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BUSINESS VALUATION IN STRATEGIC MANAGEMENT

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Abstract: The paper deals with the main problems of business value management and strategic management. A number of reasons for conducting business valuation are specified and the functions thereof are discussed. Then, valuation methods are presented and analysed, such as asset-based methods, including book value method, replacement value method, and liquidation method and income-based methods, among which the cash flow method is focused on.

Keywords: Business value, management, valuation methods

Introduction

Nowadays, economic development is based on knowledge, international integration, and globalization of goods and financial markets. Crucial for development are also business valuation and business value management, based on a sound theory of enterprise and finance management. Valuation models as well as tools for creating and assessing strategies for increasing business value are an important strand in research on modern methods of business effectiveness analysis. Besides, the maximization of business value is of great importance for its current or prospective proprietors.

The knowledge of valuation methods and techniques of creating business value is becoming vital in the light of ongoing global evolution of capital markets and the growing role of investors. Their clients expect to get increasingly high return on investment, so competition among groups of investors is growing. The valuation process and the strategy of business value management combine two basic areas of financial decisions: on financing business and on effective use of capital. To increase a business value it is necessary to find cost-effective sources of its financing and effective investment. Striving towards the maximization of business value means maximizing the value of cash flows obtained in a number of markets, and ultimately, increasing dividends and shares.

The strategy of business value maximization should be constantly supervised both by the management and by the proprietors of a company. For such supervision to be possible, it is necessary to be familiar with valuation methods and techniques, as well as with business value indexes and management. According to a widespread opinion, the true business value is related to its market value manifested in the capital market on the basis of a number of parameters available to potential investors. As economists stress, however, a current value of a business is shaped by the balance of demand for and supply of the business shares. In the market economy it is therefore necessary to monitor and predict a business value on the basis of its financial achievements.

The objective of the paper is to analyse and assess the influence of business valuation on creating it market value. The analysis is carried out on the basis of research results discussed in the literature.

Business value management

From the perspective of management, the most important goal of a company's activity is maximizing its market value in order to benefit its proprietors. Other goals of conducting business include improving the working conditions, enhancing the quality of products, and making a contribution to social development. Business value management is an idea underlying ongoing operation and investment undertaken by a company in order to raise its value.

Creating value is a strategy of running a business based on management principles. Business value management should be designed in such a way, as to facilitate the process of making strategic and operational decisions by focusing on key factors affecting the business value, referred to as value carriers[65]. Among various theories thereof, the conception known as VBM (Value Based Management) seems to have attracted interest and support among researchers.

The idea of VBM combines elements of strategic management, finance management, human resources management as well as marketing management, mainly within the sphere of company-customer interaction[66]. Thus, value management integrates a number of domains related to management, finances, and strategy. It is a system combining managerial and analytic tools originating from three basic areas, such as business valuation, gauges of periodical assessment of values preferred by a company and incentive bonuses for employees for raising a business value within a specified period of time Fig.1.

In strategic management, there are four main processes which are of interest to practicing managers:
– setting goals,
– developing strategies,
– adopting action plans for a set budget,
– implementing systems for assessing results and incentive measures[67].

[65] T. Copeland, T. Koller, J. Murrin, *Wycena: mierzenie i kształtowanie wartości firm*, WIG Press, Warszawa 1997, p. 6.
[66] R.W. Mills, *Dynamika wartości przedsiębiorstwa dla udziałowców. Zasady i praktyka analizy wartości strategicznej*, ODDK, Gdańsk 2005.
[67] P. Szczepankowski, *Wycena i zarządzanie wartością przedsiębiorstwa*, Wydawnictwo Naukowe PWN, Warszawa 2008, p. 25.

