

# Overview of Business Enterprises Valuation

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## Overview of Business Valuation

- What's the meaning of Business Valuation?
  - Business valuation – short form but comprehensive. HKIS BVS Part II – 2: the act or process of arriving at an opinion or estimation of the value of a business or enterprise/entity or an interest herein.
  - This course focus on business enterprise valuation, i.e. company valuation not investment project evaluation, i.e. business.
  - Business enterprise value is defined as the total value of a business. It comprises of monetary assets (net working capital), tangible assets and intangible assets, thereby encompassing all assets of a business enterprise. In other words, the business enterprise value is also equal to the value of its invested capital – common equity, preferred stocks and long-term debts. While there is no universal definition of the term, it is the usual practice for a professional valuer, based on his professional knowledge and experience, to identify the definition for the intended valuation.

## Overview of Business Valuation

- Past
- Current
- Future
- Practical Issues
- Q&A

## Overview of Business Valuation

- Past
  - Fact – HK
  - Land Compensation and Valuation Law in HK (Gordon N Cruden) 1999, Chapter 1
  - Preparing a Rule 20 Document for a Business Loss Claim by Lawrence H.C. PANG FRICS FHKIS AACI MBA MSc (Finance) CFA

## Overview of Business Valuation

- Standards
  - US
  - UK
  - HK
  - International

## Overview of Business Valuation

- US:
  - IRS Revenue Ruling 59-60, 1959
  - Uniform Standards of Professional Appraisal Practice (USPAP), 1987
  - Business Valuation Standards, 2002, American Society of Appraiser

## Overview of Business Valuation

- ▶ UK
  - Statements of Asset Valuation Practice and Guidance Notes (the Red Book) and Manual of Valuation Guidance Notes (the White Book), 1974, RICS
  - Appraisal & Valuation Manual, 1995, RICS – Trade-related Valuations and Goodwill – GN7
  - RICS Appraisal and Valuation Standards, 2003, RICS – Trade-related Property Valuation and Goodwill – GN1
  - RICS Valuation Standards, 2008, RICS – Trade related property valuations – GN1 – IVS GN6

## Overview of Business Valuation

- HK
  - HKIS/RICS Guidance Notes – The Valuation of Property Asset – Background Paper 7 – Trading Potential Asset, 1988
  - The HKIS Valuation Standards on Trade-related Business Assets and Business Enterprises, 2004
  - The HKBVF Business Valuation Standards, 2005

## Overview of Business Valuation

- International
  - International Valuation Standards published by the IVSC, 1985 – GN1 - Going Concern Concept
  - Eighth Edition, 2007 – GN6 – Business Valuation

## Overview of Business Valuation

- Usual question - When?
- Standard answer:
  - IPO
  - Privatization
  - Going Private
  - Mergers and Acquisitions
  - Downsizing and Restructuring
  - Security Analysis
  - Value Management

## Overview of Business Valuation

- Why?
  - Overvaluation or Undervaluation?
  - Value Increasing or Decreasing?
  - Buy or Sell?

## Overview of Business Valuation

- Current: Most Important:
  - To serve the Accounting Standards – the HK Financial Reporting Standard 3 (Business Combinations)
    - PPA – Purchase Price Allocation
  - HKAS 36 – Impairment of Assets
  - HKAS 38 – Intangible Assets
  - HKAS 32 and 39 – Financial Instruments
- How?
  - As a basis for making allocations of various assets – business enterprise residual method
  - As a mean of cross checking to the valuation of various assets of a company – business enterprise valuation analysis

## Overview of Business Valuation

- How?
  - From College – HKU/PolyU
  - From Money-worth Courses /events
  - From Books – overseas / local
  - From Masters – many

## Overview of Business Valuation

- Procedures:
  - Engagement
  - Analysis of the Company
  - Finding Supporting Data
  - Approach to Value
  - Reporting
  - Filing

## Overview of Business Valuation

- Engagement
  - HKIS BVS Part IV – GN1
  - HKBVF BVS 7.0 Guidance Notes

**To sign an Engagement Letter**

## Overview of Business Valuation

- Engagement Letter (sample)
  - Name of Valuer and the Client
  - Date of Retention
  - Definition of the Appraised Asset
  - Definition of Value
  - Date of Valuation
  - Purpose of Valuation
  - Limiting Conditions
  - Time and Scope of Work Product
  - Fees
  - Indemnification
  - Confidentiality Agreement

## Overview of Business Valuation

- Analysis of the Company
  - Financial Statement Analysis: HKIS BVS GN2 and HKBVF BVS 5.9, 5.10 & 5.11
  - Using Economic and Industry Data: HKIS BVS GN1 and HKBVF BVS 5.6  
Remember, to Quote the Sources: Copyrights
  - Site Visits and Interviews: HKIS BVS GN1 and HKBVF BVS 5.8

