Methods and procedures for company valuation in practice

The valuation of a company is an extremely challenging task. The following article gives you an overview of the most common reasons to commission a business valuation, the recognised methods and procedures to be chosen.

As you will notice, any scientific evaluation method provides different values – a review says very little without a professional interpretation of the individual results and the knowledge of realised projects.

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1. General information on company valuation

One must basically differentiate between the theoretical value of the company and the realisable value of the company: The theoretical value of the company can be determined using various methods, each method generates different values. Therefore, there is no right or wrong theoretical value of the company, but different values, which vary due to the varying viewpoints.

The realisable value of a company for a non-listed company can only be established in case of an actual sale. It is always a snapshot.

The methods applied can be divided roughly into two types: the net asset value and the capitalized earnings value. By way of the net asset value method, the value is determined as total assets as per the balance sheet, minus debt and obligations. The assets can be valued at book value, replacement or liquidation value. Hidden reserves must be considered accordingly.

However, to evaluate a company, it is not sufficient to use only the net asset value method. The tangible assets alone do not create value, if a corresponding income is not earned. It can sometimes also be the case that with very little tangible assets one can generate lots of income. Consequently, a company’s earning power lays an important role in the evaluation.

The capitalized earnings methods show what can be earned based on the existing assets. By applying this method, the value of intangible assets such as the customer base, market position, patents and reputation are taken into consideration. The company’s strategy, the market situation and the capabilities of the management have an impact on the company’s earning power and ultimately its value.

2. Reasons and occasions for a company valuation

The reasons for carrying out a business valuation are varied. In the context of a corporate sale or succession planning, the business valuation is essential for determining the price. The company valuation is also a very valuable tool in context of the strategy definition and selecting the best alternatives. Company valuations continue to be required in legal cases as part of an expert report as well as in the determining and distributing inheritances.

2.1 Company Sale/Succession Plan

Should you as the owner of your company decide to either sell or otherwise plan the succession of your company, it is important to assess the company’s value. When evaluating a company it is understood that the determined value is a snapshot. During the price negotiation phase different scenarios (conservative, realistic, optimistic) for key value drivers can be taken into consideration. The assumptions regarding the value drivers will differ depending on the viewpoint. Consequently, the eventually paid price will vary in most cases from the calculated value paid as additional specific and subjective aspects of negotiation will enter the price finding process.

2.2 Strategy definition

Based on a company valuation and the derived lessons learned, improvement measures can be established in respect of a subsequent sale of the company. As the drivers of the shareholder value are made transparent via a company valuation, it is possible to use it to (re)align strategy. It makes sense, for example, to assess individual cost components as to their value contributions. The use of personnel, premises and the tied up capital (such as machinery or vehicles) should be scrutinised and checked rigorously for possible savings. On the revenue side it is essential whether the generated revenue of a business unit also has a positive impact on the overall profitability of the company or a negative one.

2.3 Arbitration value

When parties are in a dispute, it may be necessary to determine the arbitration value of a company. As an example, a divorce proceeding can be named here, where there will be a dispute over the contribution of the company value in relation to the overall wealth situation. Business Broker AG has experience in the preparation of court reports and takes on corresponding mandates.
2.4 Inheritance

Would you like to know what the value of your business is and what value you want to leave your descendants one day, then it is essential to determine a company’s value, which is not only theoretically correct, but can also be achieved. We will help you determine a value that does not lie beside the market and is based on realistic assumptions.

If you have undergone the painful experience of having lost a family member who has built up a company over the years and you (possibly jointly with other heirs) are now faced with the issue of succession, it is imperative for the parties to use a comprehensible company valuation oriented on effective market prices as a decision basis.

3. Company valuation methods

There are a variety of company valuation methods, which as described above are divided into two basic categories: net asset value method and capitalized earnings method. In addition, there are market value methods (multipliers, multiples), which are used in valuations and with which the results of other methods can be check for plausibility. It analyses what has already been paid in past transactions (Transaction Multiples) or what will be paid on the stock exchange for market prices (Trading Multiples). Furthermore, there are valuation methods that are theoretically correct, but are not relevant in practice in the context of SMEs, as they are simply not appropriate or are of too little importance or not documented enough (e.g. the valuation using the real options theory). In practice it is customary to use a mix of the relevant methods. The valuation mix applied may vary from industry to industry, however, it is based on the experience made and the expertise acquired from completed projects.

