Business Valuation in Good and Bad times

In the world of finance, the valuation of business keeps on fluctuating. The happenings around us in recent times have brought about an accentuated appreciation of the implications of environmental factors and market dynamics over valuations. The stock markets, barometer of economic health, witnessed steep fall in the month of March, 2020 on account of pandemic. As the things settled down the comeback of markets was also quick as it happened later in the year. A new virulent strain in the UK now has again impacted the share prices for similar reasons. These times make it appropriate for us to ponder on changing valuations of business in the good times and bad times. Read on…

CA. T V Balasubramanian

The author is a member of the Institute.
He can be reached at eboard@icai.in

Lets start with looking at a classic case from the global scenario. The case of Yahoo! Is a great example of the timing of the value – In February 2008, Microsoft made a $ 44.6 billion bid for Yahoo!. However, this did not happen and later in the year 2016, Verizon agrees to purchase Yahoo!'s operating business for $ 4.8 billion. In 2008, the offer was spurned by Yahoo on the grounds that it was being undervalued significantly. While this is so, the transaction with Verizon was consummated about 8 years later. In a span of 8 years, the whole scene becomes completely different!

One can be pretty sure there would have been a plethora of advisors including valuers who had advised the parties on both sides and this clearly shows how the valuation could change topsy turvy with changing circumstances.

With this, let us proceed to look at what the ICAI Valuation Standards indicate in respect of the connect between valuation and timelines.

Valuation of a business is always with a clear linkage to the valuation date. The valuation is relevant and appropriate only as of that valuation date. Valuation date itself is defined in the ICAI Valuation Standards as the specific date at which the valuer estimates the value of the underlying asset. The Standards

also define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the valuation date.

Thus, one of the key ingredients of determining fair value is the "valuation date". It is always pertinent to note that the valuation is devoid of a valuation date to which it is linked. The value could soar great heights from a given valuation date to a later date or slip deep into the bottomless pit in the same period, due to a variety of reasons.

The standards also lay down that valuation is time specific and can change with the passage of time due to changes in the condition of the asset to be valued and / or market. Accordingly, valuation of an asset as at a particular date can be different from other date(s)

Some indicate factors which can affect the valuation between different dates classified into these two buckets are as under:

Condition of the asset to be valued	Condition of the Market
Quality being impacted due to efflux of time	Macro economic conditions and trends
Maturity in the product life cycle	Market sentiments towards future
Technological changes	Demand trend
Capability maturity	Market size and likely changes to the same

These are only some examples of the factors that impact the valuation at different points of time. But, it is pertinent to note that a broad classification of all the factors affecting valuation with passage of time can be into "condition of the asset" or "condition for the market" as mentioned in the standard.

Those who are aware of Pagers in India would really understand the import of the valuation varying enormously at various points of time.

In 1996 March when India commenced the first paging service, the market was expected to reach 600 thousand subscribed by end of 1996, arguably making India the fastest growing market for this service. The overall subscriber level peaked in 1998 with nearly 2 million subscribers to then fall to less than 500 thousand by 2002. Mobile communication brought in a early demise of the pager business in India. In contrast, in the USA, pagers were in vogue for more than a couple of decades. Globally, the peak was somewhere in 1994 when there were an estimated 61 Mn pagers in use.

In this backdrop, consider the valuation of pager companies in India in the early 1990s when companies were vying to get the licences which were being sold by the Government.

In the early 1990s, pager companies would have been valued at significant amounts.

From an asset perspective, the outlook would have been one of significant growths to be achieved with the advent of paging services in India and the power of licences held by the companies which would enable them to have such growths. Thus, the projected business plan and financials would have been on a aggressive growth plan which

"The standards also lay down that valuation is time specific and can change with the passage of time due to changes in the condition of the asset to be valued and / or market.

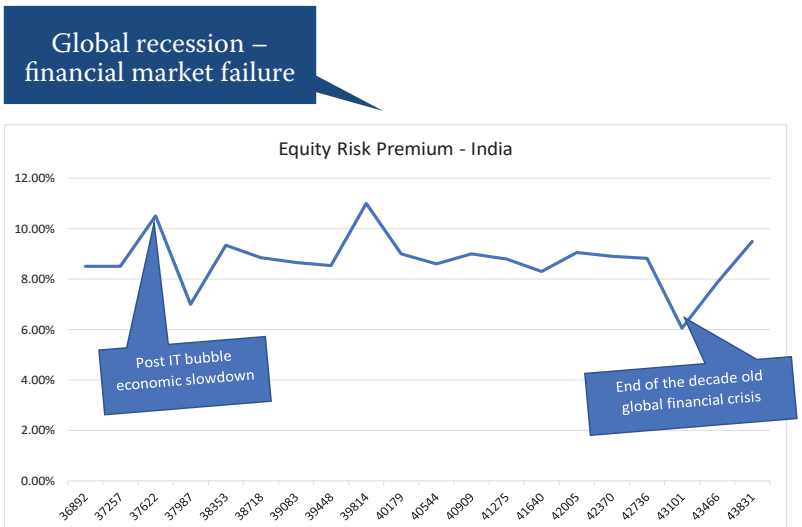
was expected by nearly anyone in the Industry and even by the investing community. It is, however, a different matter of fact that probably the risk would have been higher and accordingly the discount rate would have been probably higher.

