Emre Kazancioglu, 10/09/2006

Review on Corporate Valuation

1. **Alfred M. King, "*Valuation: What assets are really worth*," John Wiley & Sons, Inc., New York, NY, 2002.**

Very first questions an appraiser asks before a new appraisal assignment deal:

- The purpose of the valuation
- How it will be used
- The exact date of the valuation

1. Cost approach: What would it cost today to buy or build the same or a similar asset? Underlying assumption is that a willing buyer would not pay any more for the asset being valued than he would have to pay for some other comparable asset. Mostly used in a merger transaction and in insurance valuations.

2. Income approach: Considering the risks involved, what type of return can I obtain from an investment in this asset? Used more in intangible assets including business enterprises, as well as patents, brand names, and other intellectual property.

3. Market comparable approach: What are comparable assets being sold for in the open market? For many types of assets there is a well-established market, with buyers and sellers.

Best way to read an appraisal report is to see what are the key or crucial assumptions. One should see how realistic these are.

2. **McKinsey & Company, Inc., Tom Copeland, T. Koller, J. Murrin, "*Valuation: measuring and managing the value of companies*," John Wiley & Sons, New York, NY, 1990.**

Models mentioned in the book:

- Enterprise discounted cash flow model
- Economic profit model
- Adjusted present value (APV)
- Equity DCF model
- Option valuation models:

Formula based DCF approaches: These DCF approaches make simplifying assumptions about a business and its cash flow stream (for example, constant revenue growth and margins).

How to do valuation:

1. Analyze historical performance: The first step in valuing a business is analyzing its historical performance. A sound understanding of the company's past performance provides an essential perspective for developing and evaluating forecasts of future performance. It focuses on key value drivers such as return on invested capital (ROIC) which is the most important value driver.

2. Estimate the cost of capital: Creditors and shareholders expect to be compensated for the opportunity cost of investing their funds in one particular business instead of others with equivalent risk. WACC is the discount rate, or time value of money, used to convert expected future free cash flow into present value for all investors.

3. Forecast performance: Iterative steps:

- Determine the length and level of detail for the forecast. Near and long terms.
- Develop a strategic perspective on future company performance, considering both the industry characteristics as well as the company's competitive advantages or disadvantages.
- Translate the strategic perspective into financial forecast.
- Develop alternative performance scenarios to the base case you developed before.
- Check the overall forecasts for internal consistency and alignment with the manager's strategic perspective.

4. Estimate continuing value: valuation of the company's expected cash flow beyond the explicit forecast period.

In the book, there are also specific sections on valuing Dot.coms, cyclical companies, foreign subsidiaries, foreign companies, companies in emerging markets, banks and insurance companies.

3. **B. Cornell, "*Corporate Valuation: Tools for Effective Appraisal and Decision Making*," Richard D. Irwin, Inc., New York, NY, 1993.**

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The following approaches are discussed in the book:

1. Adjusted book value (balance sheet) approach

This approach relies on the information provided by the balance sheet. There are two ways that balance sheet information can be used to appraise a firm. First, the value of the company can be found by the sum of the values of all the securities. Second, the net assets can be summed and liabilities other than investor claims deducted.

The weakness of the balance sheet approach is that the book values of assets and liabilities reported on the balance sheet by accountants may not equal their market values. Because book values are based on historical cost, they fail to take into account factors such as inflation and obsolescence that will cause book value and market value to diverge. In addition, there are valuable intangible assets which are not reported on the balance sheet.

2. Stock and debt approach (market approach)

When securities of a company being appraised are publicly traded, there is a straightforward valuation procedure: sum the market values of all the outstanding securities. Efficient market hypothesis implies that appraisals should always be based on current market prices, not averages of past prices.

3. Direct comparison approach

Difficulty is finding a closely comparable asset that has changed hands between a reasonably informed buyer and seller. This approach works well in real estate.

4. Discounted cash flow approach

The DCF approach can be applied in virtually any situation if future cash flows to investors can be predicted. However, there are three problems with this approach. First, the benefits to investors must be precisely defined. Second, a method must be developed for forecasting the benefits to investors defined as the net cash flow. Third, a rate must be selected for discounting the predicted cash flows. The DCF approach to corporate valuation is conceptually identical to investment decision making based on NPV.