THE MANAGEMENT PROCESS OF THE ENTERPRISE VALUATION

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Abstract: *In order to keep the competitive advantage, the economic growth, the business expansion or the survival of the company in the context of a fierce competition, the management of a company can call on strategic decisions such as: merger, division, sale of assets which can be in turn small businesses, capital increase, acquisition of shares in another enterprise, issue of shares on the capital market or even the sale of a company or the bankruptcy. In all these situations, as the company value is not reflected in the accounts, it is necessary to evaluate it in order to estimate its market value. In this context, the paper shows the general aspects of enterprise valuation in order to estimate the market value and their use in managerial practice, comparatively examines the main aspects of approaches in the appraisal process and proposes a conceptual model for the management process of the enterprise valuation.*
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JEL Classification: *G31; M19*

1. Introduction

An enterprise value represents its entire economic value, meaning that it measures the theoretical price that an investor would pay to buy that business (Financial dictionary).

As a business strategy, the enterprise valuation is based on future projections of financial indicators (expected earnings, net income, dividends, cash flow etc.).

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Although the enterprise valuation is restricted to the application of International Valuation Standards (IVS 2013) yet the literature offers various expert opinions based on experience and judgment in certain situations.

The sellers on the capital market pay less attention to the company value and more to the price charged when concluding the transaction. This does not mean that the company value is less important because the capital value of a company is built in many years of hard work (Hamdan, 2013).

The most market valuations focus on market capitalization, i.e. the use of P/E (profit/earnings) or reports derived from the ratio of P/E. If this technique is useful to evaluate the capital attractiveness on the market at some point in time, it can hide the company value as a whole. A real perspective of the relative value in time can be obtained by analyzing both values, the enterprise as a whole and the market capitalization (Selsick, 2016).

The market capitalization is the market value of the shares of a company so as to find an enterprise value the number of listed shares is multiplied by the market value (listed) of the shares. But a company with a high value of the shares does not mean that is richer than one with a lower value on the Stock Exchange. In order to know which is the company value as a whole, a complex approach is required taking into account both the capital and the company debts (Vaidya, 2017).

The enterprise value is an indicator of how the market assigns a value to an enterprise as a whole and not only the current market capitalization because the enterprise value incorporates debt and cash reserves besides the market capitalization (McClure, 2014). In other words, a simplistic picture of the enterprise value is the sum of the market capitalization of the company and its net debt (Thorp, 2010).Usually, the data needed for calculating the value of a company is found in the annual financial reports and in the announced preliminary results (Dunne, 2015).

There are differences between the company value, the capital value and the business value which are not understood by some users of information (Scrlak, 2016). The business value includes the value of tangible assets, intangible assets, and goodwill, patrimony components that create value or the equity and debts value. The company value includes, besides the business value components and the assets that do not contribute to the value obtaining (redundant), such as unused land, buildings or equipment, or unused surplus cash. The capital value includes besides the equity the redundant assets.

Although the company value is an opinion of the value expected by the investors, estimating the market value starts from investigating the company past and present through the diagnostic analysis.

Based on the opinion expressed by some authors, the International Valuation Standards, and personal observations, this paper presents the correlation between the enterprise strategy and the need to estimate its market value, it comparatively analyzes approaches in enterprise valuation and proposes a conceptual management process model of the enterprise valuation.

2. *The enterprise strategy and the need to estimate the market value*

Although the International Valuation Standards define four types of value (market value, investment value, synergistic value and special value), in managerial practice the enterprise value relates in most cases to its market value.

According to the International Valuation Standards (ANEVAR, 2016), the market value is the estimated amount for which a property should be exchanged, at the valuation date, between a *decided* buyer and a decided seller, *in a fair transaction*, after *a proper marketing*, where *the parties have each acted* knowledgeably, prudently and without restraint.

As for the enterprise, the main uses of the estimated market value are shown in the figure 1.

As McKeown said, "strategy is about shaping the future" (McKeown, 2012), strategic decision refers to choosing the most appropriate alternative for achieving the strategic goals of the organization based on the results and on the key factors that determine in the future its success on the competitive market.

The strategic decisions are taken practically depending on the present financial condition in which the company is in correlation with its strategic goals. These situations can be grouped into increasing success situations, situations of maintaining success and failure situations.