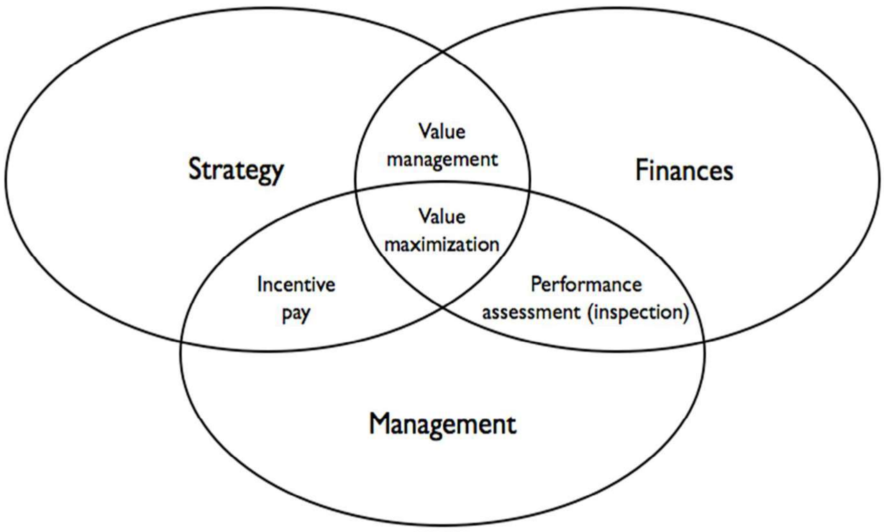

Fig. 1. Essential concepts of business value management

Source: M. Marcinkowska, *Kształtowanie wartości firmy*, Wydawnictwo Naukowe PWN, Warszawa 2000, p. 23

The rightly chosen strategy determines a long-term unique competitive advantage in the market. Due to this advantage a company provides its owners with benefits resulting from enhancing and expanding production, reducing cost, improving product quality, which, on the whole, leads to increase in economical factors.

Action plans and budgets related to them show specific benefits resulting from strategic actions aimed at achieving the goals. They enable monitoring and supervising the managing of the company and its employees.

Implementing a system of assessing results and incentive measures helps realize current and future operational aims. Adequate gauges reflect a company's economical conditions and contribute to the long-term and short-term value maximization[68]. When assessing the progress in business value creation it is necessary to observe not only financial parameters but also strategic symptoms corresponding to non-financial aspects of the company operation, such as relations among employees and interactions with customers. The combination of financial and strategic parameters is known as Balanced Scorecard[69]. It is a sum of actions and efforts involved in value management and financial results, in managing effectiveness of market undertakings, in the quality of internal processes, and in making investments to ensure future development of the company and its employees.

[68] T. Dudycz, *Finansowe narzędzia zarządzania wartością przedsiębiorstwa*, Studia i Monografie nr 143, Wydawnictwo Akademii Ekonomicznej we Wrocławiu, Wrocław 2001, p. 38.
[69] A. Szablewski, R. Tuzimek, *Wycena i zarządzanie wartością firmy*, Poltext, Warszawa 2008, p. 95.

The Scorecard combines parameters of short-term financial effectiveness with long-term factors of value creation, which promise a long-term financial and market success of a company.

It has to be noted that the idea of VBM takes into consideration the financial consequences of all actions undertaken in a company. The financial effects of introducing a management strategy are usually represented as relationships between the rate of growth, cash flows and return on equity. On the basis of these criteria one can distinguish companies generating positive operational cash flows, display high rate of growth and high return on equity. There are also companies with a positive cash flow, which is however accompanied by low rate of growth and relatively high return on equity. The third category of companies is characterized by negative cash flow, diminishing growth and negative return on equity.

Considering various aspects of a business value creation strategy, it is necessary to take into account the sale growth strategy oriented not only towards the product, but also towards the customer and his/her preferences. Nowadays, the role of customers in the process of creating business value is gaining increasing recognition, due to the changing environment. Since the world is becoming global, customers create networks and become more active, which results in companies getting more sensitive to customers' demand and trying to deliver products meeting their expectations.

Assessing the strategic perspective of business value management requires a number of methods, including the analysis of the company external and internal environments, the product's life cycle and the value alternations. These factors make it possible to determine the expected time of the company competitive advantage and the time of maintaining such a value that yields a high return on capital. It has to be noted that to remain competitive means in fact to grow and to create additional value[70].

