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## BUSINESS VALUATION: A CRITICAL ANALYSIS OF BUSINESS VALUATION APPROACHES

Avinash Ghad<sup>1</sup>, Dr. Mahesh Abale<sup>2</sup>

<sup>1</sup>NBN Sinhgad School of Management Studies, Pune

<sup>2</sup>(MIT's Department of Management Science and Research, Pune)

### ABSTRACT

Estimating the worth of an asset or a security or a business is termed as "valuation". The basic purpose of any investor is to know the value of a business before purchasing or investing. There are various methods in business which are used to assess the business worth. This paper closely analyze the prevailing trends and aspects which are used in business valuation.

### INTRODUCTION

Businesses need to be valued for a number of reasons such as their purchase and sale, obtaining a listing, inheritance tax and capital gains tax computations. Generally, valuation difficulties are restricted to unlisted companies because listed companies have a quoted share price. However, even listed companies can present valuation challenges for example when one is trying to predict the effect of a takeover on the share price.

price which can be obtained from the market if concerned fixture or machinery is sold.

Second step, is to identify all intangible assets owned by the company such as list of copyrights, trademark, brands, patent, skilled manpower and valuable customers and goodwill.

Once you have understanding of your tangible and intangible assets than only you can ask for the real value of your business.

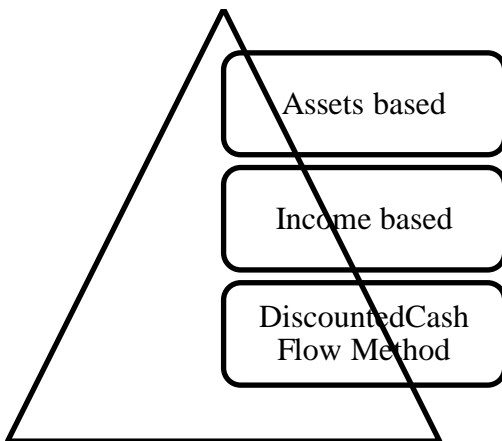


Fig. No.1 Business Valuation Approaches

### ASSETS BASED APPROACH

This is very simple method to use and widely used during business valuation but using this method will probably result in the lowest valuation of your business and normally known as the liquidation value. This is important to take the value of book values, net realizable value and replacement values.

The first step under this method is to identify tangible assets of the firm like furniture, machine, inventory etc. After identification of assets it is important to assign the value as per market value. Market value is the value or

### INCOME BASED APPROACH

Every business person invest time, money and effort to gain income for long run. The basic purpose of any business is to earn the money by utilizing all available resources. This is closely associated with the risk involved in business and income possibility in concern business. Income approach relies on the concept of capitalization and discounting. The idea is that business valuation should be based on overall earning and capitalization rate. Once income based approach is used, this is important to understand which are the factors which affect the income and growth of the firm, key factors are as follows:-

- Earning track record
- Industry growth rate
- Business growth and business financing

P/E Ratio is also widely used under this method. The P/E ratio is the price per share divided by the earnings per share and shows how many years' worth of earnings are paid for in the share price.

*Capitalization rate* is related to the discount rate and can be defined as below:-

- $Cap = Disc - G$
- In this formula *Cap* is the *capitalization rate*, *Disc* is the *discount rate*, and *G* is the expected annual long-term growth rate in the business earnings being capitalized.

The flexibility of measuring the business worth to match one's objectives is one of the greatest strengths of the income valuation approach.

## DISCOUNTED CASH FLOW METHOD

Discounted cash flow (DCF) is a cash flow summary that it has to be adjusted to reflect the present value of money. Discounted cash flow (DCF) analysis identifies the present value of an individual asset or portfolio of assets. This is equal to the discounted value of expected net future cash flows, with the discount reflecting the cost of waiting, risk and expected future inflation. Discounted cash flow (DCF) analysis is applied to investment project appraisal and corporate valuation. (Thavamani Theyy Arumugam, 2007)

Today the discounted cash flow (DCF) model is the most commonly used tool among financial analysts when valuing a firm. It is documented that almost fifty percent of all financial analysts use a discounted cash flow (DCF) method when valuing potential objects to acquire (Hult, 1998). In a study Absiye & Diking (2001) found that all seven of their respondents, which were analysts, use the discounted cash flow (DCF) model when they were conducting a firm valuation, the other valuation models were just used as complements to the valuation done by the discounted cash flow (DCF) method. Quite a lot of other studies have been conducted on business valuation. Some of these focus on the different methods that are used to conduct valuations. They investigate compare and contrast which model, analysts use and how they look at these models. For example, see Absiye and Diking (2001) and Carlsson (2000). Others centre on how one or more of the valuations models are constructed see Eixmann (2000), still others conduct case studies where a valuation approach, frequently the is counted cash flow (DCF) model, is applied to a special case. Example of such research is Bin (2001). Firstly, the focus is on one model, the discounted cash flow (DCF) model, but the whole context of the valuation process is in focus. Furthermore, the investigation is directed towards finding areas to improve within the discounted cash flow (DCF) approach and the ways to make improvements in these areas.

Business valuation is associated with periodic review of assets by considering the economic and industry look. Study reveals that *discounted cash flow models, the Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Models (APM), sales accelerator and cash flow models of investment, and economic base performance measures such as Economic Rent and Excess Market Value are key methods of business valuation.* (Jimmy Torrez, Mohammad Al 2006).

The DCF analysis is a very powerful tool that is not only used to value companies but also to price initial public offerings (IPOs) and other financial assets. It is such a powerful tool in finance, that it is so widely used by professionals in investment banks, consultancies and managers around the world for a range of tasks that it is even referred to as "the heart of most corporate capital-budgeting systems" (Luehrman, 1998, p. 51).

## CONCLUSION:

There is a no specific methods which is best, however in practice professional prefer to adopt discounted cash flow method and assets based approach for an effective value calculation in terms of reward and risk involved in purchasing the assets.

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