In case the company is looking *to increase success* by calling on strategic investment, the strategic decision might be to increase the capital, to issue in the capital market or to purchase shares in other companies.

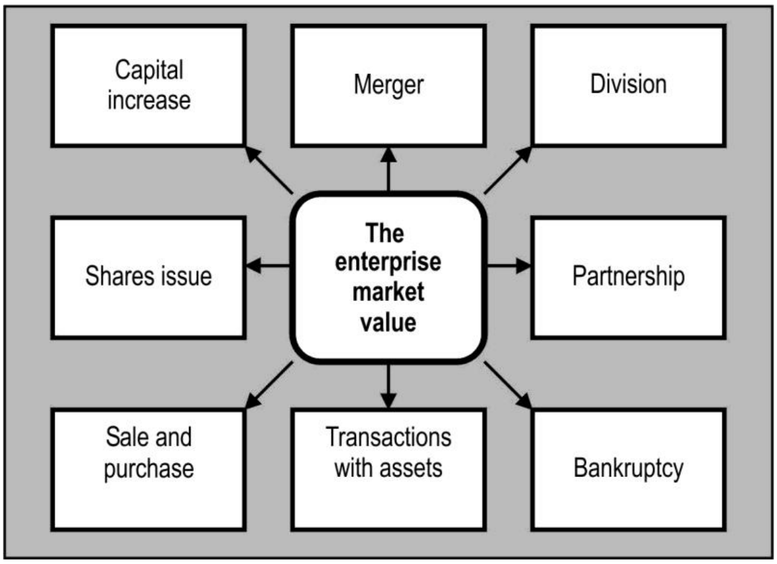

Figure 1. The uses of the enterprise market value

When the company seeks *to maintain its success* and it is forced to deal with a competitor involving high costs (research, marketing, etc.), in order to become more efficient, the strategic decision might be the fusion or the association with a partner who can bring a competitive advantage.

When the company is in *a situation of failure* (accumulated losses), the strategic decision can be the splitting, the sale of assets, the sale the business or the insolvency (bankruptcy).

In any of the above situations, the enterprise valuation at a market price is necessary.

The capital increase

When the capital increase of a company is decided, its valuation is required in order to establish the new capital contribution of the shareholders.

The shares issue

In the case of an issue of additional shares, the company shall be evaluated in order to determine the current value of the nominal value of the shares.

The purchase of shares

In the case of investment in the capital market, the company or companies in which shares will be purchased shall be evaluated in order to know their anticipated value.

The merger of companies

In the merger transactions with a second company, the both companies appraisal is necessary in order to know the value of a share or a social part that has to be "settled" to shareholders and also the value "which is included" in the absorbing company patrimony.

The joint venture

In the case of joint venture contracts, each party in kind that is subject of the partnership is to be evaluated in order to determine the optimum sharing of profits and losses resulted from the partnership.

The division

When dividing a company, the enterprise "mother" and the enterprises "chicken" resulting from the division are to be evaluated.

Sale and purchase of enterprises

Both companies where the state holds shares and companies established by private initiative may be the subject of a transaction of sale and purchase. Their value as a business or the value of the shares composing the capital is not reflected in the accounts, the appraisal being necessary.

Sale and purchase of assets

The assets, meaning commercial and not accounting, are parts of an enterprise that can operate independently, do not affect the core business and consist at least of a building or part of a building, with or without fixed assets, such as: storehouses or warehouses, workshops or production departments, stores, hotels and restaurants, land, other areas for commercial use. They may be the subject of a commercial transaction.

Bankruptcy, liquidation

If a company is declared bankrupt and follows its liquidation, with the aim of valorizing the goods that compose the patrimony, the liquidator shall proceed to appraisal.

3. Comparisons between approaches in the enterprise valuation management

In the enterprise appraisal, the management may decide on the approaches and techniques or methods used depending on the amount and quality of information available.

The International Valuation Standards specify three approaches: the market, the income and the assets (ANEVAR, 2016).

The main differences between these approaches are presented in Table 1.