Business valuation as a quantitative and analytic tool of assessing a business value can be a basis for developing a set of strategic actions undertaken by a company to achieve the ultimate goal of raising the business value. On the other hand, the value determined by means of the valuation methods becomes the main factor confirming or disconfirming the validity of the strategy and planning as a means leading to value creation.

Conditions of business valuation

The process of business valuation plays an important role in the analysis of various forms of investment, in constructing portfolios of capital market instruments and in restructuring business. The growing interest in valuation methods occurred in Poland due to privatisation and commercialization of state-owned companies, or sole-proprietor companies of the State Treasury, the development of the capital market and consolidation of companies in some sectors of economy.

[70] M. Grabowska, I. Otola, *Wartość dodana determinantą konkurencyjności przedsiębiorstwa*, [w:] *Ekonomiczne i pozaekonomiczne czynniki zarządzania wartością przedsiębiorstwa*, red. J. Duraj, A. Sajnóg, Wydawnictwo Uniwersytetu Łódzkiego, Łódź 2013, p. 83.

Business valuation attracted interest especially during the accession of Poland to the EU, where valuation procedures are detailed have to be continuously extended[71]. Generally, there are four groups of reasons for conducting valuation:

The first group includes reasons related to transferring ownership rights of the whole company or a part of it. The majority of cases here are state-owned companies undergoing privatization, whether indirectly by being transformed into sole-proprietor companies of State Treasury, or directly by selling shares to investors.

The second group includes valuations carried out because of changes in the structure of business ownership, for instance in the case of becoming part of a joint-stock company, being leased, liquidated, merged, etc.

The third group of reasons for valuation is related to the necessity to calculate taxes, fees, indemnification, insurance premiums, etc., on the basis of the company value. This may happen when a company is inherited or donated, sold, leased, participates in the creation of a joint-stock company, or indemnities have to be paid because of some unexpected events.

The fourth group includes cases related to collaterals on loans. Additionally for the company itself, valuation can be a tool for keeping the record and monitoring the value of capital, and for establishing the value of certain indexes, corresponding to the financial and economical condition of the company.

Each valuation has a number of functions, among which the following are the most often mentioned[72]:

- advisory (decision-making),
- mediatory,
- argumentative,
- informative.

The advisory function has to be fulfilled when a company bought or taken over by new owners. This means that knowing the value of the company, each party can determine the starting point for negotiations and possible concessions. Besides, valuation provides information enabling setting the minimal price for the seller and the maximal price for the buyer.

The mediating function becomes prominent when the transaction parties have diverging opinions on the business value. Then, valuation conducted by an independent expert helps reconcile the differences in the initial opinions.

The argumentative function is at play when valuation provides arguments which the seller or buyer can use in negotiations. In this way, the strength of the arguments offered by a party is augmented by information obtained from valuation.

The informative function concerns the pure supply of information on the economical and financial results of a company and perspectives for its development. The information is intended for external recipients, including potential individual and institutional investors.

There are several principles of conducting valuation discussed in the literature. One of such principles says that for the valuation results to be valid and accurate,

[71] M. Melich, *Nowoczesne metody wyceny przedsiębiorstw*, Poltext, Warszawa 2004, p. 139.
[72] R. Borowiecki, *Wycena nieruchomości i przedsiębiorstw*, Vol. 2, Twigger, Warszawa 1995, p. 44.

the valuator has to collect as much information as possible about the company by interviewing the management and employees, obtain data about other companies operating within the same sector of economy, and also about the whole sector and perspectives of its development. Besides, it has to be taken into account that some parameters change in time so that the valuation model has to be dynamic and new data can be included in it at any time.