Business Broker AG has extensive practical know-how, which it can draw on for each individual valuation mandate.

3.1 Entity vs. Equity Approach

With all valuation methods, two different perspectives and approaches can be pursued. The entity approach takes into consideration all financial streams which belong to equity owners as well as debt providers. In other words in this case the company as a whole is valued and its gross value is determined, called enterprise or entity value. By deducting interest bearing debt and other financial obligations from the enterprise value, the equity value or net enterprise value is derived. This value can also be determined directly by applying the equity approach which only capitalizes financials streams which belong exclusively the equity owners, i.e. shareholders. One application of the equity approach is the valuation of shares, which for practical reasons is limited to publicly traded corporations.

3.2 Net asset value method

With the net asset value method, all existing assets are on the balance sheet are summed up. Most commonly the net asset value is determined according to on going concern values (so-called reproductive values). All assets together form the total of the company’s assets and referred to as the gross asset value. To work out the net asset value of the company, i.e. the intrinsic value of equity, the debt (all debt and liabilities of the company) is deducted from the gross asset value.

\[
Netto-\text{Substanzwert} = \sum_{i=1}^{1} \text{Vermögensteil (Aktivum)}_i - \text{Fremdkapital} - \text{stille Reserven} \times \frac{\text{Steuersatz}}{2}
\]

3.2.1 Book value, hidden reserves and deferred taxes

The assets as per the balance sheet represent book values and need to be revised first. The difference between the book values and the actual values (the replacement values) includes hidden reserves. Hidden reserves may result in latent taxes on the incremental earnings in case such hidden reserves are dissolved. The deferred taxes can be taken into account when calculating the net asset values, by multiplying the valuation difference (between book values and replacement values) by half the tax rate and subtracting it from the net asset value. Using half of the tax rate takes into account the delay for when the taxes are due (time value of money) and, on the other hand, the ability to plan the dissolve of such hidden reserves (the tax burden will not turn out quite so high).
3.2.2 Going concern value (reproduction or replacement cost)

With the net asset value assuming going concern, the assets are valued at today’s replacement cost at market prices. The going concern value indicates how much the replacement cost would amount to in order to repurchase the company’s assets. In order to determine the replacement values, current repurchase costs can be used from which the depreciation (consumption value) is to be deducted on grounds of age.

3.2.3 Liquidation Value

The net liquidation value is the value that can be obtained by sell off the assets and deducting all liabilities and related liquidation costs. It should be noted that in case of a liquidation, the realized prices may be lower due to the tight time frame and the particular application range of the assets to be liquidated.

3.2.4 Non-operational assets

When valuing a company using the net asset value method, the operational assets are added up in the first place. The company may have, however, additional non-operational assets such as real estate, which are not related to the operational activities, or there is excess liquidity on the balance sheet that is not needed for the operation (this is usually not the case for smaller companies). These non-operational assets are to be listed separately and added to the net asset value while being disclosed separately.

3.2.5 Conclusion for the intrinsic value method

The net asset value is a snapshot of all assets of a given company. The net asset value represents the effective value of the equity, i.e. the asset values corrected for hidden reserves and pending taxes, minus the debts or liabilities of the company. The net asset value can be interpreted as the lower limit of a valuation of a company because tangible assets are physically present at the time of the valuation.

3.3 Capitalized earnings methods

The capitalized earnings or simply earnings methods evaluate a company based on the anticipated sources of income, which the company will generate for the company owners in the future by using its existing substance. The future sources of income may be in profits or cash flows. The individual earning value methods can be distinguished depending on the various income streams. The widespread Discounted Cash Flow method, considered a standard valuation method, is based on a cash flow whereas the pure earning value methods and also the excess profit methods are based on some form of profit. So-called dividend models (e.g. discounted dividends or the dividend growth models) are based on expected revenue in the form of dividends that accrue to the benefit of the shareholders in the future. The dividend models are not listed here, because they are relevant for stock exchange listed companies with a constant dividend.

