8

# Business valuations

## 1 Valuing a business

### 1.1 Introduction

In order to be able to measure the wealth of the shareholders it is important to be able to estimate the value of the whole business.

- Companies listed on a recognised stock exchange will have a value that is set by market forces and is evidenced in the share price.
- Non-listed companies will not normally have a readily available share price and so there needs to be recognised methods of estimating company value for those companies.

If a company is being purchased, the buyer and seller are likely to have different agendas and needs. It is therefore normal to use a number of different valuation techniques that can then form the basis of the negotiations.

Valuation is not an exact science and as such you should be prepared to make reasonable assumptions and demonstrate a good practical approach to valuations and acquisitions.

### 1.2 Reasons why a valuation may be necessary

- A company is seeking a stock market floatation and therefore an assessment of the issue price of the shares is necessary.
- A business may be considering buying another business (acquisition).
- Owners may be looking to sell all or part of the business.
- A bank may require a valuation of a potential borrower when making a lending decision.
- The valuation may be for tax purposes (probate value for inheritance tax, valuation when a business is passed on to a family member)

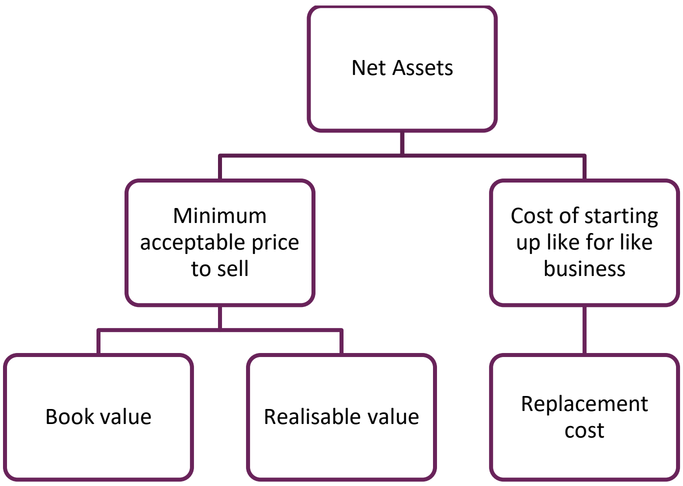
### 1.3 Methods of valuation

In the F3 exam we will be asked to value the equity (ordinary shares) in a company using a variety of approaches – these can be broken down into 3 categories:

| Asset based | Earnings based | Cash flow based |
|---|---|---|
| • Historic cost<br>• Replacement cost<br>• Realisable value | • P/E ratio<br>• Earnings yield | • Discounted cashflows<br>• Dividend yield<br>• Dividend growth model |

- In addition, the quickest way to value a listed business's equity is if given its share price:
- Value (market capitalisation) = **Share price × number of shares**
- This would be an appropriate starting point for valuing a quoted company, however a premium over the current share price would need to be paid if purchasing a large stake in a quoted company

## 2 Asset based valuations




The net asset value on the most recent statement of financial position (SoFP) is a quick and easy starting point – this represents the book value of equity:

**Net assets value** = Non-current assets + Net current assets – Long-term liabilities = Total assets – Total liabilities

| Book values | Realisable values | Replacement cost |
|---|---|---|
| Easy to determine, but may be stated at historic cost (not representative of current market values - e.g. there may be a large property element that has not been revalued) | A realisable value would give a better indication of price in a sell off or asset stripping situation (and could be substituted in to replace the book values in the net asset calculation)<br><br>Realisable values would need to be known and may be lower than market values.<br><br>This might give a **minimum price** a seller of a business might accept. | The replacement cost of the assets may be more appropriate if you are trying to duplicate an existing business.<br><br>This method may give a better reflection of a **maximum price** a buyer might consider paying for a business. |