

Terra Nova *e-book*

The valuing of a company

4th edition

The value of a company lies in the eyes of the beholder

Measuring a company

Companies are valued for takeover, merger, stock-market flotation, and for capital expenses.

Two parties are involved, the owners of the shares and outsiders, valuation is part technical calculation and part negotiation.

Negotiations are affected by the perceived strengths and weaknesses of the parties involve, while their relative size is not the only factor.

The valuation will be influenced by the needs and wants of the buyer and seller, and also by the size of the holding.

Sellers' considerations may be the following;

- What is the lowest price we will accept?
- Can we maximise profit on our original investment or is it a case of minimising losses on it?
- Do we need a quick sale in order to take advantage of other investment opportunities?

Buyers' considerations may be;

- Are there any special reasons for buying (i.e. customers, products, developments, expertise, competition)

- What is the highest price we will pay?

- How will the acquisition complement our existing holdings and or activities

- How saleable will the acquisition be in the future

Technical valuation of shares

The technical calculation may be based on;

Balance sheet valuation

Two factors do influence this value approach;

- assets are normally valued at cost value on the balance sheet, i.e. the current value may be significant more

- assets normally work for the business as dynamic earnings potential is favoured more than static asset value.

Market valuation

The capitalisation valuation is the current value per share multiplied by the number of shares issued.

Ownership of and size of share parcels may have an impact on

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This is already our *fourth edition* with new information on a variety of areas. The three previous editions are available on the company website if you so wish for download at;

www.terranoconsultancy.co.nz

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Formula for calculating earnings valuation of a company

1. Market Value divided by Earnings per share equals Price Earnings Ratio
2. Earning Valuation equals Potential Earnings next year (plus a %) times 12 divided by the number of total shares

the value of the shares and may therefore disturb the balance between supply and demand.

Earnings valuation

This is based on a combination of factors the major factor being the earnings potential of the company. This is assessed on future growth in new products, and markets, cost reduction programmes and quality of management.

Potential earnings are then multiplied by the number of years that a company would have to continue generating earnings at their present level to obtain sufficient earnings equalling the current share price.

Analysing accounts

Interpreting and analysing financial statements will enable you to compare the performance of your company with last year, compare your company with the competitors, and discover weaknesses that you may be able to improve.

Ratio analysis is a very useful tool to interpret the financial accounts of your company or of any other company. They may be compared with industry ratios.

Ratios also lead you to ask the right questions, however be aware that they hardly ever provide you with conclusive answers.

In other words, it's a tool that may give a better insight in the company and its performance, against previous years and even against your competitors in the market. It also allows you to gauge the performance of your company against industry released statistics.

The following are some type of Ratio analytical calculations divided, for ease of use, into four major groups;

- Liquidity
- Capital Structure
- Activity and Efficiency
- Profitability

Liquidity

This is to determine if the company is able to meet its short term obligations.

Depending on the type of market, type of store, i.e. retail or manufacturing, two types of calculations are used;

- Current ratio
 - Current Assets divided by Current Liabilities
- Quick ration
 - Current Assets minus Stocks divided by Current Liabilities

Capital structure

The net assets of a company may be financed by a mixture of owners' equity and or long term debts. The **Gearing ratio** analysis this mixture by measuring the contributions of the shareholders against the funds provided by the lenders of loan capital;

- Long Term Debt divided by Nett Assets

The profit and loss account may also be used for a ratio calculation;

- Times Interest earned
 - Profit before Taxes divided by Interest Charges

Confirmation that dividends are safe, shareholders wish to compare profits with the Dividend payable;

- Dividend cover
 - Profit for the financial year divided by Dividend payable

Activity and Efficiency

To confirm how effectively a company manages its assets there are two ratio calculations;

- Stock turnover
 - Sales divided by Stock
- Average Collection Time
 - Debtors divided by Sales per Day

Profitability

The following ratios are commonly used to determine management's use of the resources under its control;

- Profit margin
 - Profit before Taxes divided by Sales x 100 = %
- Return on Total Assets
 - Profit before Taxes divided by Total Assets x 100 = %
- Return on Owners' Equity
 - Profit before Taxes divided by Owners' Equity x 100 = %

Please note that Profit is closely related to the Assets employed by the company. Some may calculate the return on specific assets such as for example inventory.

When companies fail to earn a decent return, share prices may fall and may have an effect on the company's ability to secure funds or long term debts on beneficial terms.

Contributor

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