3.3.1 Basic principles of the earnings based valuation methods

3.3.1.1 Time value of the money and consideration of risks

Earning value methods are all based on the same methodology: Anticipate future income that accrues to the company owners and discount it back to the point in time of the valuation. The underlying concept is that of the time value of money. This means that a franc is worth more today than tomorrow, as the money today can be invested at a specified interest rate. In addition to the time value of money, the risk is taken into account, with which the returns vary in the future, which is referred to as volatility. The higher such volatility, the higher the risk and therefore the cost of capital with which the projected income streams are discounted, i.e. discounted back to the point in time of the valuation. The cost of capital is an interest rate that considers both the temporal component mentioned, as well as the perceived risk. Discounting specifically means that a future stream of income (FS) is divided by the term \((1 + \text{interest rate})^{\text{period}}\) to obtain the todays value of such income (present value). The earnings to be valued can take the form of profits or cash flows, which accrue at the end of each fiscal year to the company owner.

\[
\text{Endwert} = \text{Barwert} + \text{Barwert} \times \text{Zinssatz} = \text{Barwert} \times (1 + \text{Zinssatz})
\]

\[
\text{Barwert} = \frac{\text{Endwert}}{(1 + \text{Zinssatz})}
\]
3.3.1.2 Determining the cost of capital

The cost of capital has a major impact on a company's value, since the projected streams of income will be discounted at this cost of capital. The cost of capital is composed of the expected rates of returns of the equity owners (cost of equity) and the expected return of debt providers (borrowing costs). To determine the cost of capital, the cost of equity is weighted with the equity ratio while the interest rate on the debt multiplied by the debt ratio. For the cost of debt, corporate taxes are also taken into account because the interest expenses are tax deductible. Hence the abbreviation WACCₜ (tax-adjusted Weighted Average Cost of Capital) is used (see Section 3.3.2 Discounted cash flow method). Equity is the most expensive, long-term bank debt the cheapest form of capital. The required rate of return of the equity investors is much higher than that of debt providers. By borrowing funds (for example in the form of a bank loan), the total capital costs are reduced, thereby changing the financing structure (it is the so-called financial leverage effect).

The required rate of return of equity can be determined using CAPM (Capital Asset Pricing Model). In this model a risk premium is added to the risk free rate (i.e. for 10-year government bonds) and where applicable further risk premiums are added for the limited tradability (for listed companies) and the size (in case of small and medium-sized, unlisted companies) of any company. The risk premium is derived from the product of the equity beta βₚₑₚ and the market risk premium or market returns. The equity beta βₚₑₚ indicates how much the stock price fluctuates compared to the market (e.g. in Switzerland SMI or SPI). The empirical determination of the equity beta βₚₑₚ requires a stock market listing. Since each company has a different funding structure and capital structure, this must be taken into account when calculating the beta. This is done by using the so-called Hamada's formula, which transforms the beta values βₚₑₚ of a stock market (this refers only to the business risk) into the βₑₚₑ, which in addition to the business risk also incorporates the notion of the company-specific financial risk. For unlisted companies, determining the cost of equity is more difficult because no or very little empirical data on market beta derivation is available. In determining the betas, the experience of past transactions, especially in the field of small and medium enterprises (SMEs), plays a very important role. In addition, comparative values of publicly traded companies in the same industry can be used.

\[
WACCₜ = \left( kₚₑₚ \times \frac{FK}{GK} \times (1 - s) + kₑₚₑ \times \frac{EK}{GK} \right) \times (rₕ - rₜ) + \text{Risikozuschläge (Handelbarkeit + Größe)}
\]

\[
kₑₚₑ = E( rₑₚₑ) = rₕ + \betaₑₚₑ \times (rₘ - rₜ) + \text{Marktrendite} \]

\[
\text{Hamada-Formel: } \betaₑₚₑ = \beta \times \left[ 1 + \frac{FK}{EK} \times (1 - s) \right]
\]

Wobei:
- E( rₑₚₑ): erwartete Eigenkapitalrendite
- kₑₚₑ: Eigenkapitalkostensatz (an die Kapitalstruktur angepasst)
- kₚₑₚ: Fremdkapitalkostensatz
- rₕ: risikoloser Zinssatz (risk free rate)
- βₑₚₑ: Aktienbeta (levered)
- βₑₚₑ: Gesamtkapitalbeta (unlevered)
- rₘ: Marktrendite bzw. Marktrisikoprämie