It has to be also noted that valuation requires accurate economic and financial calculations as well as very precise assumptions. A valuation method has to be chosen carefully to that it suits the situation of the company and the external conditions of its operation. It is a widespread opinion that the most appropriate approach to valuation is the one based on the value of the company's assets determined on the basis of their ability to generate profit from capital invested. Thus, the value of assets is a function of their potential to create revenue when they are effectively utilized under given market conditions[73].

Business valuation can be also useful in the decision-making process in management. It can help to make a decision whether or not to introduce a new product on the market, to make an investment, and also to predict the effects of financial restructuring, or the effects of undertaking research and development work.

Business valuation methods

There are two major groups of valuation methods: asset-based methods and income-based methods. In the asset-based type of methods, it is necessary to estimate the market value of all kinds of assets belonging to the company and all rights associated with them. The income-based methods, on the other hand, involve assessment of the company's income generating ability, which is a combination of managerial skills and utilizing resources available to the company.

Thus, the most popular and, according to many authors, the most universal[74] classification of business valuation methods consists of

- asset-based methods,
- income methods,
- eclectic methods.

These methods, together with their specific instantiations, are presented in Fig. 2.

Asset-based methods are classic ways of estimating a business value. In Poland they have been commonly applied for the sake of privatisation of State Treasury companies. The results of valuating particular types of assets and the whole company by means of asset-based methods are the most easily available, since they are based on records. Thus, business valuation is first conducted in this way, and then the results are compared to those obtained by means of alternative methods. The subject of asset-based valuation is all the types of the company assets, i.e. specific utilities, which decide about the range and character of the company operation,

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[73] P. Szczepankowski, *Wycena i zarządzanie* ..., op. cit., p. 194.
[74] R. Borowiecki, *Wycena nieruchomości* ..., op. cit., p. 51.

about the ability to meet the needs of the company and its environment as the recipient of the company produce. The utility of the particular types of assets reflects their ability to generate products and services, and consequently, income and profit.

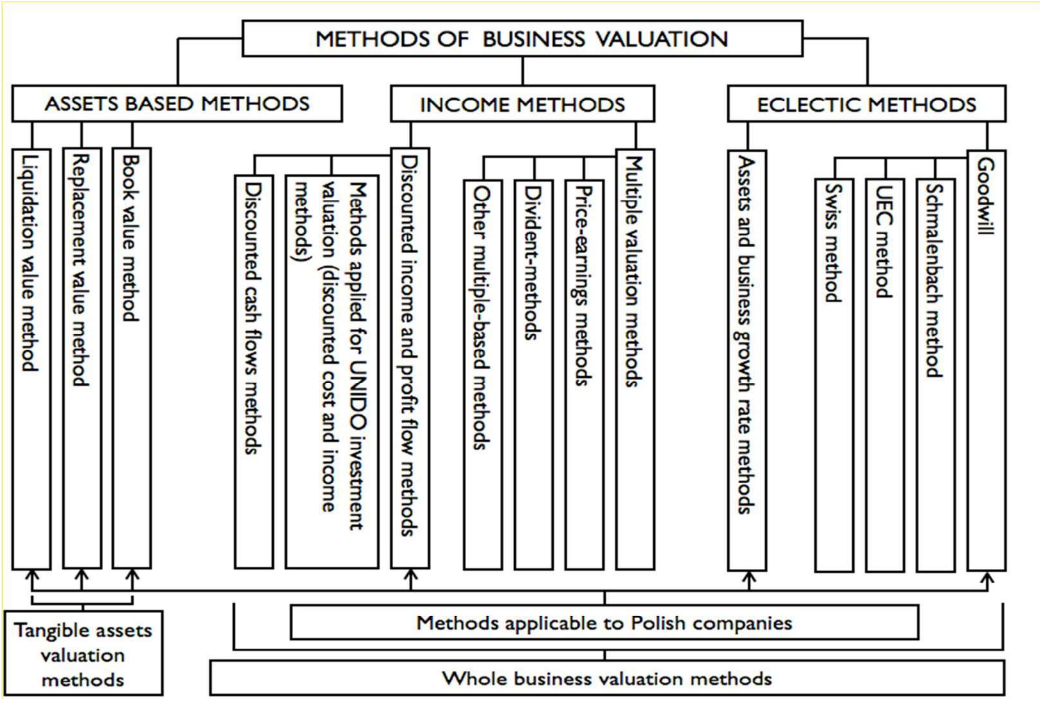

Fig. 2. Classification of business valuation methods

Source: R. Borowiecki, *Wycena nieruchomości i przedsiębiorstw*, Twigger, Warszawa 1995, p. 5

