The Six Key Valuation Principles

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- For any entrepreneur, these six principles will affect the value of their business
- So in our search to understand valuation, it is important to understand some of the underlying issues that impact on the result

The Six Key Valuation Principles

- 1. A valuation is time dependent and can change if the underlying assumptions behind the valuation change.
- This may include;
  - Cash
  - Working Capital
  - Market Conditions e.g. Dot Com Boom and Bust

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- 2. Which ever method you use for valuation, future cash flow is an essential component in determining value
- Note we refer to “Future” cash flows not historic as we are basing the valuation on our prediction of the future value of the company

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- Cash Flow takes into account;
  - Profits
  - Capital Expenditure
  - Working Capital
- Note that Financing Costs and Dividends are not included in this list
- In preparing a valuation, financial modelling enables you to construct a forecast of these cash flows
- Historic numbers underpin the assumptions for the future forecasts

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- 3. Market Forces determine the rate of return and vary over time
- Other variables feeding into Rates of Return include:
  - Market Conditions
  - Industry/Sector
  - Costs of Financing
  - Economic Conditions
- These can be reflected in the input assumptions of a model

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- In a practical sense timing is a critical issue when planning any sort of business event;
  - Investment
  - Acquisition
  - Company Sale or Exit

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- 4. Net Tangible Assets may impact valuation
- Physical Assets underpin a valuation and a company with higher levels of NTAs may benefit from a higher valuation
- This is more relevant in downside scenarios such as liquidation or bankruptcy
- Some business models are just not capital intensive

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- 5. Cash Flow should be independent of Ownership
- A business that is unduly dependent on its founder for its cash flow will have a lower value
  - Service delivery
  - Customer relationships
  - Sales growth
- Important to have a balanced management team to disconnect cash flow and ownership

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- 6. Value is a function of Supply and Demand
- If there are more buyers, the value will increase through competition
- If there are more sellers, the value will decrease through lack of demand
- It all comes down to the perceived value of the asset at a specific point in time

The Six Key Valuation Principles

- When preparing valuations, analysts need to factor in these principles to their underlying assumptions
- Variables are so called because they change and these changes can impact the results of valuation processes and models

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