3.3.2 Discounted Cash Flow Method

The discounted cash flow method (DCF) is, as the name suggests, a cash flow-based company valuation method. In a first phase, the projected free cash flows have to be derived and then discounted to the present using the tax-adjusted average cost of capital WACCₜ.
3.3.2.1 Calculation of Free Cash Flows (FCF)

Free cash flow estimates the cash flow from business operations, which, after investment in net operating working capital and fixed assets are freely available to the owners of the company's owners.

Free Cash Flow at Entity Level is derived as follows:

\[
\text{EBIT (Earnings before interest and taxes)} - \text{Taxes on EBIT} = \text{NOPAT (Net operating profit after taxes)} + \text{Depreciation on tangible assets} + \text{Amortisation of intangible assets} - \text{Increase / - Reduction in Net Working Capital} - \text{Capital Expenditures (Capex)} - \text{Additions to Goodwill} = \text{Unlevered Free Cash Flow (at enterprise/entity level)}
\]

The DCF method according to the entity approach is considered Best Practice when it comes to valuing a company, whereby the free cash flows are discounted based on the tax-adjusted average cost of capital \(\text{WACC}_s\). The tax adjustment with the \(\text{WACC}_s\) is necessary because in the calculation of free cash flow, taxes are directly deducted from EBIT (earnings before interest and taxes). This is theoretically incorrect because the borrowing costs are tax deductible and so taxes must not be subtracted directly from the EBIT, but from the EBT (earnings before taxes) - (disclosure of too high taxes). However, since in practice it is difficult to predict the exact taxes applicable, the "incorrectness" mentioned is corrected via the \(\text{WACC}_s\), as the tax shield will reduce the overall cost of capital.

A projected income statement has to be drawn up for the next 4-5 years, starting from a valuation point. A simplified scenario is worked with for the time period beyond the initial 4-5 years. A so-called residual value is determined. Here, the assumption is made that the investment currently meets the depreciation, such that the free cash flow on entity level to be discounted equals the NOPAT (Net Operating Profit after Taxes). The gross value of the company consists of the present value of free cash flows at the Entity level and of the present value of the residual value.

To obtain the net value of the company, the value of equity, the net debt is subtracted from the company's gross value.

\[
\text{Unternehmenswert (netto)} = \sum_{t=1}^{T} \frac{\text{FCF}_t \text{ (Entity)}}{(1 + \text{WACC}_s)^t} + \frac{\text{NOPAT}_{T+1}}{\text{WACC}_s \times (1 + \text{WACC}_s)^T} - FK
\]

3.3.2.2 Residual value, planning horizon, eternal growth

The difficulty in defining the planning horizon is the weighting of the residual value. The greater the number of planned years, the more difficult it is to plan the future free cash flows. On the other hand, the impact of the residual value is reduced. It therefore makes sense to forecast only about 4-5 years, as these are justifiable and understandable, and as trade-off accept a higher proportion of the residual value on the company's value.

When planning future profits or free cash flows one can make the assumption that profits should show an eternal growth after the planning horizon. In the denominator of the DCF formula, the growth rate \(g\) is then subtracted from the \(\text{WACC}_s\). The assumption of perpetual growth at the NOPAT level has a significant impact on the valuation and must be viewed with great caution and above all be based on a reasonable and well founded justification.
3.3.3 **Pure earnings value method**

Aside from a detailed planning of the future years, one can perform a simplified earnings value calculation. Here it is assumed that a perpetual profit (before interest payments) can be achieved and that this profit is equivalent to the free cash flow at entity level. This stems from the fact that there are no changes in working capital and that investments just meet the depreciation, which implies that only replacement investments will be made. The resulting profit is regarded as eternal and is discounted with the tax adjusted WACC, because the taxes in the calculation of EBIT (earnings before interest) are not calculated correctly.

\[
\text{Unternehmenswert (netto)} = \frac{\text{NOPAT}_T}{\text{WACC}_g} - \text{FK}
\]

3.3.4 **Goodwill**

The difference in valuation between the earnings and net asset method is called goodwill. Goodwill describes the part of the purchase price, which is paid in addition to the value of the material asset on the balance sheet, e.g. for the customer base, reputation, brand, market position, access to the work related performance of employees and for other intangible assets. The amount of goodwill depends among other factors on the industry sector. If a company with a capital intensive business is sold, the goodwill in relation to the sales price is considerably lower than in the case of a pure service company, where there are few tangible assets on the balance sheet.

