us stick to the pure approaches for the time being and check them against different types of companies.

- Consider a real estate management company which owns 200 million worth of buildings with a total debt-load of 100 million and rents them. The company has produced an operational loss for the past five years. Would the income approach alone make sense in valuing that company? Obviously not, since the net asset value of 100 million would easily overshadow any discounted cash-flow (not to mention that if the cash-flow continues negative an incomebased valuation would compute a negative company value!). The valuation yard-stick for this company might be "net asset value less a discount for bad management".

- Consider, on the other hand, a highly successful consultancy with almost no assets but something like a monopoly for helping genetic engineering start-ups go public. Where would a solely asset-driven approach get you with that company? Probably nowhere.

- Consider, finally, any small business in a wildly uncertain business environment e.g. a night-club. Its cash-earning capacity is by no means subject to competent management alone or to the tangible assets with which it has been furnished. Its continuing success depends on intangibles like fashion or being "in vogue" which resist prediction and analysis. This is the case where, "Let's find out what ***La Cage Aux Folles*** was sold for and use that as our guideline!" makes quite a bit of sense.

To summarize, two of the three basic approaches seem to be geared to special types of companies or companies in special circumstances:

The **benchmark approach** works for companies where neither assets nor cash-flow projections yield reliable results;

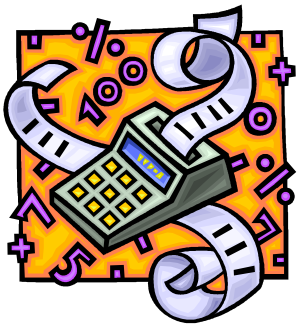
The **asset approach** works for companies where assets are the principal movers.

The **income approach**, one might say, works for companies where cash is the prime mover – and that covers a lot of companies.

One other fact about company valuation should be mentioned in passing: different countries have evolved their own mixes of the three basic approaches which usually reflect a particular country's predominant industries and / or its economic history; and, needless to say, tax authorities all over the world pride themselves on their own myriad and well-ingrained ways of determining company values for their sinister purposes.

Having said that, let's return to the everyday world of business. As we have seen, of our three basic approaches to company valuation, the **income approach** is the most promising as far as general applicability is concerned while we should regard the two other approaches in their pure and undiluted state as suitable for special types of companies only.

COMPANY VALUATION according to the INCOME APPROACH

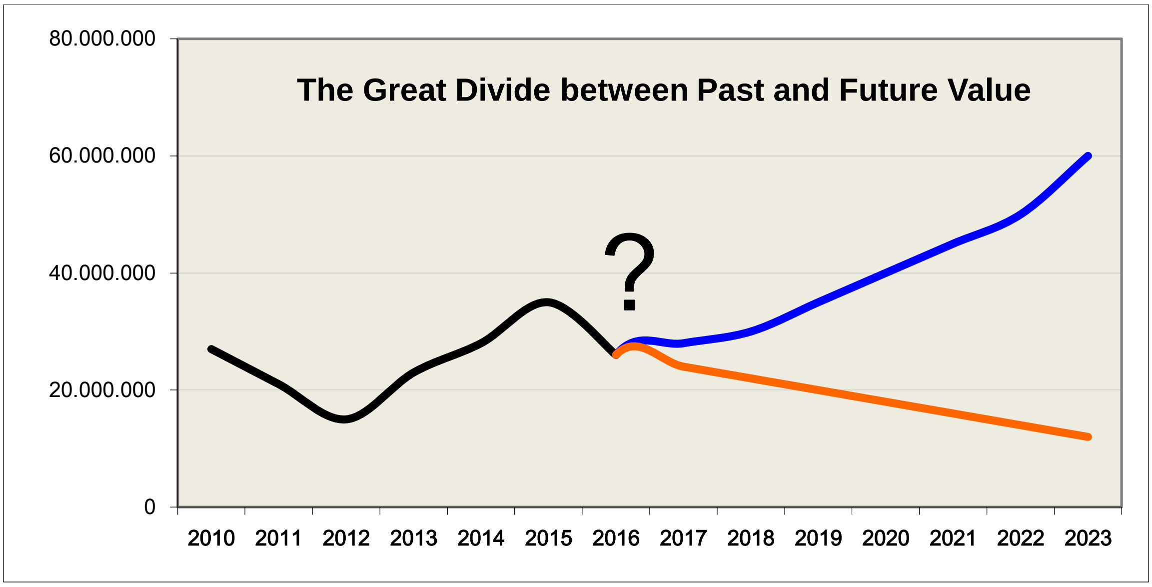


We will not bore you with a discussion of every method subsumable under the income approach. The best-known method is the **DCF** or **Discounted Cash-Flow** method. As the name suggests this means that company value is defined as the sum of future cash-flows, discounted to net present value.

