How much is a company worth?

Business history is rife with companies that went bust because of errors in their valuation. These are common errors when assessing the value of a company.

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In their reports on a company's financial statements, auditors tend to use this phrase: "These consolidated financial statements present fairly, in all material respects, the financial situation" of the firm. Such was the case with the Spanish multinational Abengoa in its annual

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report for 2014.

But the true status of the company, which in November 2015 lost half of its market value, was starkly different than that suggested by its financial statements. How did it reach the verge of bankruptcy? What mistakes were made in its valuation? Did the auditors' report really reflect the company's condition?

A more thorough analysis shows that it did not. For one thing, it was almost impossible to detect the multinational's actual debt level because, as of the end of 2014, it was made up of 653 companies.

What is more, the number of companies crossing Abengoa's so-called "consolidation perimeter" every year is very high, so any year-over-year comparison of its finances is risky. One simply does not know what is being compared.

Therein lies the $64,000 question: how could a company with 2.9 billion euros in cash and cash equivalents in December 2014 find itself in trouble less than a year later?

A lack of judgment

A series of valuation errors seems to be the cause of Abengoa's fall. And, as IESE professor **Pablo Fernández** has argued, most of these errors stemmed from a lack of experience and sound judgment. Analyzing such lapses in judgment is the task of the sixth edition of his book *Valuation and Common Sense.*

In this book he shows that calculation or methodology errors, due to hasty work and simplification, can be very costly at the negotiating table or in the financial markets.

So, in order to carry out a company valuation, basic technical know-how is needed. But, first and foremost, one must have common sense and ask questions that address obvious issues. What is a company doing? Why is its valuation being carried out in a given way? For what purpose and for whom is the valuation being conducted? Most errors come from not answering one or more of these questions properly, says Fernández.

Real valuations

Fernández's book, whose 48 chapters can be **downloaded from the Internet for free**, provides the tools needed to assess any company, no matter how complex, and the know-how essential for understanding the various valuation methods.

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The book addresses well-known cases and more than 100 mistakes, and features hundreds of charts to help readers grasp the concepts that are explained.

Fernández argues that the only "conceptually correct" system for evaluating an ongoing company — i.e., one that is not being liquidated — is cash flow discounting. This method is based on a detailed forecast of all sources of positive cash flow (sales, divestments, reductions in working capital, etc.) and negative cash flow (payments to suppliers, administrative and staff costs, taxes, loan repayments, etc.).

Forecasting cash flows, their distributions over time, and the risks associated with them — along with shareholder requirements of return — are key elements in evaluating a business.

The book also examines other methods that are used frequently, such as balance-sheet-based techniques, although Fernández feels they are "conceptually incorrect" and make no sense in most cases.

Aside from cash flow discounting, the only other system the author considers valid is one based on liquidation value. But note that this is applicable only when a company is acquired with the purpose of liquidating it at a later date.

Fernández also examines a firm's break-up value, made up of the sum of the values of its different business units. From there, he moves to valuation methods used depending on the nature of the company. He next explores the key factors affecting equity value: growth, return, risk and interest rates.

The value of experience

Fernández says that in order to carry out a proper valuation it is a good idea to draw on experience and compare data with those of similar companies or businesses in the same sector. It is also necessary to be able to do a business viability analysis and have knowledge of business strategy.

Throughout the book, he makes many references to current events and recent economic history: from analyzing risk premiums (critical to determining the profitability of a company's stock) or the keys to the valuation of a government bond. The book also includes examples of Internet companies that stirred false hopes over their true value and collapsed in the dot.com bust of the late 1990s.

Also included are high-profile failures seen during the global financial crisis, where pain still

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lingers — as with Bankia and Lehman Brothers. Fernández asserts that, in these cases, it is helpful to analyze how the valuations were carried out, what the expectations and forecasts were, and how their stocks ended up performing in trading.

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