



# EVALUESERVE

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## Mastering the Art: **Deciphering** Financial Modeling Secrets

As rightly emphasized by Aswath Damodaran, valuation is both a science and an art. Factors including the perspective of value, purpose of valuation, what is being valued, premises of value and date of valuation play a vital role in a valuation process. In fact, a good valuation is an outcome of two effectively executed steps: choosing the appropriate valuation methodology and building the financial model to reach the appropriate valuation

## Corporate Valuation and Financial Modeling

Corporate valuation forms the bedrock of contemporary investment strategies and risk management practices. In the intricate world of investment banking, the art of valuation and financial modeling stands as a pivotal pillar in the Deal Execution process. However, the concept of valuation itself is far from absolute as it resides in a realm of uncertainty, characterized by the intricate interplay of assumptions, projections, and circumstances.

### Selecting Valuation Approach

The value of a business/or an asset can vary significantly based on the approach and methods used. Selecting the most appropriate techniques to accurately capture the essence of the company's value, is the most important step in valuing the Company.

Once a mix of appropriate valuation technique is finalized, it is then an alchemical process of assigning a value on the business based on its operating and financial data, put together as a financial model.

There are many different possible techniques to arrive at the value of a company – a lot of which are company, industry, or situation-specific. Some of the key factors to be accounted, before finalizing the valuation mythology includes:

- **Purpose of Valuation** – Are you valuing the company for a potential sale, for financial reporting, for litigation, or for internal strategic decisions? Different purposes might require different methods to emphasize different aspects of the company's value.
- **Nature of the Business** – Some industries have unique characteristics that might require specialized valuation techniques. For instance, technology companies might heavily rely on market-based approaches, while asset-heavy industries like manufacturing might require an asset-based approach.
- **Availability and Quality of Data** – Some valuation techniques demand more historical financial data and market information than others. If reliable data is scarce, you might need to consider techniques that rely on broader economic indicators or industry benchmarks.
- **Stage of the Business** – The valuation technique will vary based on the company's growth stage. There are different methodologies and valuation techniques used for start-ups, as compared to those used for large / mature corporations.
- **Risk and Uncertainty** – Some methods, like the DCF approach, require assumptions about future cash flows and discount rates, making them sensitive to changes in those assumptions. If the business carries a high level of uncertainty, you might consider methods that account for this risk, such as the option pricing model.

## Types of Valuation Methodologies

The above-mentioned points can help in selecting an appropriate methodology for valuation. However, a single approach might not capture the entirety of a company's worth. To account for this inherent diversity, a prudent practice in valuation involves employing a range of techniques, such as the Discounted Cash Flow (DCF) method, Leveraged Buyout (LBO) analysis, and Comparable Company Analysis.

These are then used to prepare a "football field" of valuations. This field delineates a range of potential values, from conservative to optimistic, allowing decision-makers to grasp the spectrum of possibilities and make more informed choices based on a comprehensive understanding of the company's intrinsic worth. The most common ones that are frequently used, are presented below:

