Valuing a Company using different approaches –

Investors are always interested to know while they are buying the shares of a particular company, that whether they are getting the right value on their investment or not. To help them find an answer to this, let us explain them with the help of an example of how an asset is valued be it a house or property.

Arguably one could find three different ways to value a property:

1. **Bricks and Motor Approach** – It can be used by doing a bottom up estimation to buy a land and building and calculation of all the construction cost involved in the entire process for its preparation.
2. **House next door Approach** – It can be used by looking at the prices of houses nearby of similar sizes and characteristics.
3. **Value from future rentals Approach** – We can say that property is somewhat worth the amount that someone is prepared to pay for it to live in it. Thus, one could do calculations of future rentals that an asset is expected to generate in the future and then bring it back into today's money term by using a technique called discounting.

Well these values which will be derived using the three different approaches in valuing a house will not always give us same or exact number. But can give us a fair range or estimation.

Similarly Companies which are listed on the stock exchange or Private Equity firms for that matter can be valued using the somewhat similar approaches to valuation.

So now comes the million dollar question, how to value a Company? Well fundamentally it's an art than science so there is

no exact or one way to do it as it requires quite a bit of assumptions and estimations which makes it a subjective technique.

The different ways to value a Company are:

1. **Asset based approach** – Similar to the brick and motor approach we discussed earlier in valuing a house. In the Asset based or aka, Cost based approach take the Company Balance sheet as a starting point and look at the list of assets in it and find out what their fair worth is net off liabilities. When using the Cost based approach an investor should ask oneself a question that how much will it cost to create another Company like this one that will bring the same economic benefits for its owners and investors.
2. **Market Approach** – Similar to the house next door Approach we discussed above in valuing a house. In the Market or aka, Relative Approach we use comparable Companies of similar business nature, size and Characteristic to determine the value of an entity. This can be done by doing ratio analysis of the Company and comparing it with Companies with identical nature of business. Some of the most popular ratios used in this approach are PE ratio, Price to Sales ratio, Liquidity ratios, Solvency ratios etc.
3. **Income Approach** – Similar to the future rental approach discussed above in valuing a house. It is one of the trickiest and biggest methods in finding the Fair value of a company and requires a lot of estimations and assumptions. The Income Approach is based upon the

value of future cash flows an asset will generate over its remaining useful life. It involves the projection of the cash flows the company is expected to generate in the future and then calculating the net present value of these future cash flows by discounting it with an appropriate rate.

Please Note: The valuation approaches mentioned above will be of utmost value to investors before doing stock selection provided they do it diligently, precisely and intelligently. Thus, to make these valuations more meaningful and precise investors will be better off if they use these different approaches according to the different stages of the Company. For instance Asset Approach is the most apt valuation method for valuing Companies in the early stage or infant stage, Market Approach for Companies which are at the growth phase as it is very hard to project future cash flows of a Company who is growing rapidly. Similarly for more mature and stable firms the best possible way to value a Company is by Income Approach as less uncertainties are expected to arise in mature and big firms thus making our job of future estimates for the Company in terms of profitability, sales, capital spending much more easy and doable.

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