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Valuation Methods

Jaipur Branch of CIRC of ICAI

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What’s the value of a specific asset/business?

“What this all means is, it depends.”

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Price is what you pay.

Value is what you get.

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"We drilled down, but we didn't like what we found, so we filled it all back in."

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No one is right.

No one is wrong.

Twelve financial analysts came up with 12 different valuations for this company. All they had in common was their $500/hr fee.

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Quality of inputs & assumptions, drive the defensibility of valuation

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Valuation could be completely disconnected from the cost of the asset

Antiques Roadkill.

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Choosing a valuation method

→ Purpose & context [base & premise] of valuation

→ Nature of asset being valued – business, investment property, tech company, mining/telecom rights

→ Availability of inputs and it's credibility – industry/market research reports, annual reports

→ Relevance of each method in the case in point – not every method may be suitable for every situation

→ Methods prevalent in specific industries/businesses – cement co, telecom co, e-com operators

→ Select the most appropriate method by evaluating the case in point and relevance of the available methods

→ Can consider a unique or hybrid method as well

→ Range of values if using multiple methods

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Valuation Approaches

- Market Approach
- Income Approach
- Cost Approach

Market approach is a valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities, such as a business.

Market Approach

→ Comparable Companies Multiple (CCM) Method

→ Comparable Transaction Multiple (CTM) Method

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Comparable Companies Multiple Method involves valuing an asset based on market multiples derived from prices of market comparables traded on active market.

Comparable Companies Multiple (CCM) Method

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Comparable Companies Multiple Method

PROCESS

→ Select the comparable (s)

→ Select & Calculate the relevant multiples for the selected comparable

→ Adjust for differences

→ Apply the multiples to the case in point

→ Review for sanity/reasonableness

CONSIDERATIONS

→ Nature of business/industry/operations

→ Geography (ies)

→ Business/economic environment

→ Size/profitability

→ Stage of lifecycle

→ Management profile

→ Historical/expected growth

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Comparable Transaction Multiple Method involves valuing an asset based on transaction multiples derived from prices paid in transactions of asset to be valued /market comparables (comparable transactions).

Comparable Transaction Multiple (CTM) Method

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Comparable Transactions Multiple Method

PROCESS

→ Identify the comparable transaction (s)

→ Select & Calculate the relevant multiples for the selected comparable transaction

→ Adjust for differences

→ Apply the multiples to the case in point

→ Review for sanity/reasonableness

CONSIDERATIONS

→ Date of the comparable transaction. Closer the better.

→ Shouldn’t be a one-off/outlier transaction

→ Credibility of the comparable transaction information

→ Others – same as CCM

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Commonly used multiples

→ GMV

→ Revenue

→ EBITDA

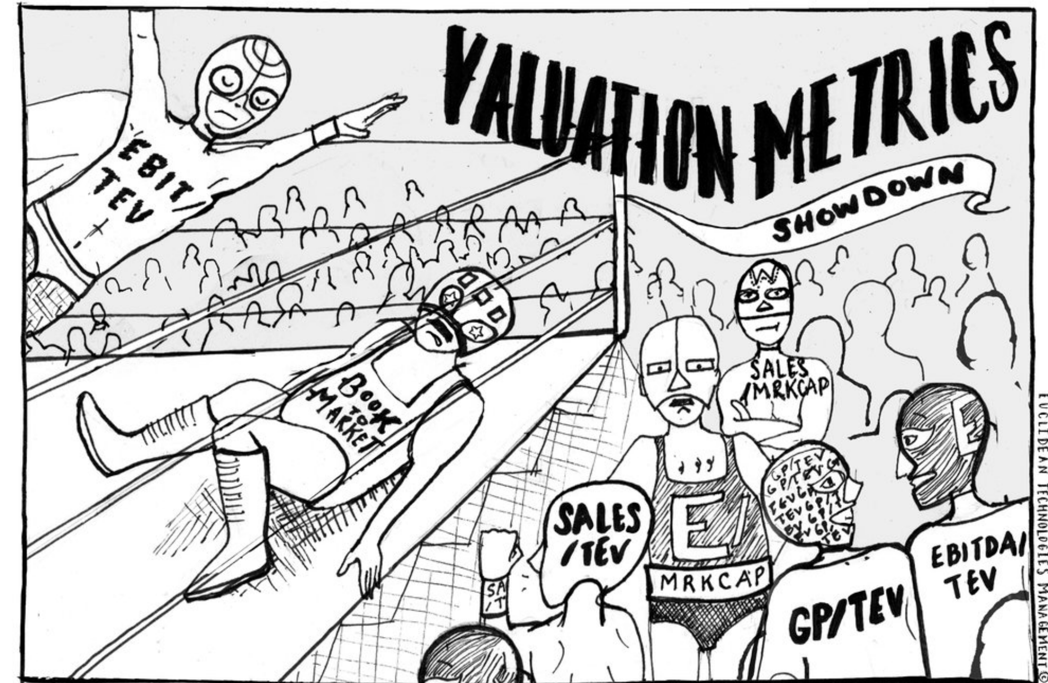
→ Book value

→ PE

→ Revenue/Profit/Value per employee/store/tower/tonne etc

→ Price to book value

→ Many others



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Income approach is a valuation approach that converts maintainable or future amounts (e.g., cash flows or income and expenses) to a single current (i.e., discounted or capitalised) amount. The fair value measurement is determined basis the value indicated by current market expectations about those future amounts.

Income Approach

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Discounted Free Cash Flow Valuation

→ **Important Concepts**

- → Free cash flow
  - → Free Cashflow to the Firm
  - → Free Cashflow to Equity
- → Discounting Factor
- → Terminal Value

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DCF Valuation – Free Cash Flows

→ Free cash flow

→ Free Cashflow to the Firm

→ Cashflows that are available to all the providers of capital, i.e. equity shareholders, preference shareholders and lenders.

→ Payments to the providers of funds such as interest on loan, dividends etc will need to added back

→ Free Cashflow to Equity

→ Cashflows available to equity holders

→ After interest on loans, dividend to preference shareholders

→ **Whichever approach one adopts, the valuation should be the same**

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DCF Valuation – Discounting Factor

→ Expected Return >> Reflects time value of money + Risk

→ Generally following rates are used as DF

  → Cost of equity

  → Weighted average cost of capital (WACC)

  → Internal Rate of Return (IRR)

  → Yield

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DCF Valuation – Terminal Value

- → Terminal value represents the present value at the end of explicit forecast period of all subsequent cash flows to the end of the life of the asset or into perpetuity if the asset has an indefinite life.
- → Methods:
  - → Gordon (Constant) Growth Model
  - → Variable Growth Model
  - → Exit Multiple
  - → Salvage / Liquidation value
- → Terminal Growth Rate

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Questions & Additions

Thank you!

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