

# Corporate Valuation

In essence, there are three generally accepted methods of valuation: the discounted cash flow approach, the market approach, and the net asset approach. This book deals with the market approach. However, a common misconception is that these three concepts represent three fundamentally disparate or independent methodologies that, applied to the same subject of interest by the same analyst under the same valuation purpose, should or may generate three fundamentally different outcomes. *This is not the case.* Carried out correctly, a business valuation (under an assumption of continued pursuit of activities, i.e. under a going concern assumption), given a single well-defined subject and valuation purpose, shall in theory *as well as in practice* produce *exactly* the same output (i.e. value) irrespective of the model(s) utilized. To put it another way, *company value is driven by company fundamentals, not by the choice of valuation model(s).*

From a strictly theoretical perspective, the value of a company (or any other cash flow generating asset for that matter) will equal its projected future returns discounted to a present value by a risk-adjusted rate of return. This relationship will hold regardless of the methodology or methodologies used to derive that value. Hence the three methodologies presented above express exactly the same thing, but in three totally different ways. In order to fully appreciate the concept and structure of the market approach it is vital to recognize the fundamentals of the other two methodologies in isolation as well as in conjunction with each other. Set out below is a brief introduction to these three methodologies.

## 1.1 THE DISCOUNTED CASH FLOW APPROACH

The discounted cash flow approach (DCF) aims to establish the net present value of a cash flow generating asset (e.g. a company) by discounting its future expected returns with an appropriate required rate of return.

Performing business valuations, the cash flow which forms the basis of the net present value calculation is usually the “free cash flow to firm” (FCFF), explicitly the expected cash flow of the business independent of its financing (i.e. cash flow accruing to the company’s shareholders and lenders). Consequently, the cash flow in question should not be affected by such things as interest or dividends; however, it will be burdened by tax. Hence, the discount rate must reflect a weighted cost of capital for debt and equity financing after tax. A discounting (i.e. a net present value calculation) of the expected cash flow

at the appropriate weighted average cost of capital will give the value of the business enterprise (i.e. the market value of operating capital or, alternatively, the market value of invested capital).

To obtain the value of the shares, i.e. the value of the equity, the business enterprise value needs to be adjusted by the net debt position at the valuation date, i.e. subtracting financial liabilities, and including excess cash and non-operating assets.

It is also possible to compute the equity value, i.e. the market value of all shares, via a direct approach, that is, by projecting future cash flow specifically attributable to the shareholders of the company, free cash flow to equity (FCFE). Such cash flow has already been charged with financial items (interest and suchlike) and should accordingly be discounted by a matching rate of return (specifically a required return on equity). Hence, discounting this cash flow at the appropriate capital cost of equity therefore gives the equity value directly.

## **1.2 THE MARKET APPROACH**

The market approach aims to derive the value of a company based on how similar firms are priced on the stock exchange or through company transactions.

Using the market approach, price-related indicators such as price in relation to sales, earnings, number of employees, etc. are utilized. Consequently, the pricing of the valuation subject will implicitly be dependent upon other actors' assessment of future growth potential, profitability, risk profile (cost of capital), etc. for the valuation subject in question, which may or may not be appropriate.

The task is therefore to find comparables with as similar a structure and operations as possible to the company in question. Differences between the comparator group of companies and the valuation subject at issue as regards the size and nature of their operations, among other things, will justify correspondingly different levels of business risk, growth potential, margins, etc. These differences must therefore be considered when justifying different levels of value, i.e. when justifying the relevant or appropriate value multiple to be applied to the subject company.

## **1.3 THE NET ASSET APPROACH**

The net asset approach implies an adjustment of the balance sheet with regard to the market value of assets and liabilities. The net asset approach is often cited as an independent valuation method, but given an assumption of ongoing business operations, i.e. a going concern assumption, a proper implementation will, in order to properly capture the value of the subject company's intangible assets, and synergies among assets, normally require the use of several DCF

calculations. Consequently, fully executed, the concluding value derived from the net asset approach under a going concern assumption will, to the dollar, match that derived by the DCF approach.

Often a simplified form of the net asset approach, where only book tangible and intangible assets and liabilities are adjusted to their market value equivalents, is applied. The net asset value thus calculated can then be used as a basis for comparison and reconciliation of the DCF value. The difference between the simplified net asset value above and the DCF value may then be deemed to represent the value of non-book intangible assets including goodwill.