3.3.5 **Weighted average method (practitioner method)**

The average method represents a weighted average of the net asset and capitalized earnings value.

\[
\text{Unternehmenswert (netto)} = \frac{x \times \text{Ertragswert (netto)} + y \times \text{Substanzwert (netto)}}{(x+y)}
\]

**Schweizer Methode**

\[
\text{Unternehmenswert (netto)} = \frac{2 \times \text{Ertragswert (netto)} + \text{Substanzwert (netto)}}{3}
\]

3.3.6 **Excess profit methods**

The intrinsic value method and the discounted cash flow method can be combined by using the excess profit method. Here recoverable excess profit is added to the gross asset value over a certain period T. The excess profit is the difference between the budgeted profit after tax (NOPAT) and the regular profit, which is the product of asset value and the tax-adjusted cost of capital (WACCₙ). The budgeted profit can be higher than regular profit, for example due to a strong market position, due to competitive advantages, but it is time limited. The excess profit adopted for a certain period is capitalized with the present value annuity factor, composed as in the following formula:
3.4 Market Value Method (multipliers, multiples)

In the case of publicly listed companies, the corporate value can be compared with the prices paid on the stock exchange (trading multiples) or with the acquisitions, transaction prices (Transaction multiples) where paid prices are known to the public. Trading multiples and transaction multiples are summarized under the term of market multiples (multipliers). Important Market multiples are revenue, EBITDA, EBIT, net profit multiple, the price-earnings ratio (PER or P/E ratio) or the Market-to-book ratio, where the multiples are always a multiple of the indicated key figures. Applying multiples of stock traded companies in the context of private companies can prove to be relatively difficult. A comparison may be of use to establish a price range.

With the multiple-evaluation it is important to start from the same base. Either one rates at the corporate level (enterprise value, gross, unlevered) or at the equity level (equity value, net, levered). It is also useful to form an average of the respective multiples, so as to balance a possible bias or offset. Moreover, it makes sense to form an average over several years for each multiple used.

3.5 Owner’s profit (at EBITDA level)

Particular attention is given to the important EBITDA Multiple. EBITDA stands for Earnings before interest, tax, depreciation (fixed assets) and amortisation (on intangible assets). This represents an important tool in corporate valuation especially for small and medium-sized companies. This multiplier is independent of the financing structure and investment cycle and therefore one of the most meaningful multipliers. A company that has just made significant investments finds itself confronted with a higher depreciation and a lower profit than a company that has made no investments over a longer period of time.

The owner’s profit based on the EBITDA represents the actual cash flow generated for corrections. If the gross salary (including benefits) of the owner is added to the EBITDA, this results in the owner’s profit which can be used according to the owner’s discretion. Multiplied by a certain factor, this represents a fundamental price indicator in particular when evaluating small and medium-sized companies, where a DCF valuation may not make much sense. The origin of the term: owner’s profit (EBITDA) or owner’s cash flows is an Anglo-American term. Usually the owners themselves are active in the company and will benefit from various discretionary expenses paid for by the company. If he/she were a regular employee, he/she would have to finance for such spending out of his salary.
The starting point for calculating the owner’s profit at EBITDA level is always the EBITDA according to the financial statements. To which the following adjustments or corrections are to be made:

- **EBITDA according to the financial statements**
- Addition of the gross salary of the owner or owners (including bonuses, bonuses and benefits)
- Addition of additional charges which are not included in the gross salary
- One-off addition/subtraction, non-recurring expenses/revenues, which were debited/credited to the P&L account
- Addition/subtraction income/expenses not operationally required, which were debited/credited to the P&L account
- Addition/subtraction of income/expenses of a private nature, which were billed to the business
- Addition/Subtraction formation/release of hidden reserves
- Addition of easily and quickly realisable savings
- \[ = \text{owner's profit at EBITDA level} \]

With over 400 sales of companies over the past ten years, Business Broker AG has built up a very valuable database in terms of multiples, which are actually paid in the area of SMEs. Of course, this requires a prior adjustment of the financial statements as described above.