If we dissect this definition, we come up with three elements:

Net present value	that one is easy, definition to be found in any economics textbook
Cash-flow	ditto
Future	well, it would be no fun if there was no icky-tricky element in it, and this is it.

Here is the central problem of establishing a company's income value: The company will change over time in unforeseen ways, to put it mildly, which has implications on its value. And evaluating a company correctly will have to take those not precisely foreseeable changes into account.
That's the dilemma: the company past is documented but hardly relevant because it is over and done with; the company future is open to conjecture but needs to be fixed with a price tag.



Of course, every company management is quite familiar with the problem of projecting company development into the future: the whole process of **BUDGETING** has been invented specifically to overcome this problem.

The valuation of a company future – putting a price-tag on the unknown – is largely dependent on budget data. In fact, it is arguable that the budget or forecasting data used in this process have a far greater impact on the outcome than any part of the valuation methods and their variants which economists have at their fingertips.

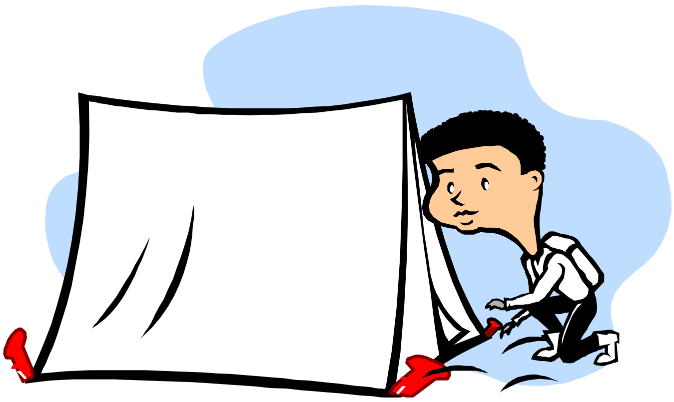
And the basic dilemma always remains: budget data cannot be verified until they are supplanted by actual data – which is useless for valuation purposes because as soon as the verification can be made, we need a new set of budget data to evaluate the company future, thus leaving us with an infinite iteration.

It may well be that this simple but baffling obstacle has led to the proliferation of ever more complex valuation methods as if layer upon layer of arcane formulae could mercifully hide the appalling lack of facts at the bottom of it all.

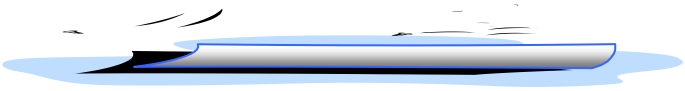
Since the basic dilemma cannot be solved, the only practical way to deal with it is this:

Root the budget as firmly as possible in reliable ground.

Think of putting up a tent:



No matter how expensive, beautiful and rainproof that tent is, unless you manage to secure it firmly to the ground by ramming in the tent pegs, it is just going to be a heap of billowy stuff lying about.



How does one root a budget in reliable ground? What are the tent pegs for a budget?

A budget consists of a series of assumptions about the future.
Each of these assumptions has to be laid open and examined for reliability.

Start with a general overview:

Are there indications for major changes in the economic climate?
Is a rise or fall in interest rates imminent?
Was there some recent ecological catastrophe or scientific breakthrough that will exert influence on your products, your customers, or your market-share?

Then fine-tune on the level of your assumptions about future revenue and future expenses.
Look closely at the life-cycles of your products before assuming that sales will rise another 10 per cent each year.

Note and evaluate any changes in the group of your major customers over the last few years.

Take a good look at the variances between your last few budgets and the actual figures of those years: the variances may well be pointers to facts and developments you are apt to overlook or to estimate incorrectly.

For an introduction to the art of budgeting, you can also download the Business Survival Manual chapter "Budgeting".

And while you're at it: take a good look at your balance-sheet. Do you carry any "ghosts from the past" around with you such as Accounts Receivable that will in fact never be received? Now is the time for a thorough house-cleaning.

A foam-padded balance-sheet does not make a good impression in the due diligence process that nowadays precedes every company-sale, and has an adverse effect on the credibility of your assumptions about the company future.

For valuation purposes, the budgeted time-period should extend to no less than five years and it should comprise not only the income statement but also the balance-sheet. Necessary investments or re-investments and debt pay-off or re-financing need to be computed as well.

If you are interested in a tool that was designed to accommodate all the necessary information for a valuation you might have a look at the following MagicWorkbooks®

CompanyEvaluator in both cost of sales and period accounting format

This tool automatically produces a valuation of the company and a recommendation for the best year in which to sell as well as lots of graphs and spreadsheets which come in handy when negotiating with potential buyers. You only have to input your last income statement, balance sheet, and your expectations for the next five business years.

As you may have gathered from the above, it makes good sense to compute the value of a company not only for the purpose of selling it but also to get an idea of what one's life-time effort has accomplished in terms of value, and last but not least: to check on the company's wellbeing and identify the need for major reforms.