# IMPORTANCE OF CARRYING OUT BUSINESS VALUATIONS OF PRIVATE COMPANIES

A valuation of a business is the process of determining what a business or a company is worth. The process of determining what a business is worth is concerned with establishing the intrinsic value that resides within that company, that is, the future benefits that can be enjoyed by owning a share of the company or business. In retail trading, the price of a product is ordinarily set based on factors that include but are not necessarily limited to the costs that went into producing that product, the forces of supply and demand, as well as consideration of the product replacement costs. On the other hand, in determining the value of a company, the process is concerned more with trying to put monetary value to the expected future benefits that would accrue to the current or future owners of the company.

It is important at this stage to differentiate between the valuation of a company that is listed on a stock exchange and one that is not listed. The two forms of companies are normally denoted by the ‘limited’ and the ‘(private) limited’ suffixes respectively. When a company lists on the stock exchange, it issues shares that are bought and sold on the particular stock exchange. In this instance, the shares are akin to a retail product as they are bought and sold, respectively, from or to several market players. What determines the value of the shares of the company is then the interplay of market forces of demand and supply. Demand could be influenced by a host of factors that include the current and expected future performance of the company, the outlook of the industry in which the company is operating in as well as a consideration of the intrinsic value of the company. For a company that is not listed on a stock exchange, there is limited interplay of market forces since not many investors would know about the company, its performance and future plans. There is therefore no market derived value or price, which then must be determined through a business valuation process. This write up focuses on determining the value of a company that is not listed on a stock exchange.

**NEXT PAGE >>>**





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There are many reasons why it may be important to determine the value of an unlisted company. The owner of the company may be considering selling it outrightly. It would be important therefore for the owner of the company to have an idea of its value as a basis of negotiation for its selling price. There are also instances where the company owner may be considering admitting another partner into the company for various reasons that may include but not necessarily limited to raising capital or securing a strategic partner. Again, it is important that the company owner has an idea of the value of the business so that he or she is able to determine how many shares to give to the new shareholder in exchange for the capital or value contributed or to be contributed by this new shareholder.

We can illustrate how this process would work. Suppose a new shareholder pays $1,000 to acquire shares of a company whose value per share has been estimated as $5 per share. The total number of shares that would be issued to this new shareholder should therefore be 200 shares. It has generally been observed that in reality, many business owners often rely on thumb suck figures when it comes to determining their company share prices. This is especially so in companies within the Small to Medium Enterprises category, where many company owners and executives do not seek the services of financial advisors to advise them in the share sell and share purchase transactions. The risk to the business owner for not relying on a properly established business value is giving too many shares to the new shareholder than is necessary or selling their entire company at a giveaway price. In the example above, a new shareholder may end up being allotted more than 200 shares, meaning that they would have acquired the company or part of it at a discount, a fact often hidden from the company owner. This often results in shareholder squabbles when the true value of the business becomes apparent later on.

It is equally important for the prospective buyer of shares of an unlisted company to have the value of the shares determined. The fact that a company is doing well today is not necessarily an indication that it will continue doing well into the future. The opposite could be true. Let us take the example of a bus company with a fleet of say 20 buses. Further assume that more than half of these buses were bought within the same year. While all these buses could be generating good revenues now, they may not be able to continue doing so in say the next 5 years as they may be nearing the end of their economic life, which could be characterised by constant breakdowns and downtime. If half of the company fleet becomes unavailable, the impact on the cash-flows will be very significant to make the assumptions made at the time of purchase about the sustainability of the cashflows wrong.

NEXT PAGE >>>



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This scenario could result in the company making a capital call on the shareholders for more shareholder funding. A proper business valuation process will investigate all the relevant facts behind a company's assets, and may reveal, among other findings, that the assets are possibly nearing the end of their economic life, or that they are now or are potentially a drain to the company's cash flows through repair and maintenance, or still, that a significant amount of money could be required soon to replace some of the company's assets. To fund the replacement of fixed assets, shareholders are often called upon to contribute by way of an equity injection. A valuation that does not incorporate future expected cash outflows of this nature, and therefore ignores the fact that cash injection could be required from the shareholders, is flawed because the investor may end up paying for value created by their own investment.

Similar to valuation of unlisted companies is the valuation of a project. Project promoters often struggle in determining the amount of shareholding to give out to other investors contributing equity, as well as, how much to take up themselves as sweat capital. A simplistic allocation of shares to the project investors purely based on dollar value contributed ignores several factors that would change the shareholding significantly had these factors been considered.

Another interesting scenario found in the valuation of unlisted companies is for deceased estate distribution purposes. Let us assume that one of the company shareholders dies. The question that often presents challenges is determining how much to pay to the estate of the deceased assuming that the beneficiaries do not wish to continue as shareholders in the company. It may not be appropriate to rely on a net asset valuation, which is simply the company's total assets less its liabilities. While this is an acceptable business valuation method that many companies use for such purposes, it is flawed in that it ignores the portion of the value of the business that is attributed to other factors like goodwill and any other future developments that could positively impact the value of the company. For example, the value of a company determined under an assumption of say a 2% gross domestic product (GDP) growth rate could be materially different from one where GDP is assumed to grow at say 5%, holding other things equal. While the determination of the value of the shares of the company on a net asset basis could benefit the surviving shareholders, it clearly would prejudice the deceased estate.

NEXT PAGE >>>

What must be emphasised in unlisted company valuations is that the value of a company is a result of an interplay of several factors, including an interpretation by business valuers how those factors affect or will affect the business. Quantifying the effect of the factors is also one problematic area. Because of this, it is possible that an unlisted company could have different values depending on the motivation of the valuation.

However, the fact that at the end of the day the value arrived at is a matter of opinion, a valuation conducted by different professional and independent valuers should not result in materially different values for one unlisted company, assuming the same motivation for the business valuation. This is so because there are principles and standards that ought to be followed in carrying out any business valuation, which helps to narrow the differences.

Quite clearly, an unlisted company valuation is something that is important not just for academic purposes, but also as an important basis for some of the most important decisions made in corporate reorganisations and ownership.

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**THE END.**