## Overview of Business Valuation

- Supporting Data
  - Sources of data and verification
    - HKIS BVS GN1 (2.) & PS4 (4)
    - HKBVF BVS 5.3, 5.4 & 5.5



## Overview of Business Valuation

- The Use of Appropriate Valuation Approach
  - IVS GN6
  - HKIS BVS PS2
  - HKBVF BVS 5.12
- Market Approach
- Income Approach
- Asset-based Approach

## Overview of Business Valuation

- Basis of Value
  - Market value – IVS 1 & GN 6, HKIS BVS PS 1, HKBVF BVS 5.1.1  
“Estimated amount, exchange, willing buyer/seller, arm’s length after proper marketing, knowledgeable, without compulsion.”
  - Value bases other than Market value – IVS 2, HKIS BVS PS 1 (not encourage), HKBVF BVS 5.1.2

## Overview of Business Valuation

- Basis of Value - Continue
  - Fair value – amount, exchange, willing and knowledgeable parties, arm’s length transaction
  - Investment value – value to a specific investor
  - Special value – value to the special purchaser
  - Synergistic value – marriage value or the like
  - Define the difference between market value and the standard of value being used.

## Overview of Business Valuation

- Basis of Value – Continue
  - Fair value
    - Fixed asset? Fair value = market value
      - IVA 1 Financial Reporting
      - HKIS PVS VS 7
    - Business? Value-in-use – to find out the present value of the future cash flows expected to be derived from an asset or a cash generating unit

## Overview of Business Valuation

- Market Approach
  - The Guideline Public Company Method
    - Almost all transactions in publicly traded securities are at arm’s length
    - Can directly observe capitalization rate for public companies
    - The most commonly used multiples are price-to-earnings (“PE”), price-to-sales (or revenue), price-to-book and price-to-EBITDA (earning before interest, taxes, depreciation and amortisation) multiple.

## Overview of Business Valuation

- Market Approach – continue
  - Really comparable in nature, similar products, similar risks, similar capital structure
  - The financial ratio to use – distorted earning (accounting treatment), distorted price (mal-function of the stock market)
  - Must forward looking
  - Equity value multiples or Invested capital multiples

## Overview of Business Valuation

- Market Approach - Continue
- Guideline Merger and Acquisition Method
  - Same value multiple concepts
  - No or low transaction details made available to public – simple question – are you able to read the P&L statements and balance sheet?
  - Uncertain to the issue of arm's length transaction or not

## Overview of Business Valuation

- Income Approach
- The discounted method – DCF – Term+Rev
  - Expected cash flows
    - the Free Cash Flows to Equity ("FCFE") Technique and the Free Cash Flows to the Firm Technique ("FCFF", invested capital as a whole)
  - Rate of return
    - Equity the Build-up Model, the Capital Asset Pricing Model and the Arbitrage Pricing Model
    - Invested capital - the Weighted Average of Cost of Capital
  - Residual life of the company
    - Infinite or finite life

## Overview of Business Valuation

- Income Approach - continue
- Capitalization method
  - Short-cut version of the discounting period
  - Looking for next period financial performance – cash flow and rate of return
    - $DisR = CapR + LTGR$ ;  $CapR = DisR - LTGR$
  - Stable growth is assumed
  - Not for start-up or high growth
  - Similar to the Market Approach
  - YP in Prep at the date of valuation

## Overview of Business Valuation

- Income Approach - Continue
- The Cash Flow analysis reflects investment criteria and requires the valuer to make empirical and subjective assumptions
- Assumptions need justification and test on reasonableness
- Information need verification and disclose the sources

## Overview of Business Valuation

- Asset-based Approach
- Cost Approach in Asset Valuation
- Adjusted Net Asset Method (Asset Accumulation Method)
  - Investment Holding
  - Asset wealth company
  - Not the only one approach in valuation
- The Excess Earning Method
  - Tax Rule in US

## Overview of Business Valuation

- Discounts and Premium
- Minority versus Control
- Discounts for Lack of Marketability (for closely held company)
- Blockage discount

## Overview of Business Valuation

- Reconciliation
  - HKIS BVS PS 3.1 Commentary 5
  - HKBVF BVS 5.13
  - IVS GN 6
- To use more than one and to reconcile a reasonable amount

## Overview of Business Valuation

- Reporting
  - HKIS BVS PS 4
  - Identity of the Client
  - Definition of the valuation assignment
  - Business description
  - Valuation approach and methods used
  - Assumptions
  - Restrictions and valuation comments
  - Conclusion of value
  - Warning statement
  - Signature
  - Appendix PS 4.1

## Overview of Business Valuation

- Filing
  - Keep confidential
  - Work paper file

## Overview of Business Valuation

Q & A