Article – Business Valuations
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Business Valuation

There may be many circumstances in which a business' owner/company shareholders may wish to value the business/the shares of the company. They may include;

- A takeover bid
- Sale/divestment
- Management buy out
- Public flotation
- Pledging shares as collateral for borrowings (private)

Typically, management will employ an advising accountant to carry out the detailed valuation procedure. It is essential that all accountants;

- Appreciate that there are a number of methodologies used to value a business/company
- Can apply the main methods of business valuation and advise clients accordingly

Valuation Methodologies

There are many methodologies used for valuing a business/company. The main bases used to do so are;

- Assets Basis
- Earnings Basis
- Income Basis incorporating the dividend and discounted cash flow methods

I shall use a company valuation context to explain the above valuation methodologies.

Net Assets Basis

The value of a share (in a class of shares) is equal to the net tangible assets (after deducting liabilities) attributable to a class of shares divided by the number of that class of shares in issue.

Some of the difficulties encountered in establishing asset valuations include:

- Are the entities assets to be valued as a going concern or on a break-up basis?
- What values are more appropriate to use - historic or replacement/current cost values?
- Are professional valuations required?
- Have all liabilities been disclosed i.e. are there any hidden/contingent liabilities not disclosed?

Foe examination purposes assets and liabilities will be valued as a going concern at current values (independently and professionally valued where considered necessary and affordable), unless indicated otherwise.

Earnings Basis

This method determines the annual expected recurrent earnings to be derived from the business that is subject to the proposed purchase/takeover. These earnings are multiplied by an agreed price earnings (P/E) ratio to determine the valuation of the business i.e.

Indicative Value = EPS * P/E Ratio

It is important to appreciate that a single year's EPS may not be fully representative of past and future performance. Ideally, the due diligence audit will certify the earnings/EPS for a number of years prior to the potential takeover and an averaged annual earnings will used for the purpose of the valuation.

There are a number of difficulties associated with determining the Price/earnings multiple to be used in any earnings based valuation, these include:

- Deciding on the quality of the earnings e.g. recurrent contractual income vs casual earnings. The perceived quality of earnings will impact on the P/E ratio used for valuation purposes.
- Allowing for expected future economic and trading conditions

Further difficulties when valuing an unquoted company namely;

- Finding a similar quoted company to use as a benchmark P/E ratio
- Deciding on a reduction in the quoted P/E ratio to allow for the increase risk associated with an unquoted company

When employing this valuation method one must consider the future financial impact of the proposed acquisition. This might include;

- Synergistic benefits expected to arise as a result of the combination
- Cost savings to be delivered from the combination

- The one off costs of planned post-acquisition changes e.g. rationalisation Schemes, redundancies etc.

Income Basis

Dividend Valuation Method

This income based approach considers that the value of a share is the future expected stream of dividends from a share discounted at an appropriate cost of capital. This is based on the Fundamental Theory of Share Valuation.

This method involves the two following steps;

- **Step 1**: Determining whether dividend growth is expected or not. This will involve an examination of historic dividend payments to discern whether growth has occurred, and, if so by what averaged annual percentage.
- **Step 2** : Applying the appropriate dividend valuation formulae (dependent on whether growth is expected or not) to determine share value

The assumptions on which the dividend valuation model is built include:

- Estimates of future dividend growth based on historic trends are considered accurate
- The chosen discount rate will have ongoing applicability
- Dividends either show no growth or constant growth
- Earnings will continue/increase sufficiently to maintain dividend levels
- Other influences on share price are ignored

When deciding on an appropriate discount rate one must consider both the business risk of the company being valued and the method of finance planned to finance the proposed purchase.

This method is typically used to value an individual share. It would not be commonly used for the purposes of valuing a business/company in a takeover context. This is due to the discretionary nature of dividend policy.

Discounted Cash Flow Method

This method involves discounting the expected future cash inflows expected from a proposed acquisition at an appropriate discount rate to determine the maximum amount (Year 0) affordable for the proposed acquisition.

Conclusion

There are many methods that can be employed for the purposes of valuing a business/company. In practice more than one (if not all) methods may be employed to determine a range of potential values. Thereafter, the price that is agreed between a willing seller and willing buyer will be dependent on the negotiation skills of the respective parties.

The following worked example on the following pages demonstrates business valuation in practice.

Worked Example

M PLC, an Irish quoted conglomerate is considering acquiring T Limited a private Carlow based restaurant chain. M PLC's Financial Director has met with T Limited's management who were receptive to the proposed takeover, subject to an acceptable cash price being offered per share. At that meeting, T Limited's management agreed to the commencement of the due diligence audit by M PLC's financial and legal advisors.

M PLC's Weighted Average Cost of Capital (WACC) is 10%.

