HOW A BUSINESS IS VALUED?

Source: Investopedia

What Is a Business Valuation?

A business valuation, also known as a company valuation, is the process of determining the economic value of a business.

Business valuation is typically conducted when a company is looking to sell all or a portion of its operations or looking to merge with or acquire another company. The valuation of a business is the process of determining the current worth of a business, using objective measures, and evaluating all aspects of the business.

A business valuation might include an analysis of the company's management, its capital structure, its future earnings prospects or the market value of its assets. The tools used for valuation can vary. Common approaches to business valuation include a review of financial statements, discounting cash flow models and similar company comparisons.

Important: Estimating the fair value of a business is an art and a science; there are several formal models that can be used, but choosing the right one and then the appropriate inputs can be somewhat subjective.

Methods of Valuation

1. Market Capitalization

It is the simplest method of business valuation. It is calculated by multiplying the company’s share price by its total number of shares outstanding. For example, as of January 3, 2018, Microsoft Inc. traded at $86.35. With a total number of shares outstanding of 7.715 billion, the company could then be valued at $86.35 x 7.715 billion = $666.19 billion.

Methods of Valuation

2. Times Revenue Method

Under this method, a stream of revenues generated over a certain period of time is applied to a multiplier which depends on the industry and economic environment. For example, a tech company may be valued at 3x revenue, while a service firm may be valued at 0.5x revenue.

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3. Earnings Multiplier

The earnings multiplier may be used to get a more accurate picture of the real value of a company, since a company's profits are a more reliable indicator of its financial success than sales revenue is. The earnings multiplier adjusts future profits against cash flow that could be invested at the current interest rate over the same period of time. In other words, it adjusts the current P/E ratio to account for current interest rates.

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Methods of Valuation

4. Discounted Cash Flow (DCF) Method
This method is based on projections of future cash flows, which are adjusted to get the current market value of the company. The main difference between the discounted cash flow method and the earnings multiplier method is that it takes inflation into consideration to calculate the present value.

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Methods of Valuation

5. Book Value

This is the value of shareholders’ equity of a business as shown on the balance sheet statement. The book value is derived by subtracting the total liabilities of a company from its total assets.

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Methods of Valuation

6. Liquidation Value

Liquidation value is the net cash that a business will receive if its assets were liquidated and liabilities were paid off today.

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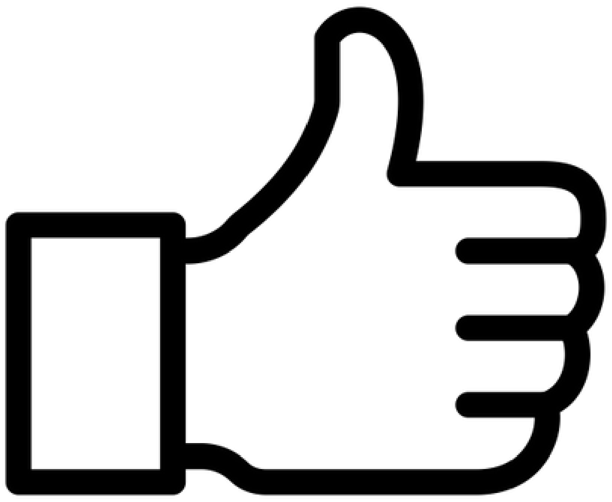


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