Table 1. Comparisons between approaches in the enterprise valuation

Characteristics	The market comparison approach		The income approach		The assets approach
	Listed companies	**Unlisted companies**	**Direct capitalization**	**Discounted Cash Flow**	
Complexity	Low	Medium	Medium	High	High
Input source	Securities financial markets	-enterprises acquisitions market; -previous transactions	-The profit and loss account (net reproducible income; profit, dividends)	-The financial statement; - The profit and loss account; -The forecasted cash flow	- The financial statement; - The list of redundant assets (valuated separately)
The techniques applied	Multipliers	Comparisons of financial indicators	The net income capitalization (profit, dividends)	The discounted cash flow and the forecasted residual value	The appraisal of balance sheet components that add value by techniques specific to each component
The resulting value	The shares value (usually minority shares)	The company value	The business value	The business value	- The company value; - The enterprise value; -The equity value

The market approach

The market approach compares the enterprise (or the company) to evaluate to other similar enterprises, to shares in enterprises and to shares sold on the market. These similar enterprises must operate in the same field as the subject evaluated or in an area that responds to the same economic variables. The comparison should be done in a clear and unambiguous manner.

The factors to be taken into account for determining the existence of a reasonable basis for comparison include:

- The similarity with the enterprise in question, in terms of quantitative and qualitative characteristics of the enterprise;
- The amount and degree of verifiability of information on similar enterprises;
- If the price of the similar enterprise represents the price resulting from a free and unbiased transaction.

The three most common sources of information used in the *market approach* are:

- the securities financial markets, where shares in similar enterprises are traded,
- the enterprises' acquisitions market in whole and
- the previous transactions of the property subject to evaluate.

The market valuation is relevant as it uses observable, factual records regarding the current sales of properties from which the value indications is deriving.

The methods listed in the market comparison approach are the following:

- *The method of the comparison with similar listed companies or with minority shares transactions* (shares in listed companies). The value rates or the multipliers (e.g. Price Earning Ratio – PER) result from transactions on the financial market (in most cases it is about minority shares).
- *The method of the comparison with sales of similar unlisted companies* (the companies' acquisitions and merger market), in which the basis of comparison is the companies' transactions on the whole or transactions with majority shares, usually considering the unlisted companies market.
- *The method of the comparison with previous transactions or with offers of capital evaluated company capital shares*. The value estimation is based on previous transactions, offers or agreements aiming the ownership of the evaluated company, usances.

The income approach

The income approach is to estimate an enterprise value, an equity stake or a share by calculating the present value of the anticipated profits.

The methods included in the approach based on income are the following: the income capitalization (profits or dividends) and the DCF – Discounted Cash Flow.

The method of the income capitalization (profits) is based on the reporting of a steady and reproducible flow of income (usually net profit or dividend) at a capitalization rate. In this case, it is a single flow of economic benefits, related to a single period (usually one year).

In the (direct) income capitalization, a representative income level is divided by a capitalization rate or multiplied by an *income multiple* in orders to convert the income into value.

In theory, the income can be defined in a variety of income and cash flow forms. In practice, the income estimated is usually either gross (before tax) or the net (after tax). The capitalization rate should be appropriate to the definition of used income form.

The method of the discounted cash flow or the dividends, where all projected economic benefits (cash flows or other similar variables) of the enterprise are updated to the present value, using a discount rate representing the cost of the capital for that investment. Discounting requires an explicit forecast period and residual value (non-explicit period).

In the discounted cash flow analysis and/or the dividends method, the cash receipts are estimated for each future period. These receipts are converted to value by applying the discount rate, using present value techniques**. S**everal definitions of the cash flow can be used. In practice, frequently used is the net cash flow (cash that could be distributed to shareholders) or the current dividends (especially for minority shareholders). The discount rate must be coherent with the definition of the cash flow used.

The assets approach

In the enterprise valuation, *the assets approach* may be similar to the cost approach, used by the evaluators of different types of assets. The enterprise value is actually thevalue of the invested capital in the enterprise (Crivii, 2009). The invested capital includes the equity (investorsequity) and the long term loans or in some cases, such as credit lines, thetotal loans. Therefore total assets equal total liabilitiesincluding equity plus long (and short) term loans plus non-financial liabilities. In*the assets approach*, the balance sheet drawn up on the basis of costs is replaced with the balance reflecting all the assets, tangible and intangible, as well as all the liabilities, at *theirmarket value* or another appropriate current value.

