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ACCA Research Institute

ACCA F9

Financial Management (FM)

财务管理

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Part F: Business Valuation

1. Introduction to business valuation
2. Valuation methods

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Introduction to Business Valuation

The purpose of valuation:

- For quoted companies, when there is a takeover bid and the offer price is an estimated 'fair value‘ in excess of the current market price of the shares.
- For subsidiary companies, when the group's holding company is negotiating the sale of the subsidiary to a management buyout team or to an external buyer.
- For unquoted companies, when:

(i) The company wishes to 'go public' and must fix an issue price for its shares
(ii) There is a scheme of merger with another company
(iii) Shares are sold
(iv) Shares need to be valued for the purposes of taxation
(v) Shares are pledged as collateral for a loan and the bank wants to put a value to the collateral
(vi) Another company is proposing to take over the unquoted company by making an offer to buy all its shares

Introduction to Business Valuation

Information requirements for valuation:

- Financial statements
- Summary of non-current assets and depreciation schedule
- Aged accounts receivable summary
- Aged accounts payable summary
- List of marketable securities
- Inventory summary
- Details of any existing contracts: eg leases, supplier agreements
- List of shareholders with number of shares owned by each
- Budgets or projections, for a minimum of five years
- Information about the company's industry and economic environment
- List of major customers by sales
- Organisation chart and management roles and responsibilities
- Profit forecasts or budgets

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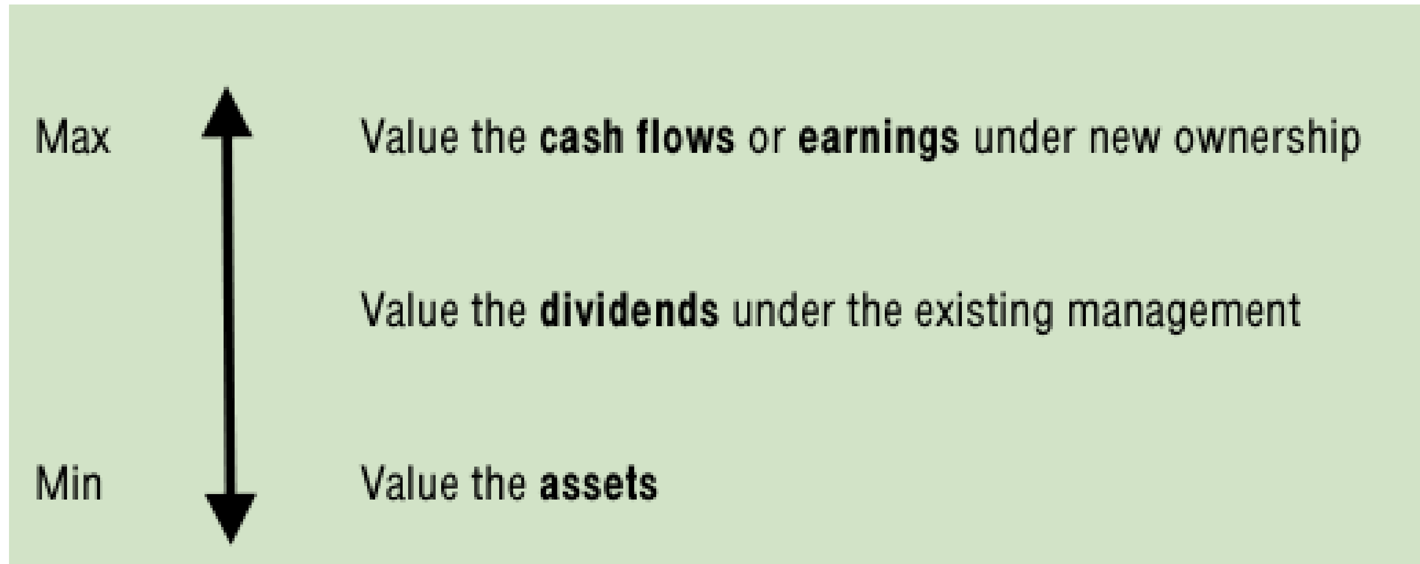
Introduction to Business Valuation

Business valuation methods:



Market capitalisation is the market value of a company's shares. This is the share price multiplied by the number of issued shares.

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Valuation Methods——Asset Valuation

Net assets method of share valuation:

the value of an equity share is equal to the net tangible assets divided by the number of shares.

Net tangible assets are the value in the statement of financial position of the tangible non-current assets (net of depreciation) plus current assets, minus all liabilities. Intangible assets (including goodwill) should be excluded, unless they have a market value

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Valuation Methods——Asset Valuation

Choice of valuation bases:

- Historical cost basis (net book value) – unlikely to give a realistic value as it is dependent upon the business's depreciation and amortization policy
- Realisable basis – if the assets are to be sold, or the business as a whole broken up. This won't be relevant if a minority (non-controlling) shareholder is selling his stake, as the assets will continue in the business's use
- Replacement basis – if the assets are to be used on an on-going basis

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Valuation Methods——Asset Valuation

The net assets basis of valuation might be used in the following circumstances:

(a) As a measure of the 'security' in a share value. A share might be valued using an earnings basis.

(b) As a measure of comparison in a scheme of merger

(c) As a 'floor value' for a business that is up for sale –shareholders will be reluctant to sell for less than the NAV

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Valuation Methods——Income-based Valuation

P/E ratio (earnings) method of valuation:

A P/E ratio-based valuation of equity shares may be used to value a controlling interest in the shares of a company, where the owner can decide on dividend and retentions policy.

market value per share = EPS * P/E ratio

Market value in total=P/E ratio* total earnings

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Valuation Methods——Income-based Valuation

A high P/E ratio may indicate:

(a) Expectations that the EPS will grow rapidly: A high price is being paid for future profit prospects

(b) Security of earnings: A well-established low-risk company would be valued on a higher P/E ratio than a similar company whose earnings are subject to greater uncertainty.

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Valuation Methods——Income-based Valuation

Using the P/E ratios of quoted companies to value unquoted companies may be problematic——a P/E ratio must be guessed at, using the P/E ratios for similar quoted companies as a guide.

- Finding a quoted company with a similar range of activities may be difficult. Quoted companies are often diversified .
- A single year's P/E ratio may not be a good basis, if earnings are volatile, or the quoted company's share price is at an abnormal level, due for example to the expectation of a takeover bid.
- If a P/E ratio trend is used, then historical data will be being used to value how the unquoted company will do in the future.
- The quoted company may have a different capital structure to the unquoted company.

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Valuation Methods——Income-based Valuation

Earnings yield valuation method:

Earnings yield (EY) =EPS/Market price per share*100%

Note that where high growth is envisaged, the EY will be low, as current earnings will be low relative to a market price that has built in future earnings growth.

$$\text{Market value} = \frac{\text{Earnings} \times (1+g)}{(EY - g)}$$

Valuation Methods——Income-based Valuation

Examples:

A company has the following results:

	Y1	Y2	Y3	Y4
PAT	6	6.2	6.3	6.3

The company's earnings yield is 12%.

Required: Calculate the value of the company based on the present value of expected earnings.

$$\text{Market value} = \frac{\text{Earnings} \times (1 + g)}{(EY - g)}$$

$$\text{Earnings} = \$6.3\text{m}$$

$$EY = 12\%$$

$$g = \sqrt[3]{\frac{6.3}{6.0}} - 1 = 0.0164 \text{ or } 1.64\%$$

$$\text{Market value} = \frac{6.3 \times 1.0164}{0.12 - 0.0164}$$

$$= \$61.81\text{m}$$

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Thank You!