T Limited's most recent summarised Balance Sheet reads as follows:

T Limited **Balance Sheet as at 30th September 2008**	
	€000s
Non Current Assets at NBV	
Freehold Land & Buildings	625
Property and Plant	125
Fixtures & Fittings	50
Total Non-Current Assets	800
Current Assets	
Inventories	125
Trade Receivables	40
Cash & Cash Equivalents	0
Total Current Assets	165
Total Assets	965
Equity & Liabilities	
Equity Attributable to Equity Holders	
Share Capital (@ €5 each)	400
Other Reserves	235
	635
Non Current Liabilities	
Long term borrowings	40
Current Liabilities	
Trade payables	110
Dividend payable	0
Short Term Borrowings	60
Current portion of long term borrowings	120
Total Current Liabilities	290
Total Liabilities	965

Note: A recent independent valuation of T Limited's non-current assets is summarised as follows:

T Limited Non Current Assets at Market Values	€000s
Freehold Land & Buildings	1200
Property and Plant	80
Fixtures & Fittings	50

Due Diligence Findings

- €15,000 of the trade receivables are considered uncollectible.
- €10,000 of inventories are considered to be obsolete
- The market value of all other balance sheet items are considered as per their balance sheet values
- T Limited has certified average post tax profits for the last five years of €160,000 per annum
- T Limited paid a dividend of €.50 per share for the year ended 30/9/2008

Other Information

M PLC does not plan to assume any of T Limited's borrowings. M PLC plans to close T Limited's warehouse at a pre tax cost of €1 million. Annual recurrent pre-tax savings of €200,00 are expected as a result of this closure.

M PLC pays corporation tax at 20%

The following extracts are taken from the Irish Stock Exchange for Tell PLC and Crown PLC. Both companies have a similar business and financial risk profiles to T Limited.

2008 – Share Information							
Company	**High (Cent)**	**Low (Cent)**	**Price (Cent)**	**Dividend**			**P/E Multiple (Times)**
Tell PLC	220	290	270	10			9 times
Crown PLC	420	590	495	5			11 times

It is generally agreed that the price earnings multiple of a quoted company should be reduced by 30% to value an unquoted company.

The dividends paid by T Limited have been increasing by 7% over the last three years.

Required

M PLC is due to meet T Limited's management team in one week's time to negotiate a per-share valuation. In advance of the meeting M PLC's Board of Directors have asked you to prepare a briefing note that;

1) Provides an indicative valuation per share using the following valuation bases:

- Net Assets
- Earnings (P/E)
- Income using the Dividend Valuation Model

2) Advises on negotiation tactics prior to the forthcoming meeting with T Limited's representatives.

BRIEFING NOTE

To: Board of Directors, M PLC
From: Mr X, Advising Accountant
Date: 2nd November 2008
Subject: Valuation of T Limited

Introduction
This briefing note advises on an indicative valuation for your takeover target T Limited.

Approach
There are a number of methods used to value businesses. For the purpose of this report I have used the following methods to provide a range of indicative share values;

- Net Assets
- Earnings
- Dividends

Findings
The range of indicative share values of T Limited are:

Tomas Limited - Indicative Share Valuation	
	€
Net Assets Method (note 1)	17.00
Earnings Method (note 2)	18.00
Dividend Method (note 3)	17.83

Detailed workings can be found at Appendix A to this briefing note.

Negotiation Tactics
Before you meet with T Limited's representatives you must identify the maximum price affordable per share. The valuation process indicates the €18 per share would be the maximum share price payable. Please ensure not to reveal this valuation at the meeting unless it is considered absolutely necessary to do so.

At the meeting you should commence negotiation at around the €12 per share mark. Ideally, this would:
- Be sufficiently high so as not to insult T Limited's Management to the point that they may decide not to sell the company
- Be sufficiently low to allow scope for increase if the negotiations require same.

Conclusion
With the above information you will ideally be able to negotiate a satisfactory price for the takeover of T Limited.

Appendix A

Note 1)

T Limited Net Asset Valuation	
	€000s
Freehold Land at Market Value	1,200
Property and Plant at Market Value	80
Fixtures & Fittings at Market Value	50
Inventories (125-10)	115
Trade Receivables (40-15)	25
Trade Payables	-110
Total Net Assets to Take Over	1,360
Divided by: Shares In Issue	80
Indicative Per Share Valuation	17.00

Note 2)

T Limited Earnings Valuation	
	€000s
Averaged Post Tax Profits (last five years)	160
Warehouse closure savings (€200K-20% tax)	160
Annual Recurrent Post Tax Profits	320
Multiplied by: P/E ratio (9+11)/2*70%	7
Indicative Valuation	2,240
Less: Redundancy & Closure Costs (post tax)	-800
Final Indicative Valuation	1,440
Divided by: Shares In Issue	80
Indicative Per Share Valuation	18

Note 3)

Market Value - T Limited Share	
[.50*(1+.07)/(.1 -.07)] =	17.83