4. The management process of the enterprise valuation

The valuation is the act or the process of estimating value. It is an activity of expertise that requires special skills and competencies, knowledge and use of a complex of multidisciplinary and specific techniques.

The valuation can not be considered a pure science as it has the characteristics of an art, consisting in applying the experience and judgment of facts in order to reach a reasonable value.

The valuation process is all research, data, reasoning, analysis and conclusions to reach an estimated credible value.

The purpose of the valuation process is to present an unbiased opinion of the value by which the evaluator demonstrates that he took into account all the factors affecting substantially the value.

Like any process, the valuation process is run as well by a manager since an enterprise valuation involves teamwork of experts.

It is considered that the management process of the enterprise valuation comprises five main steps and 15 sequences (Figure 2). The five steps are the following:

- defining the valuation issue;
- the organization, the team formation, and the inspection
- the market and data analysis;
- the implementation of the approaches, methods and valuation techniques;
- drawing the conclusions on the value.

After the enterprise valuation process, the appraisal report is resulting.

Defining the valuation issue

The first step in the appraisal process is to contact the customer wherewith the scope of the valuation is identified and the required type of value and the appraisal purposes are defined.

The intended use of the appraisal and any limitation related to it, identifying any co-worker and his contribution refers to the customer on the one hand and on the other to the users of a valuation report.