It may be the case that the market value resulting from the location of the company, its structure, the managerial skills, the quality of labour and experience of employees exceed by far the value obtained as sum of tangible assets of the company. Because of that the asset-based valuation is used as a first approximation of the company value.

Specific types of asset-based methods include[75]:

– book value method,
– replacement value method,
– liquidation method.

In the book value method, the business value is established on the basis of its balance sheet. Valuating assets is thus the fastest, simplest, and least effort-consuming method of business valuation. But the book value can diverge from a real market value in many respects: the price and related costs of fixed assets can

[75] Ibidem, p. 62.

change, especially during high inflation. Because of that it is often necessary to revalue particular assets and liabilities to determine their market value, i.e. the price most likely to be obtained or paid on the market, determined on the basis of other transactions involving similar objects[76].

An alternative approach to estimating a market value of a business is the replacement value method. The replacement value is determined on the assumption that the value of a property is equal to the cost of land, materials and construction, taking into account the present condition and wear[77]. This method is often employed by entrepreneurs who want to decide whether it is more advantageous to buy an existing company, or to build a new one. The replacement value method is very effort-consuming, since it requires not only the knowledge on the book value and condition of particular components of the property but also a confrontation with their actual condition and examination of their physical and economical wear.

The liquidation method involves estimating income which would be obtained by selling particular components of the company's property. The liquidation method is often applied in the case of companies facing liquidation, or under liquidation, and also in profit making companies, in which return on capital is, however, lower than expected. This method is often applied in Poland for valuation of privatised state-owned companies, and the results obtained are often compared to those of other methods. A potential benefit of the liquidation method is that the property inventory has to be conducted and the actual physical and economical condition of the property has to be determined, together with its effect on the liquidation price.

In market economy it is generally believed that income-based valuation methods are the most appropriate for valuating individual assets, whole companies, or organized groups of companies in order to assess the potential capital investment undertaken by a rational investor[78]. Income-based approach to valuation is based on estimating future income of the company valuated. Since there are various ways of determining a company's income as well as various ways of tying the income with value, a number of income-based methods have been created, among which two major groups can be distinguished: multiple valuation methods and discounted cash flow methods.

Multiple valuation methods, also known as relative valuation methods are based on a set of multiples existing in the capital market in a given country, calculated on the basis of a number of transactions. The value of a business is determined indirectly, by comparison to the market-assessed value of other similar businesses[79].

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[76] P. Kuraś, *Współdziałanie rzeczoznawcy majątkowego z innymi uczestnikami rynku nieruchomości*, [w:] *Współdziałanie gospodarcze podmiotów na rynku nieruchomości*, red. M. Sitek, P. Tomski, Wydawnictwo Wydziału Zarządzania Politechniki Częstochowskiej, Częstochowa 2011, p. 6.

[77] P. Kuraś, M. Kuraś, *Podstawowe zasady wyceny nieruchomości ze szczególnym uwzględnieniem podejścia kosztowego*, [w:] *Zarządzanie kosztami przedsiębiorstwa w warunkach globalizacji*, red. J. Kluska, Monografia cz. I, Wydawnictwo Wydziału Zarządzania Politechniki Częstochowskiej, Częstochowa 2012.

[78] P. Szczepankowski, *Wycena i zarządzanie* ..., op. cit., p. 202.

[79] R. Borowiecki, *Wycena nieruchomości* ..., op. cit., p. 72.