### 4. How to proceed during a company valuation

To perform a meaningful due diligence, regardless of the method chosen, some key steps have to be undertaken:

- Adjustments in the financial statements
- Business valuation with a method mix
- Comparison and interpretation of results

#### 4.1 Adjustments in the financial statements

The balance sheets and income statements for the past 3 years must be adjusted for non-operating, and extraordinary personal income and expenses or assets and liabilities. Examples of this can include rented business premises, which are shown as an expense in the P&L account, but are not required for the business activities. Or the owner runs an expensive car and pays for its leasing costs through the business. These additional expenditures are to be neutralized or to be ignored.

#### 4.2 Company valuation method mix

The presentation and selection of valuation methods always give rise to discussions. First, it should be noted that any given company valuation method is limited to its own explanatory power. In our experience, the mix of company valuation methods has proven to be useful. First, the lower limit of a valuation range is determined by using the net asset method. Subsequently, the capitalized earnings value is determined by using the discounted cash flow method and is weighted and combined with the earning value indicated by multiples, which is already a temporal and methodological average. This allows us to combine our extensive experience from past transactions (transaction multiples) and the discounted cash flow method.

#### 4.3 Comparison and interpretation of the results

##### 4.3.1 Plausibility check

The plausibility of the valuation results can be done through technically simple valuation methods, such as the pure income capitalization method. This makes sense particularly with the discounted cash flow method, in which the cost of capital, the planning figures and the residual value represent particularly value-sensitive factors. Furthermore, plausibility checks can be made with multiples. Crucial when interpreting the valuation results is the experience of the respective consultant based on past projects. An experienced consultant can use his knowledge of the existing company valuations that come from different industries and are characterized by a variety of company-specific traits, to the benefit of his/her clients. Over time, he/she has developed a practical and goal-oriented perspective and is able to assess very whether a determined company value is reasonable and whether the applied mix of methods makes sense or not.

When executing a company valuation, assumptions are made regarding the sales development and the development of costs (staff costs, material costs, other operating expenses). Also to apply any earnings based method, a
certain cost of capital has to be fixed and used for discounting the various streams of earnings. As the future is
certain, it makes sense to work with different scenarios (conservative, realistic, optimistic), especially with re-
gard to the sales projections of a company, which may depend in particular on the industry or market develop-
ment. The other highly sensitive element in an earnings based valuation is the cost of capital applied (company-
specific risks). By changing the cost of capital, it is easy to see how sensitively the earnings based value reacts.

4.3.2 Traceability

Particularly when using earnings based methods (particularly the DCF method), it is essential that the assump-
tions are reviewed critically. In order to do so, one has to analyze a company’s business model and key value
drivers in detail such that their impact on the valuation becomes clear. By completing a purely technical valuation
on the basis of a business plan or planning figures (plan P&L statements, projected balance sheets, schedules of
cash flows) the job is not done. The assumptions must be well founded, so that an outsider sees and also under-
stands the most important value drivers of the valuation of a business.

5. Conclusion

The company valuation is not about finding the absolutely correct value. Company values do not represent purely
objective values, instead they are based on many subjective assumptions. The goal of a company valuation is to
determine a value bandwidth, which can be used for plausibility and communication purposes. The valuation
bandwidth based earnings is due to the fact that different scenarios (conservative, realistic, optimistic) and various
other assumptions were made. The income/cost development is evaluated and so are the business and financial
risks of the company and the industry development is accessed according to different variants. The lower limit of
the value range is determined based on the net asset value that is largely physically present in a given company
and which may vary depending on the capital intensity of operations. Based on one of the earnings scenarios
used, the top end of the valuation range will be determined. As a consequence of that, the goodwill to be at-
tained will be the difference between top end of the valuation range and the net asset value. All the results ob-
tained in the context of a company valuation require expert assessment and a plausibility checking. Only those
who can see the value driving factors and assess the underlying assumptions in detail, will be in a position to
interpret the calculated value of the company properly.