भारतीय दिवाला और शोधन अक्षमता बोर्ड
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Analysis of Qualitative factors affecting Valuation

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REGISTERED VALUER - SECURITIES OR FINANCIAL ASSETS
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SIGNIFICANT QUALITATIVE VALUATION DRIVERS:

What is a Value Driver?

Value drivers are factors that drive a company's performance, growth and hence its value. Value drivers for closely held companies either reduce risk or increase growth/return. Value drivers can be both quantitative as well as qualitative in nature and which significantly affect the value of the business enterprise.

Significant qualitative valuation drivers which impact the business:

The qualitative valuation drivers which significantly affect the financial performance, business risk and enhancement of overall value of business are as follows:

1) A diverse, capable management team

A company's employees are the heart of an organization and an important key value driver. Key value drivers include the knowledge, skills, experience, training, personalities, capabilities, effectiveness and creative abilities employees bring to a business and also determine the health of its company culture. This team is made up of qualified managers with the ability to keep its employees' interest and engagement in the company at a high level. A potential investor considers favourably an investment in a company with leadership that brings a variety of skill sets to the table rather than over-dependency on certain individuals.

Additionally, an investor is interested in a potential purchase when the incumbent management and identified leaders would succeed in a formal succession plan who may command a stronger negotiation bargain.

A recent research and study about Employee Stock Ownership Plans (ESOPs) unfurled that one of the advantages of implementing an ESOP is that it fosters a sense of ownership in the company. Participants develop a vested interest and actively contribute to the financial performance of the company. According to a Hewitt Associates study reported in TIME magazine, 9,000 private companies and 1,000 public companies have an ESOP and the total shareholder return for companies with an ESOP was reported at 26% vs. non-ESOP companies at 19%.

Therefore, motivated and skilled human resources are powerful creators of value for any business organization which lead to a rise in operational efficiency, greater production output with a decrease of wastages.

2) Customer Loyalty and Numbers

One of the major and effective value creations by a business is a large diversified and loyal customers base. Repeat and loyal customers is a direct result of effective value creation in the past and the business should not be over-dependent on the creation of new customers, since it is an uncertain and expensive affair. Also, it is imperative that the company has a diverse customer base so that it is not dependent upon only a few customers for the bulk of its sales and it should not have a single client accounting for more than 10 percent of the total sales. A diversified customer base ensures insulation of the company from the loss of any single major customer, therefore, companies must manage the allocation of customer concentration judiciously to reduce the risk of losing a large source of its earnings. Also, customer concentration is always a risk since if the customers are loyal to a particular individual, then it is likely that they switch over to other products when that individual exits.

3) Economies of Scale

As production output increases, businesses usually achieve lower costs per unit. Whether through quantity discounts or spreading fixed establishment and capacity costs over higher volumes, bigger companies command distinct advantages in certain operations and markets in which they attain the specialization due to economies of scale in production or any other factor.

After ensuring the adequacy and access to capital, companies ensure the most efficient use of their limited resources. By ensuring that the production is occurring at the optimum level with least wastages, the management ensures exploiting the advantages of lower cost per unit of output due to economies of scale. The cost-spread among a large number of products should be proper and the per-unit cost of those products should be the least. Economies of scale should be ensured across the optimum mix or variety of products rather than just focusing on one or two items in the product line.

4) Macro-Economic Factors

Macro-economic factors such as interest rate, inflation, foreign direct investments, economic growth rate, Gross Domestic product, Price Level, unemployment etc. are uncontrollable value drivers which may substantially affect the business. Hence, the management should be prepared to evaluate, monitor and manage risk from such impacts and continue to create business value by understanding how the industry is structured to minimize such impacts of economic and macro trends on the business. Proper planning and implementation are essential to combat variations in the macro-economic factors. For example, in an adverse economic situation such as depression, a company can strengthen and use a fierce marketing strategy so as to keep its market share as well as sales numbers intact.

5) Marketing Strategy and Branding.

Marketing is the link between customers' needs and their response to a company's products/services. Strong branding will not only improve company sales by increased market recognition, but it will also provide a clear direction that will improve operational efficiency when tied to the company's mission.

A strong marketing and branding strategy is an invaluable and can prove to be an intangible asset and a powerful valuation driver for the company. A good marketing program ensures to improve brand visibility, awareness, and recognition. Also, it improves brand recall and places the product in the active and immediate memory of consumers. The company benefits by an increase in sales and profits and stakeholders gain by an increase in the value of their portfolio as well as increased dividends.

6) Business Strategy and Growth Plan:

It is imperative to formulate a growth strategy to strategically and strongly position or accelerate the business as a key value driver which uncovers the future road map of the business. It may be in the form of growth organically or inorganically, expanding or diversifying, trading vs. manufacturing, etc. Sound knowledge of the core competencies by the management helps in maximizing business value. A clear business strategy will help the business to gain a competitive edge in the market and make an overall growth.

By analysing the current management team and by harnessing its experience and skills to execute the growth strategy and also by combining next-level management and external resources with the growth strategy, the company may accelerate its growth.

7) Product Lines and Mix

A company boasting a wide product mix consisting of multiple product lines is well-diversified and is insulated to a certain extent against changes in economic trends and tastes and preferences of consumers. The loss of sales from seasonal products can be compensated with the extra sales from other products during the year. The customers are loyal and may prefer the brand and company that may provide an array of products under one umbrella of products. That could be belonging to the same user stream or diversified.

Also, in case there is a single product concentration and the company relies too greatly on any one product or service, it could increase the company's risks if that product or service became obsolete or unnecessary.

8. Competitive Advantage

A core competency may be converted into a competitive advantage and results in customer stickiness with the product. This may be due to better quality products or lower prices than their competitors. It is imperative to identify such a competitive advantage and protect and promote it.

9. Operating Systems that Support Sustainable Cash Flows

Robust and updated operating systems are the well-documented standard operating procedures that instils confidence in the buyers about the perpetual succession of the company even after an individual's exit. Standardized and repeatable and automated processes ensure easy scaling, repeat customers, and predictable management without much investment and dependence on specific individuals or their actions, which presents the company to be a *system-driven* business which is much more valuable than an *owner-driven* business.

10. Technological Expertise

The intellectual property rights (IPRs) owned by the company is a propeller for growth and companies can create value by offering technologically-advanced product and service offerings at competitive price. Therefore, large sums of amounts are invested in research and development activities to ensure effective and timely invention and innovations in the products to avoid technological obsolescence. It is equally important to maintain cost effectiveness with the innovated products. Moreover, latest technology will have the advantage of longer lasting, thus avoiding frequent changes unless sudden technological disruptions occur due to macro-economic factors in the industry.

Summary and Relevance of the Valuation Drivers

Frequent value assessment of any business is imperative to know the standing of the company and as well as to evaluate whether the company has been able to consistently add value and increase its valuation and highlight the real intrinsic value of the firm and ultimately maximize returns. On evaluation of these valuation drivers, the management determines the success of its strategies and it gives a chance to replan, rectify its strategies, and plug any of loopholes, if the valuation is lower than its expectations. Arranging an appropriate mix of valuation drivers suiting the individual company's needs and its eco-system, and its successful implementation is a key business management exercise.

Valuation may seem to be much more of a quantitative exercise like financial statements, future projections, multiples of EBITDA, rate of return, etc. However, qualitative aspects led by valuation drivers may have more impact and influence on the business valuation in several situations.

The above discussion is just one of many steps in a valuation expert's process for determining value. However, these 10 key inputs drive the appraiser's due diligence and set the preamble for the analysis and report that identifies, supports, and opines to value.

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