The valuation procedure consists in the following:
- selecting a multiple to be used in the valuation;
- identifying a peer group, i.e. a group of companies, or assets of similar characteristics to the one undergoing valuation;
- selecting a quantity to which the multiple will be applied;
- assessing the company value by applying the multiple to the quantity selected in the peer group.

The selection of multiples depends on the company type, operating conditions, and the correlation of particular multiples to the market value of the company. The experience of a developed market economy suggests that it is best to choose a number of various multiples and to assess the business value on the basis of an average value.

The core idea of the discounted cash flow methods is to tie the current business value with the income it is expected to generate in the future. Establishing a business value on the basis of its future income requires discounting the future cash flow in order to obtain their present value. The cash flows in question include all kinds of incoming and outgoing flows, such as income, expenditure, profit, cash resources, liabilities in consecutive years or during the whole period analysed.

Assessing a business value by means of the discounted cash flow method is a challenging task, since it includes all economical variables of a company. Because of that the method requires using a financial model. The structure of such as model has to include the sum of discounted free operational cash flows and free non-operational cash flows. Next, assets not included in the calculation of free cash flows and the discounted residual value have to be added. From the gross value obtained it is necessary to subtract the market value of the company debt and the net value of owner's equity, or the net value of the company will be arrived at.

The methods based on discounted cash flows are more accurate than other income-based methods, however, they are also more time consuming, since they require detailed estimations of a number of economical parameters, a thorough financial and marketing analysis of the company, not only in the present period, but also in the future. These methods are sometimes criticised for not taking into account risk resulting from uncertainty concerning the future conditions of a company's operation, the greater, the longer the period analysed. The uncertainty factor thus favours another variant of the income-based methods, namely the cash flow method with a residual value[80].

Concluding remarks

Summing up, it has to be noted that business value management is a systemic approach to its functioning, encompassing different, yet related areas. These areas include:
- The company's market environment, with customers, suppliers, competition, labour market resources, and knowledge and technology resources;

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[80] P. Szczepankowski, *Wycena i zarządzanie ...*, op. cit., p. 210.

- Employees and the systems of incentives, the culture of the organisation, education, training and development;
- Management systems based on various methods and styles, internal organization of the company, planning and setting a budget, technologies applied, assets and financing sources.

The VBM conception stresses firmly that the aim of the company is a continuous creation of value and the necessity of strengthening the competitive position of the company in the market.

Such a complex analysis can be carried out by means of a business valuation model. Valuation as an analytic tool of assessing a company value is necessary for undertaking a set of strategic actions leading to increasing the business value, which is the ultimate aim of management.

The paper described asset-based business valuation methods, consisting in determining the value of assets, possibly diminished by the value of liabilities. In the years of high inflation such methods, especially the book value method, proved to be inadequate and lost popularity.

The income-based methods, on the other hand, are based on the assumption that the value of a company is determined by the current value of income it is able to generate for its owners or investors. Such an approach to business value is the most useful in the practice of running a business and also the most theoretically sound according to the science of investment and finances. At the same time, estimating the income may be subjective, which is the greatest weakness of the income-based methods of valuation.

The eclectic methods lead to an average result between that obtained by means of other methods, typically the asset-based and income-based ones.

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WYCENA MAJĄTKU PRZEDSIĘBIORSTWA W ZARZĄDZANIU STATEGICZNYM

Streszczenie: W pracy przedstawiono główne obszary zarządzania wartością przedsiębiorstwa oraz scharakteryzowano podstawowe procesy występujące w zarządzaniu strategicznym. Następnie przedstawiono liczne uzasadnienia wprowadzania wyceny wartości przedsiębiorstwa oraz opisano szereg funkcji jakie mają spełniać wyceny przedsiębiorstw. Przeanalizowano wyceny majątkowe opierające się o metodę księgową, odtworzenia i likwidacyjną. Wśród metod dochodowych wyceny przedsiębiorstwa szczególną uwagę zwrócono na metodę przepływów pieniężnych.

Słowa kluczowe: wartość przedsiębiorstwa, zarządzanie, metody wyceny