Unpacking Investment Banking

Company valuations

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INTRODUCTION

Our previous article focused on the importance of conducting a due diligence prior to execution of Mergers and Acquisitions ("M&A"), Management Buy Outs ("MBO") and Joint Venture ("JV") transactions. We further highlighted that due diligence reviews are often a precursor to the valuation of a target entity given that information gathered from a due diligence process forms the basis of various aspects of valuation models.

The valuation of a company can best be described as a process and a set of procedures used to determine what a business is worth. Valuation is used by financial market participants to determine the price that the parties to a transaction are willing to pay or receive to conclude a sale or purchase of a business. Business valuations depend on parameters set by the parties to a transaction, hence the body of information contained in a due diligence report provides valuable information that can be relied on to develop a list of assumptions about the future outlook of an entity.

Valuation of unlisted companies usually presents challenges due to inadequate information disclosure level, whilst for listed entities, it is often assumed that the market properly prices listed share.

There are three primary valuation approaches that can be employed in determining the value of a company, namely:

- Asset based approaches;
- Market based approaches; and
- Income based approaches.

The decision to rely on either of the three valuation approaches depends on the suitability of each valuation approach to a particular industry. Asset intensive companies tend to place greater weight on asset based approaches whilst companies in the services, manufacturing and technology industries usually place more emphasis on market and income based approaches.

WHY VALUE A BUSINESS?

During the lifecycle of a business, the circumstances of a business change as a result of economic variables, trading conditions in an economy, legislative changes or company specific issues such directorship and executive management changes. Company valuation attempts to capture these changes and ensure that at any point in time, a proper value is attached to the company.

The valuation of a company can be interpreted differently from the perspective of the buyer and the seller. From a buyer's perspective, the driving intention is not to pay more for an asset than it is worth. The aim of the seller on the other hand is to avoid "selling the business for a song" whilst ensuring that the buyer at best eventually pays a premium after negotiations.

These are conflicting views that must eventually be aligned if a deal is to be sealed. Owing to these competing interests, whose underlying objective is to maximise the return from a transaction, both the buyer and the seller end up selecting different advisors to represent their interests. It is not uncommon that parties to a transaction can agree to jointly appoint an independent expert to value the business. The two parties however may retain independent valuing experts to express an opinion on the valuations done by the independent expert.

In an Initial Public Offer ("IPO") of a company's shares and listing on the Zimbabwe Stock Exchange ("ZSE'), an indicative valuation of the company would be required. The valuation forms a basis of determining the value of each share being offered to public investors. Stock Brokers and Financial Advisors often spend time, prior to the listing of the company, reviewing the pre listing statement in an effort to determine whether the share offer price is properly valued, after which they will advise their clients of the appropriate investment strategy to implement.

The need for a valuation is also important in merger transactions given that shareholders in the two companies are swapping their shares. To determine the share swap ratio, valuation of the two entities to be merged are also carried out.

COMPANY VALUATION METHODOLOGIES

THE ASSET BASED APPROACH

The asset based approach is a business valuation method that is primarily focused on deriving the value of a business through the computation of the Net Asset Value ("NAV") of the business. In essence the NAV of the business is derived by computing the total assets less the total liabilities to determine the value of the business.

As such, the building blocks in conducting an asset based valuation, are schedules of all the business liabilities and tangible assets. The determination of the value of assets is usually complicated by the fact that different valuers can arrive at different values given that valuation can be considered to have a degree of subjectivity.

Often, asset based valuation practitioners would need to ensure that a fair market value of the asset is established. In most circumstances, the latest balance sheet of the company can be utilized as the basis for an asset based valuation of a company. In certain industries however, where components of the company's assets and liabilities are fluid from one business cycle to the next, a valuation of assets closer to the transaction date would be conducted.

The asset based approach may be considered to be the least complex of the business valuation methodologies. It however has its own complications if assets and liabilities are not properly accounted for in accordance with International Financial Reporting Standards ("IFRS").

One weakness of the asset based approach is that it does not account for the value of the business' intangible assets, such as goodwill and brand value. Its limitations mean that it can't be used to value service industry companies such as advertising agencies which derive their value from brand power or intellectual capital. In addition, the asset based valuation approach may not capture the cash flow generating potential of a company especially if the company being valued is not asset intensive. Notwithstanding these apparent limitations, the asset based approach is used by many as a means of establishing a baseline value which forms the basis of valuation negotiations in conjunction with other valuation methods.

The asset based approach is also suitable for new businesses without a track record, those in financial distress or any other circumstances where the business may be required to dispose part or all of its assets in a forced sale transaction. Companies under liquidation or where the company's cash flows are nominal, are also ideal for an asset based valuation approach.

THE MARKET APPROACH

Under the market approach, a valuation of an unlisted entity is arrived at by means of comparative analysis with publicly available information on similar enterprises. The information is utilized to determine the market comparable multiples which will be compared with those of the company that is being valued. The approach involves the identification of comparable enterprises within the same industry, which make up what is referred to as the peer group. The financial and operating data of the peer group is obtained and converted into standardized industry averages, that is the valuation multiples, which are then used to value the business. The market approach is also ideal in making comparison of listed companies to determine whether the company is properly. The Price to Earnings Multiple (P/E) is often used to compare companies in the same industry to identify undervalued shares that investors can buy into.

The most common multiples utilized under the market based approach include the following:

- Enterprise value to revenue multiple (EV/Sales);
- Price to earnings multiple (P/E);
- Price to book multiple (PBV); and
- Price to revenue multiple.