With the growth in the industry as it moved forward, say, sometime by end of 1998 or so, any valuation engagement would have probably by then had a better grip on the growth plans which may have been moderated and considering a more informed projections. With this, there is likely that the risk rates applied also were moderated to be lower than what was considered in the early stages of this industry, considering that there is experience of the industry's performance to rely upon in the business plans forming the basis of the future expectations.

However, as the industry moved on into tough times in the later

part of 2000s, the business plans would have factored the waning nature of the industry and accordingly would have a dim outlook forming the basis for the valuation. However, with the uncertainty plaguing the industry, the risk profile for the industry would have also probably gone up resulting in the discount rates once again becoming higher, thus leading to a probable double whammy on the business valuation.

To summarise what transpires as a principle from this example of the pager industry, the likely implication on the valuation on a comparable basis would have been as under:



This brings out the effect of the "condition of market" with a negative impact to the risk premium in case of "bad times".

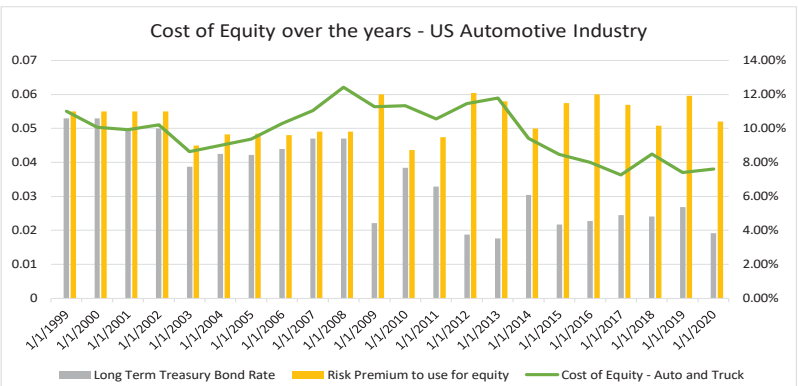
The chart above depicts the cost of equity for the US automotive market and it can also be seen that the spikes and troughs therein are linked to the economic condition of this industry. 2001 saw a recession coming in, which led to a small peaking which then ebbed downward. Once again, from 2005 it started peaking in vie wof the rising oil prices which peaked in 2008, coinciding with the financial crises too. All these led to peaking of the cost of equity too in this period. The automotive industry was in a crisis thereafter for 3 – 4 years which is also reflected in the

Stage of Business	Nascent	Maturing	Waning
Business Plans	Aggressive	Moderate	Subdued
Risk perception	Very High	Moderate	High
Discount Rates	Higher	Normal	Higher
Net effect to valuation, say as a multiple to current revenue or PAT	Higher multiple	Normal	Lower multiple

From the above illustration of the likely effect to the pager business valuation at various points of time, it clearly emerges that the business valuations are impacted by both the factors of "market condition" and "condition of the asset" with passage of time.

A look at the equity risk premium determined for India by Sri.Aswath Damodaran in his dataset over the years, clearly it can be seen that there are upward spikes connected with the "economic bad times".

higher cost of equity in this period. After this period, there was a blip in 2017-18 due to the increasing unemployment, increasing interest costs and the small drop in sales of vehicles in 2017 compared to 2016 – an effect of affecting the consumer confidence at this point of time.



This again reinforces the impact to the valuation in bad times through the "condition of the market" reflected by the cost of capital / discount rate.

Looking at the condition of the asset being valued, the example of Ford Motor Company, USA could be taken for analysing and understanding this aspect.

In 2015-16, University of Connecticut MBA program students did a valuation of Ford Motor Company using source data from Bloomberg, which presented a very optimistic scenario being the growth period of automotive industry in the USA, post the financial crisis of 2008. Another valuation which was undertaken in 2018 by Minnesota State University students using projected data from past five years revenue growth. This considered only a smaller growth compared to the estimates used in 2016 and also estimated the operating income to be significantly different.

Ford Motor Company's projected Operating Profit based on these two period studies:

	Projected Operating Profit in USD 000's			
Study Reference	**2017**	**2018**	**2019**	**2020**
Valuation in 2016	7,730	9,348	8,313	8,507
Valuation in 2018	4,813	4,667	4,820	4,978

This brings out the practical effect of how, the future estimates are also significantly based on the view point of the future developments at a point of time and how these significantly vary over a period of time when new information coming forth could lead to a complete overhaul in the expectations about the future. Without going into the reasons and rationale for the differences between the projections used in these two studies, it can be concluded that the practical application does indicate that the data used to reflect the "condition of the asset" also could significantly be impacted during good and bad times.

> A broad classification of all the factors affecting valuation with passage of time can be into "condition of the asset" or "condition for the market" as mentioned in the standard.

Thus, to conclude, valuation during good times and bad times are impacted by a twin factor of the "condition of the asset" as well as the condition of the market". Of course, these two could have varied combination of effect at different points of time. In other words, the market condition may remain the same but the condition of the asset could change or vice versa or even still both could change over the period of time.