The labyrinths of Corporate Valuation: A Case Study

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Abstract— The case study is the theoretical overview of corporate valuation issues and approaches, including Discounted Cash Flow Valuation, Relative Valuation, and Contingent Claim Valuation. The value of the firm or the equity capital is derived through this method. The basic method is Discounted cash flow (DCF) valuation; newer methods include Relative Valuation (RV) and Contingent Claim Valuation (CCV), Valuation models. The individual model uses a particular premise, if the premise is real and correct, then the value will be appropriately accurate. The model should be chosen post consideration of the purpose of valuation. So, the methods cannot be categorized as good or bad. Different models support different premises and are useful for different goals and aims. The requirement for an appropriate valuation is to define the purpose and to find the most appropriate technique.

Indexed Terms— Valuation, Discounted Cash Flow Valuation, Relative Valuation, and Contingent Claim Valuation

I. INTRODUCTION

One of the trickiest things is to evaluate the value of corporate. It does not change anything practically except the rationality it provides to support the decision regarding the asset under consideration. Valuation is not an end in itself, it is just a means to an end. How fruitful the outcome is dependent entirely upon the user who is using the information. The valuation model beyond a point becomes a black box leaving the users with some inputs to ruminate and ponder upon [4]. The input details in valuation can be beneficial in taking a decision or it may lead to loss. It depends on how the user uses the information provided by the valuation. The valuation of corporate is defined as a combination of theory, experience, and judgment. The appraisers cannot rely solely on experience, but failure is assured without experience and judgment [12].

A financial analyst's interest is in the firm's operating performance, which is under contemplation for investments. Due to the dynamic nature of the market, systematic, unsystematic risks, and recurring corporate bankruptcy, financial managers, are using multiple valuation techniques. So that the derived results are accurate before the final investment. There are multiple purposes of valuation like, acquisition & disposal, stock market flotation, purchase or disposal of unlisted companies, trading, the tax liability of owners, determining collateral for loans, etc. [12].

There are many myths and troubles linked to the valuation. The troubles in valuation include biases and uncertainties, which are part and parcel of the valuation. The awareness of such limitations in valuation makes people wiser to understand that valuation is not a precise estimate. Rather, the less precise valuation estimate provides a higher pay-off than the precise estimate [8].

Practically estimate value of all categories of asset can be discovered. An asset will sooner or later realize its true value and the market cannot hold an asset for long from realizing it. The market imperfection which occurs at a particular point in time is the crux of valuation [6]-[3]-[2]-[14]. Market Imperfection is two-pronged. Situation one is when the asset in hand is normal but the market is causing under or overvaluing the asset at that point in time. Such things happen due to market imperfections in that time period. Situation two happens when the market is on an average is correct but it can be wrong for the particular asset in that time frame. Situation one is the essence of DCF valuation, and the latter is the essence of Relative valuation (here on referred as RV) [4].

The valuation is not a static phenomenon. It changes its features over a period of time. This is more pertinent when we have firms or companies in hand to value. A firm has its life cycle; similarly, it needs to be valued differently at every stage of its life cycle.

- Negative cash-flow/ high-growth/ start-up firm valuation
- Private firm Valuation
- Mature firm valuation/declining stage firm valuation
- Distressed firm valuation

In addition to the valuation of tangibles, there are ways even to value the intangibles. Brand valuation is in the same league as intangible asset valuation. Moreover, there are situations where different contingencies are linked to the assets/firms, and those contingencies can be analogous to the options (financial options). Such situations may be apt for the use of the Real Option Valuation (or contingent claim valuation (CCV)) approach [4].

II. LITERATURE REVIEW

Historically Valuation gained attention as a relevant field of research in the aftermath of the great depression in the US. Theories of Corporate Finance evolved in the 1950s from the normative approach to the positive approach. It explains how the companies decisions and announcements regarding financial and investment decisions affect the investor's reaction and investment perspective. The principal to investing in an asset successfully is to determine its real value. To find the value of asset varies from situation to situation [11]. Valuation directly affects investment decisions and the allocation of resources in an economy. In recent times the valuation of assets and corporate worth has gained more and more important reasons being dynamic changes in the business environment. The main aim is to invest in assets that can generate the biggest cashflows to get more and more income and profit, causing an increase in firm value [7].

The valuation process has developed its myths, like if the method of valuation is quantitative, then only the valuation is objective. Another myth is well-made valuation will not expire, valuation is the science that yields precise answers, the rate of borrowing at is the cost of debt, DCF is an end to valuation, and many more [4]. The valuation biases starts with the company we choose to value since the choice of company is never random. Why we have chosen them lays the foundation of bias. Further, biases add on when we collect the information to evaluate the value of the entity. There are multiple sources of bias in the valuation of a firm. The bias cannot be eliminated in totality but we can try to minimize its impact. This can be done by designing a valuation process that is shielded from the influences from outside and also by reporting the biases along with the estimated values [5]-[13].

An important discussion in valuation theory is to find out the best method to value a company effectively. Among all the valuation models, three models stand out on the ground of theoretical basis, Practicality and popularity. The models are the discount model of cash flows, also known as DCF, the relative valuation model or multiples model, and the option valuation model. These models are used interchangeably. The different models used in valuation uses different premise. If the premises are taken correctly, then the value derived from the model will be appropriate [10]-[11].

The discounted cash flow (here on referred to as DCF) model is an income approach valuation technique. The free cash flow of the firm is used to determine the value of the firm. Free cash flow means the money which remains with the firm post payment of the operating costs and taxes levied on the entity, working capital requirements and fulfilling the capital reinvestment needs. The value can be determined from the Net Income or the EBIT. It is the money that the debt and equity owners can use. The discount rate used to valuate the firm reflects the risks in the expected cash flow. It is the most used and well-known method [7]-[9].

Another method of valuation is Relative Valuation (RV). The asset is valued by considering the market prices of similar assets in the market. It considers the market share price of the company, Earnings, Equity book value, and total sales to get the value of the firm. There are three variations of RV. The direct comparison between companies who look similar, peer group average based on the average of multiple company and peer group average which is adjusted for the differences in value. It is a simple method but it is also easy to misuse and manipulate. The methods majorly depend on the choices of comparable companies [4]-[11].

The revolutionary method is the CCV method using option pricing models. The option is a kind of asset that pays only under certain contingencies. Some assets can be valued only by this method because the value is derived from the option characteristics. The DCF model generally understates the value of an asset with option characteristics. Some assets usually do not show option characteristics but are option assets [4]. The valuation has a wide range of usage. It is useful to manage a portfolio for an active investor. It plays a central role in acquisition analysis. It helps decide the fair value of the target asset and helps the bidding firm. Valuation is required at every stage of firm's life cycle, from initial investment to expansion.

III. ISSUES TO BE SOLVED

Question 1. What are the issues in Valuation which are quite often seen by the people?
Question 2. Discuss on the approaches/method of valuation
Question 3. Provide a comparative view of the different approaches to the valuation.

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