Summary of company valuation methods

Business

Summary of “ Company Valuation Methods” This paper summarizes the article by Fernández (2007), “ Company valuation methods: The most common errors in valuations.” He stressed the importance of accurate company valuation for mergers and acquisitions and in identifying value-adding or destroying activities in the company. He described four methods: “ balance sheet-based methods, income statement-based methods, mixed methods, and cash flow discounting-based methods” (p. 2). First, Fernández (2007) said that value is different from price, because it is negotiated between buyers and sellers. Factors such as “ economies of scale, economies of scope, or different perceptions about the industry and the company” (p. 3) also affect the value of the company. Valuation serves several purposes, including process of buying and selling, valuation of public companies, public offerings, inheritances, compensation systems, determination of value drivers, and for conducting strategic planning and producing strategic decisions (p. 3). Second, balance sheet-based methods (shareholders’ equity) aim to identify the company’s value by approximating its assets’ values. It is a traditional method based on the balance sheet. Fernández (2007) criticized the “ book value,” because it is vulnerable to subjectivity and it cannot fully match the “ market value” (p. 4). Third, income statement-based methods are based on the firm’s income statement (p. 7). These methods want to compute the company’s value through the amount of its earnings, sales, and other indicators (p. 7). Fernández (2007) provided indicators several valuation methods, such as Value of earnings or PER and value of dividends. Fourth, mixed methods are also called goodwill-based methods (p. 10). In general, goodwill is the value higher than the company’s book value or the adjusted book value (p. 10). Goodwill aims to include the value of the firm’s intangible assets, which are not frequently included in the balance sheet, but is considered a core competency and source of advantage (p. 10). Fernández (2007) noted problems of consistency and accuracy in measuring goodwill, because there is no consensus on its measurement (p. 10). Some of the methods that measure goodwill are the classic valuation method, “ abbreviated goodwill income” method, indirect method, and Union of European Accounting Experts (UEC) method, among many others (pp. 10-11). Fifth, cash flow discounting-based methods aim to assess the company’s value by aproximating the cash flows it will produce in the future and then discounting them at a discount rate that are related to the flows’ risk (p. 12). At present, cash flow discounting method is more used than mixed methods, “ because it is the only conceptually correct valuation method” (p. 12). It comes from the view that companies produce cash flows that can be determined by computing the flows’ present value using an appropriate discount rate (p. 12). Discounted cash flow is more conceptually sound and can be measured more accurately than goodwill. Finally, the article argued that the most appropriate method for valuing a company is to apply cash flow discounting-based methods, which means that the expected future cash flows are discounted and treated as the value of a company’s equity, with the belief that company will continue to operate and produce cash (flows) for the shareholders. The author provided a real-life example to exemplify the valuation of businesses through its break-up value, which will explain how cash flow valuation will help understand its “ value” in more realistic and measurable terms.

ReferenceFernández, P. (2007). Company valuation methods: The most common errors in valuations. IESE Working Paper No 449.