Thereafter, the valuation multiples are applied to the key statistics of the company that is being valued, to obtain the comparative valuation of the company.

The market approach is one of the more preferred valuation methods based on the fact that the approach uses publicly available information.

The approach, whilst based on market data, is not without limitations. In developing markets, it is often difficult to identify comparable companies or transactions. In the case of Zimbabwe, which only has sixty three counters listed on the ZSE, publicly available information on more than two comparable companies is usually not available. Furthermore, finding companies in the exact line of business often presents challenges for valuation practitioners.

To go around the hurdle of lack of comparables, regional and international peer companies are often used, but due to the difference in size of these companies, jurisdictions, regulations etc. valuations become distorted and often require adjustments. Discount factors can be applied to align the comparable data which introduces subjectivity in the valuation process, hence affecting the objectivity of the exercise. Experience and expertise is therefore required in making these adjustments based on the knowledge of the specific industry dynamics and those of the company being valued.

Based on the merits and demerits outlined above, the market based approach is largely used in instances wherein there is sufficient credible data available on the peer comparatives. As such, this valuation method is used when information on other established corporate entities is readily available.

THE INCOME APPROACH

This approach seeks to determine the present market value of a business by discounting its future cash flow streams. This has the effect of transforming the forecasted future cash flows into a single value in the present, aptly referred to as the Present Value of future cash flows.

Under the income approach, two key methods are commonly used, namely the Discounted Cash Flow method ("DCF") and the Earnings Capitalization method.

THE DCF METHOD

The DCF method is largely used as a means of arriving at the intrinsic value of a business using the Time Value of Money principle, which attempts to compute the present value of a company's future free cash flows. It is therefore a valuation of the future prospects of a business enterprise.

In arriving at the value of the company, the DCF method considers three inputs, namely:

- The stream of expected free cash flows of the business,
- A discount rate which establishes cost of capital which could be debt, equity or a combination of the two; and
- The expected gain from disposing the business at the conclusion of the ownership period, often called the terminal value.

EXPECTED FREE CASH FLOWS

The expected future free cash flows of the business generally require an understanding of the historical and current status as well as future prospects of the company which form the basis of various assumptions utilised in deriving the future free cash flows of the business. These assumptions are central to deliberations between negotiating parties to the transaction. As highlighted above, the due diligence report should aptly capture the historical position and future management aspirations, which will drive future free cash flows.

THE DISCOUNT RATE

The discount rate represents the level of return that makes a business acquisition worthwhile to the purchaser. Given that most businesses are financed by both equity and debt, the discount rate to be utilised in DCF is usually the weighted average cost of capital.

THE TERMINAL VALUE

The terminal value represents what the business is worth beyond the present value of the projected income streams. It is a key input in the DCF valuation.

In order to determine the value of a company using the three aspects above, valuation experts often spend time developing robust financial models of the business. Independent advisors on M & A and MBO transactions often spend time auditing the financial models to ensure that appropriate assumptions on the future prospects of the company have been captured.

As with the other valuation approaches, the DCF method has inherent limitations particularly with regards to the quality of data used in the computation of the valuation. The quality of the valuation results, is greatly influenced by the quality of the data used in the computation, with small changes in the assumptions and inputs often resulting in huge variances in the output results.

EARNINGS CAPITALIZATION METHODS

The Earnings Capitalization method is another common income approach in determining the value of a company. The value is determined by dividing the expected business free cash flows or Earnings before Interest, Tax, Depreciation and Amortisation ("EBITDA") by a capitalization rate.

The capitalization rate merely represents the risk associated with receiving future revenue streams. One common method of determining the capitalization rate is to score key financial and operational areas of the company on a scale, say between one and ten, or some other appropriate range. The financial and operational areas may include, earnings track record, industry growth prospects, business growth prospects, competition, management employees, equipment availability etc. The resultant score is then applied to the free cash flows or EBITDA to determine the value of the company. The scoring process therefore tends to bring subjectivity to the valuation method. As an alternative to determining the capitalization rate, an earnings growth adjusted discount rate is often utilised.

The capitalization of earning method is ideal for companies that are expected to grow at a relatively stable and modest rate since it tends to rely on the company's current or historical level of operations, such as net cash flows and EBITDA, as a representation of future operations.

CONCLUSION

Based on the discussion above, it is evident that there is no single valuation approach that can be termed the sole panacea to business valuation. The valuation approaches are often complementary as the merits of one approach seem to address the limitations of another. As a result, business valuation experts tend to use a combination of the valuation approaches to arrive at an acceptable business valuation. Companies in asset intensive industries in which the size of the asset base determines revenue generating capacity, often rely on asset based valuation approaches, whilst companies in the technology and services industry, wherein intellectual capital is key, market and income based approaches will be more ideal.

wValuation, by its very nature, and as is apparent in this article, is not an exact science; it establishes a range in negotiations between parties to an M&A or MBO transaction. The final purchase consideration will depend on other factors which may include a change in company circumstances post negotiations. A case in point relates to the acquisition of Yahoo by Verizon in July 2016 for USD4.8 million. In October 2016, four months post acquisition negotiations, news about Yahoo's massive data breach and questionable security practices surfaced and Verizon requested for a USD1 billion discount on the original USD4.8 billion deal.

Negotiation skills of the parties does make a difference between buying or selling a company at a premium or discount. Assembling a negotiating team comprising financial advisors, commercial law experts, and technical experts in the specific industry is recommended.

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