Valuation Methodologies	Description	Specific Value Drivers	Common Operating Drivers
<b>Comparable Companies</b>	<ul style="list-style-type: none"> <li>Based on the trading multiples of comparable companies / peers</li> <li>Based on the nature of business and availability of data, an appropriate multiple (current, historical, or estimated) may be selected</li> </ul>	<ul style="list-style-type: none"> <li>Current Capital Market Performance</li> <li>Relative performance to peer companies</li> </ul>	<ul style="list-style-type: none"> <li>Industry outlook</li> <li>Company's Historical Performance</li> </ul>
<b>Precedent Transaction</b>	<ul style="list-style-type: none"> <li>Valuation based on the actual multiples paid for comparable companies / peers, in past M&amp;A transactions</li> <li>Based on the nature of business and availability of data, an appropriate multiple (current, historical, or estimated) may be selected</li> </ul>	<ul style="list-style-type: none"> <li>M&amp;A market momentum</li> <li>Control premium paid</li> <li>Synergies</li> </ul>	<ul style="list-style-type: none"> <li>Growth outlook</li> <li>KPI metrics</li> <li>Strength of Balance Sheet</li> </ul>
<b>Discounted Cash Flows (DCF)</b>	<ul style="list-style-type: none"> <li>Valuation based on the present value of projected free cash flows</li> <li>Based on the stage of Company's business (growth stage), quality of data, risk, and uncertainty.</li> </ul>	<ul style="list-style-type: none"> <li>Cost of Capital</li> <li>Terminal Growth Rate</li> <li>Free Cash Flows</li> <li>Discount rate Assumptions</li> </ul>	<ul style="list-style-type: none"> <li>Current ownership and capitalization structure</li> <li>Differentiation of product or service</li> <li>Management track record</li> </ul>
<b>Leveraged Buyout (LBO)</b>	<ul style="list-style-type: none"> <li>Valuation is based on price that a financial buyer would be willing to pay based on targeted IRR</li> <li>The approach assumes a leveraged capital structure and is dependent on the cash flow profile of the asset, and the exit value</li> </ul>	<ul style="list-style-type: none"> <li>Factors related to Credit</li> <li>Free cash flow</li> <li>Required returns</li> </ul>	<ul style="list-style-type: none"> <li>Reputation and market feedback</li> <li>Competitive Landscape</li> </ul>
<b>Sum-of-the Parts (SOTP)</b>	<ul style="list-style-type: none"> <li>Valuation based on sum of valuation of individual operating segments/ assets of a Company</li> <li>Based on standalone valuations for respective segment using DCF or Comparable method</li> </ul>	<ul style="list-style-type: none"> <li>Level of comparability</li> <li>Availability of division's financial metrics</li> </ul>	<ul style="list-style-type: none"> <li>Organic &amp; inorganic growth opportunities</li> <li>Synergies</li> </ul>

The process of finalizing the valuation methodology is of the utmost importance as this becomes the basis for the structure of the financial model. The financial model takes into account the quantitative and qualitative characteristics of the business. Building the financial model itself is the art of presenting the data into insights, which are then used for valuations. A meticulously built financial model is the lighthouse that guides valuation efforts, providing clarity in a sea of variables.

## Financial Modelling: Best Practices

Financial Modelling is a process of transforming raw data into a dynamic representation of a company's financial health and future prospects. This process involves crafting intricate spreadsheets that incorporate historical financial data, market trends, growth projections, and industry benchmarks. The model becomes an arena where different scenarios play out, offering insights into potential outcomes under varying circumstances. Within the excel spreadsheets, cells and formulas, the financial model captures the essence of a company's operations, revealing the intricacies of its revenue streams, cost structures, and investment strategies.

The breadth and depth of the model's inputs and outputs determine its capacity to simulate real-world complexities. While historical financial data provides a foundation of authenticity, assumptions breathe life into the numbers, enabling exploration of the future's potential hues. The outputs of the model offer a window into what lies ahead. These outputs may range from a detailed three statement, working capital, and debt schedules, among others.

A well-built financial model doesn't merely offer isolated calculations; it weaves these figures together into a narrative that illuminates the company's journey forward. Further, the model built becomes the first point of input for the prospective buyers, for understanding the value, and creditors, who aim to assess the risks associated. Therefore, transparency is not an option but a necessity, enabling the parties involved to understand the narrative the model tells. Some common dos and don'ts are as follows:



### Do's

- ✓ Plan, design, and structure the model upfront – data should flow from inputs to outputs, without any exception
- ✓ Have an assumption sheet and ask the right questions
- ✓ Use consistent structure and formulas
- ✓ Use schedules – keep it simple by breaking down into intermediate steps using flags
- ✓ Use color coding: (blue for hardcodes, black for formulas, green for links to other sheets)
- ✓ Add a check sheet
- ✓ Limit the file size and clean the model regularly`



### Don'ts

- ✗ Don't mix input, calculation, and output – makes it hard to understand and navigate
- ✗ Don't hardcode data into formulas – makes it tough to track, review, and edit
- ✗ Don't overcomplicate the structure and formulas – makes the model difficult to review
- ✗ Don't overengineer – build complex logic around parts that do not drive the business decisions
- ✗ Don't neglect color coding – since it becomes hard to audit and to find errors
- ✗ Don't have checks scattered across the model
- ✗ Don't keep unused named ranges and clean the

## Conclusion

The assessment of corporate valuations serves as the fundamental building block for modern investment approaches and the implementation of risk management procedures, establishing a primary basis for decision-making in the field of investment banking. The valuation process begins by selecting appropriate methodologies, a decision influenced by factors such as the purpose of valuation, the nature of the business, data availability, growth stage, and risk considerations.

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