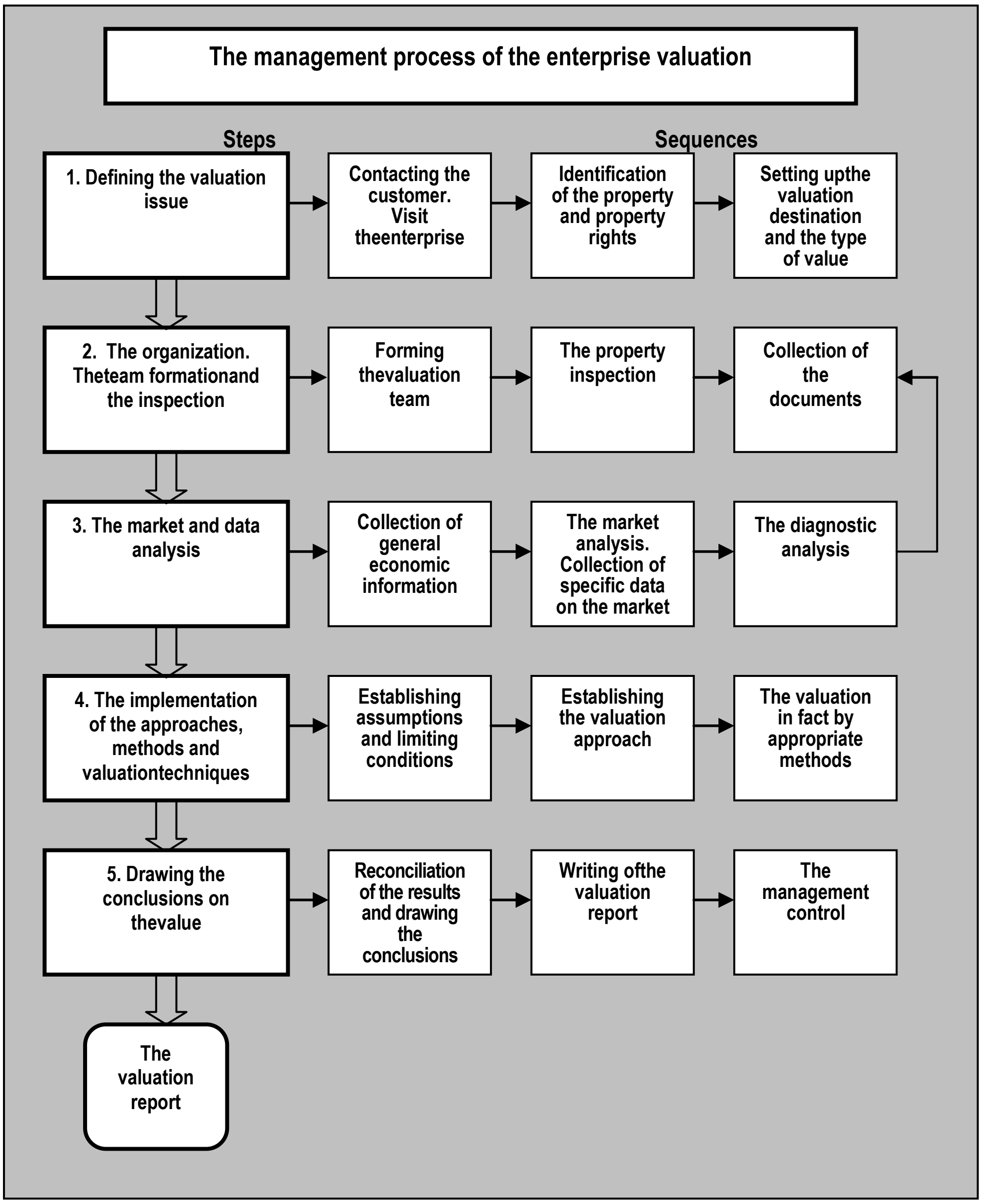

Figure 2. The management process of the enterprise valuation

The organization. The team formation and the inspection

Based on this information included in the contract of services, the project manager performs the work plan and forms the team of experts.

An identification of the real estate, the movable goods, the enterprise or other property that is subject to the appraisal follow, as well as other classes of property included in the appraisal, in addition to the main category of property by onsite inspection.

The property inspection consists of watching the property on the field to evaluate and establishing an opinion on its status by direct observation.

During the inspection, the documents necessary for the analysis and the appraisal are collected (legal, financial, commercial, etc.).

Depending on the nature of the property being evaluated, the information sphere necessary for the appraisal is very wide.

The market and data analysis

At this stage data and information on national economic trends and specific market of trading enterprises and/or shares are collected and analyzed.

The general economic information refers to the growing (growth) rate of the Gross Domestic Product (GDP), in the past and for the forecast period, expressing the real growth of the economy and the purchasing power of incomes; the annual inflation rate, calculated based on the consumer price index, both the historical and projected; the level of interest rates; the industrial production; the exports; the business investment and the capital market activity (Damodaran, 2017).

Information on similar enterprises trading, Stock Exchange shares trading and information on the income generated by comparable companies is gathered. The main sources of information are the literature, the internet, the public auctions, the rating agencies etc.

Based on the documents collected, the diagnostic analysis of the company to evaluate is realized, data necessary for the appraisal is extracted and the main aspects concerning its forecast correlated with overall trends in the economy and specific market are concluded. Based on the analysis of the documents collected, an identification of any assumptions and limiting conditions underlying the valuation is required.

The implementation of the approaches, methods and valuation techniques

The valuation approach refers to:

- the sales comparison approach;
- the income approach;
- the assets-based approach.

Depending on the data collected and the relevance of the comparables collected from the market, the valuation approach is established and the most appropriate methods and techniques are applied. Usually, at least two approaches are applied.

Drawing the conclusions on the value

The results obtained from the various valuation techniques are analyzed and a value level is selected. The proposed value is the result of the professional judgment of the evaluator. The conclusion on the final value proposed must be explained.

The appraisal report shall be made in accordance with the Valuation Standards. The management control is exercised throughout the entire appraisal process, but its responsibility derives after verifying and signing the valuation report. The verification of the appraisal report is performed in accordance with the Valuation Standards.

Conclusions

The enterprise valuation is required in different situations of the strategic decision concerning its future. If the enterprise strategy is the development through investment, the approach by market comparisons for share issue and acquisition of shares and the income approach for the capital increase are applied.

If the enterprise strategy is to maintain success in the competitive market or to seek for a financial recovery solution, the income approach and/or the assets approach for the merger, joint venture, division and sale of assets are applied.

If the strategy is to close the business, the income approach and/or the assets approach for the enterprise sale and the assets approach for the bankruptcy/liquidation are applied.

Nevertheless, in either case, the enterprise valuation is a management process. The comparisons between the approaches in the enterprise valuation may be a useful tool for the users of the appraisal report. Also, the conceptual model proposed for "the management process of the enterprise valuation" is a complex approach to this management process and is useful for both experts and management of the enterprises to be evaluated.

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