Reading between the lines

The merits of an asset-based approach to valuing businesses

Tangible assets form the core of many companies' balance sheets. These include real property (such as land, building, improvements) and personal property (including machinery, equipment, motor vehicles, furniture, computer equipment, etc.)

The 2008 financial crisis and the recent economic sentiment from the relatively low oil price has reminded investors of the instability of earnings and the associated unpredictability of the future performance of businesses. This increased risk from cash-flow uncertainty is encouraging equity and debt investors to understand the worth of a business based on the value of its underlying tangible assets.

The asset-based valuation approach is less complex and easier to apply

The asset-based approach to valuation focuses on a company's net asset value (NAV), or the fair market value of its total assets minus its total liabilities, to determine what it would cost to recreate the business. While there is some room for interpretation in terms of deciding which of the company's assets and liabilities to include in the valuation, an asset-based valuation approach is generally the easiest to apply relative to the traditional income-based and market approaches.

As an illustrative example, if we consider Company A, a pipe manufacturing business that has been operating for 10 years and has a net book value of US$7.5m, its tangible assets are estimated to have a fair market value in excess of their book value if applying the adjusted net asset approach. One of the reasons for this is that some equipment that was fully depreciated for accounting purposes is expected to have an economic useful life for years to come. In applying the adjustments, the value of the equity of Company A becomes US$12.5m.

Illustrative example Company A (US$' 000)	Net book value	Adjusted NAV
Tangible assets	12,500	20,000
Intangibles (software)	500	500
Intangibles (customer relationship)	1,000	1,000
Goodwill	2,500	
Other assets	1,000	1,000
Total assets	**17,500**	
Bank debt (loan for assets)	7,000	7,000
Other liabilities	3,000	3,000
Net book value of equity	**7,500**	
Adjusted net asset value		**12,500**
Going concern value (income-based)	***17,500***	***17,500***
Implied price/book multiple	*2.3*	*1.4*

When valuing income-generating businesses, the usefulness of this approach may be limited as it does not capture the future income-generating potential of the business or the value of its goodwill and other intangible assets. It does, however, present a reality check to the overall business valuation in providing an estimate of the potential lower end of the valuation range of the business.

The asset-based valuation provides an indication of the downside risk

In order to correctly apply the asset-based valuation approach, a fundamental decision needs to be made upfront as to whether the net tangible assets of the business comprise part of a going concern entity or, alternatively, they do not and must be liquidated.

Taking our example further, if say, due to certain new industry regulations, the prospective viability of Company A as a going concern is uncertain, it would be appropriate to understand its value under a liquidation scenario. In determining the value using this approach, the intangible assets that cannot be sold separately from the business are excluded and the value is adjusted for estimated costs of disposal; implying a value of US$9m to Company A.

In instances where the business is a going concern, an assessment of the liquidation value acts as a useful measurement aid of the downside risk for an investor by providing an approximation of the net realizable value in the event the business is wound up shortly after investment.

A value of the underlying tangible assets impacts the overall business value

A potential debt or equity investor will take into consideration the value of the underlying tangible asset when deciding on the appropriate pricing for equity or a loan rate for providing debt to a businesses with limited historical information.

Illustrative example Company A		Adjusted NAV	
(US$' 000)	Net book value	Value in use	Liquidation value
Tangible assets	12,500	20,000	17,500
Intangibles (software)	500	500	500
Intangibles (customer relationship)	1,000	1,000	
Goodwill	2,500		
Other assets	1,000	1,000	1,000
Total assets	**17,500**		
Bank debt (loan for assets)	7,000	7,000	7,000
Other liabilities	3,000	3,000	3,000
Net book value of equity	**7,500**		
Adjusted net asset value		**12,500**	**9,000**

A business with a greater portion of tangible assets on its balance sheets is considered safer for an equity investor as it may mitigate the loss potential. The higher the value of the tangible assets, the lower the potential risk and the higher the potential business value, and vice versa.

The asset lever for an equity investor

The asset lever for a debt investor

Debt investors often seek assets pledged to them by the borrower as collateral. These are viewed by the debt investor as a secondary source of loan repayment should the borrower be unable to repay the full amount. As such, all things being equal, the higher the value of the collateralized assets, the less risky the borrower, and the lower loan rates obtainable.

An asset-based valuation may not always represent the true value of a going concern

Back to our illustrative example, Company A and Company B are identical in all material aspects and have the same net book values. However, Company B has a significantly lower liquidation value as its tangible assets are not as valuable in the used equipment market. Considering its higher tangible asset backing, Company A will be perceived as a less risky investment to a potential equity investor or a debt provider. While US$9m may indicate a downside value for Company A given the operating risk from the new industry regulations, it is not necessarily representative of the actual value of Company A under a going concern scenario.

	Company A		Company B	
(US$' 000)	**Net book value**	**Liquidation value**	**Net book value**	**Liquidation value**
Tangible assets	12,500	17,500	12,500	13,500
Intangibles (software)	500	500	500	500
Intangibles (customer relationship)	1,000		1,000	
Goodwill	2,500		1,500	
Other assets	1,000	1,000	1,000	1,000
Total assets	**17,500**		**16,500**	
Bank debt (loan for assets)	7,000	7,000	6,000	6,000
Other liabilities	3,000	3,000	3,000	3,000
Net book value of equity	**7,500**		**7,500**	
Adjusted net asset value		**9,000**		**6,000**
Tangible Asset Backing (TAB)	*2,500*	*7,500*	*3,500*	*4,500*
Loan to net assets %		*78%*		*100%*

It is important to note that while making an assessment of the underlying tangible asset backing and the liquidity value is a useful tool when deciding on the value of a business, these do not necessarily represent the true value of a going concern. The asset-based valuation methods are more suited to valuation of going concern operations of asset-intensive businesses with little value from goodwill or intangibles, not-for-profit organizations or businesses to be purchased from a competitor in a similar industry.

Concluding remarks

The need to know the worth of a business is one of the most common questions that transacting parties look to address upfront. While different valuation methods may be considered in undertaking a potential valuation, the choice of the appropriate methodology is dependent on the characteristics of the subject asset being valued, the purpose of the valuation and the availability of reliable data.

While an asset-based valuation approach provides a comprehensive analysis of the asset position of a business, its benefits vary across industries. Medical device manufacturers, for example, have high levels of valuable intangible assets that may be difficult to value. In valuing a going concern the assessment of the asset-based liquidation value provides an investor the potential downside value of the business. It may, however, not necessarily represent the true value of a company.

It is important to note that while making an assessment of the underlying tangible asset backing and the liquidity value is a useful tool when deciding on the value of a business, these do not necessarily represent the true value of a going concern

In emerging economies there generally is a high level of information asymmetry and the investor has a significant information disadvantage due to opaque financial statements or undisclosed information. This has led debt and equity investors to look more closely at their downside risk, and seek asset-based valuations as a supplemental, if not an alternate approach, to the traditional income and market-based valuations. Considering the challenging market sentiments and the tightening liquidity conditions, the relevance and demand for asset-based valuations is expected to increase across the region.

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