SIGNIFICANT QUANTITATIVE 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 quantitative valuation drivers which impact the business:

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

1. **Growth in Revenue and EBITDA Margin** –

EBITDA is the recurring operating profits before the impact of depreciation and amortization and is the determinant for the operating cash flows generated by the entity. The financial performance of the business is directly proportional to these metrics and higher the Revenue and EBITDA, higher the Free cash flows to the firm and higher the valuation of the entity.

2. **Debt to Equity Ratio/Leverage Ratio in Capital Structure**–

A higher proportion of debt in the capital structure results in a higher Equity/levered Beta, when the industry unlevered beta i.e Asset Beta is re-levered to arrive at this levered Beta of the company using the Hamada Equation Formula.

Since, a higher leverage ratio means higher levered beta which results in higher discount rate and further implies a lower valuation.

If the leverage is too high, it also increases the risk of going concern or survival risk of the company which again raises the discount rate.

Also, a high amount of debt also reduces the final equity value of the business since i.e. Equity Value= Enterprise Value- Debt, and Enterprise value is arrived at after discounting with WACC, the Free Cash Flows to Firm and the Terminal Value.

Hence, a highly leveraged capital structure may adversely impact the value of the company and vice versa.

3. **Capex and Investment in Fixed Assets** –

A company with higher investment in fixed assets such as a manufacturing concern, will have lower Free Cash Flows to the Firm (FCFF) than that of a trading concern with a lower investment in fixed assets, provided other things remain constant.

Future Capital Expenditure (Capex) requirements may include both maintenance capex and incremental capex. A company should judiciously determine the amount of maintenance capex required to effectively maintain the efficiency and utility of its current plant and machinery and other productive fixed asset.

If the company includes incremental capex in its projections, then it is important to match the explicit forecast period with the expected gestation period of the new investment so that the results of the new investments are also included in the cash flow projections along with the cash outflow for investment itself.

Usually, higher the capex, lower the cash flows and lower the valuation, unless the amount of depreciation offsets the change in total capex.

4. **Investment in Working Capital and Cash Conversion Cycle Management** –

Cash Conversion Cycle (CCC) is the sum of days outstanding in receivables and the days of holding Inventory and as reduced by days of payable outstanding. A company with a higher CCC shall mean a higher investment in its working capital i.e. (Cash invested in Receivables and Inventory). A higher investment in working capital shall reduce the free cash flows available for the entity.

Therefore, the shorter the period of CCC, the better the company is at selling its inventories and recovering cash from these sales while paying suppliers and should aim to increase the value of the entity.

5. **Investments and reserves** –

The value of current investments the company has a significant impact on the holistic value of the company. Current Investments are usually by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made and is neither not yet ploughed back in the operations of the company nor has been distributed to the shareholders as dividends or returned back in a buy back of shares mechanism. Higher the investments, higher shall be the value of the entity.

In order for such investments to be effectively managed, the return on such investments should be higher than the return on equity from the operations of the entity, otherwise it may imply sub-par use of such funds and may bring down the projected financials and hence bring the value down.

6. **Explicit Forecast Period and Terminal Growth Factor** –
Usually the explicit forecast period should be equivalent to a period of an expected high growth period or a period of next 5 financial years, which is higher.

The various factors for taking an explicit forecast period include factors like investment gestation period, high growth period, etc. The length of the explicit forecast period should be based on the factor for which the period is being considered. E.g if the explicit period is taken assuming high growth then the explicit period should be equivalent to the high growth period of the company. The sustainable growth or the terminal growth should be considered post the explicit period.

7. EBIT–

Earnings Before Interest and Taxes (EBIT) is the recurring operating profit. It is based on the operational profitability and is a driver of enterprise value.

8. Earnings Per Share (EPS) –

Earnings per share (EPS) is the profit attributable to common shareholders on a per share basis. It is post capital structure meaning all expenses related to providers of capital (and government in the form of taxes) are included. It is a driver of equity value and expressed on a per share basis as the P/E multiple.

9. Sustainable projected cash flows–

One of the major yardsticks of high valuation of the business is a high amount of sustained Free Cash flows of Firm being generated over the explicit forecast period and also in perpetuity. A sustainable operating model supported by a robust business plan with a credible documentation system in place (i.e., audited or reviewed financial statements) is required to support their performance. It is important to evaluate the susceptibility of the industry to disruptions due to changes in technology over a period of time.

It is no less important to look at historical trends for a company to determine how it has performed in a recessionary economic environment vs. a bull upswing market while forecasting the financial figures for the future. Key Performance Indicators (KPIs) metrics may be used to compare the company to its peers which may determine a good indication of value and efficiency of operations.

FCFF = NOPAT + D&A – CAPEX – Δ Net WC

Where,

NOPAT = Net Operating Profit

D&A = Depreciation and Amortization expense

CAPEX = Capital Expenditure

Δ Net WC = Changes in Net Working Capital

Summary and Relevance of the Valuation Drivers

Ultimately, all value drivers contribute to growing and sustainable free cash flow. It is the cash flow that determines what a buyer will offer to pay. Buyers buy cash flow, especially that which they expect to increase. Therefore, in order to increase value, the management should ensure to:

- Implement procedures and systems to increase productivity, reduce costs, and increase cash flows.
- Consider benefits that they receive from the company that are not necessary to the operations.
- Postpone unnecessary capital expenditures and budgeting plans for discretionary equipment.
- Monitor the company's Internal Rate of Return (IRR) and NPV of new projects.

Companies that focus on developing and/or enhancing their value drivers will position themselves to attract buyers who are willing to pay a premium and may justify a higher intrinsic valuation for shares of a higher P/E ratio.

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He is an active member of several study circles of ICAI and frequently delegates in discussions and knowledge sharing sessions on several topics on valuation and taxation.

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