Valuation of Shares

Introduction

In the financial world, the value of a company's shares plays a crucial role in **investment decisions, mergers, acquisitions, and taxation**.
Since the **market price of a share** fluctuates frequently based on demand and supply, it is often necessary to determine its **true or intrinsic value** — this process is known as **Valuation of Shares**.

Meaning and Definition

Valuation of Shares means determining the **real worth (intrinsic value)** of a company's shares based on its financial performance, earning capacity, assets, and market conditions.

Definition:
According to G.C. Lall,
"Valuation of shares is the process of determining the fair value of the shares of a company."

Thus, share valuation helps investors, management, and other stakeholders to **assess the fair price** at which a share should be bought or sold.

Need / Importance of Share Valuation

Valuation of shares is necessary in several situations:

1. **Sale or Purchase of Shares:**
   When shares are not quoted in the stock market (unlisted), their value must be determined for transactions.
2. **Amalgamation and Merger:**
   To fix the exchange ratio of shares between merging companies.
3. **Takeover or Reconstruction:**
   To determine compensation or the value of shares in a new structure.
4. **Taxation Purposes:**
   For wealth tax, gift tax, estate duty, or capital gains tax.
5. **Conversion of Shares or Debentures:**
   To fix the conversion ratio.
6. **Issue of Shares to New Partners or Shareholders:**
   To determine the value of equity for new entrants.
7. **Liquidation of a Company:**
   To distribute assets among shareholders according to share value.

Factors Affecting Valuation of Shares

The value of a share is influenced by various internal and external factors:

A. Internal Factors:

- Nature of the business and stability of earnings.
- Dividend policy of the company.
- Growth prospects and profitability.
- Quality of management.
- Capital structure (debt–equity ratio).
- Book value of assets and liabilities.

B. External Factors:

- General economic conditions.
- Government policies and tax rates.
- Industrial performance.
- Market competition and demand for shares.
- Interest rates and inflation.

Classification of Shares

Before valuing shares, it's important to understand the types of shares:

1. **Preference Shares:**
   Have fixed dividend and preferential rights to dividend and capital repayment.
2. **Equity (Ordinary) Shares:**
   Have variable dividends depending on profits and bear higher risk, but also higher potential returns.

Valuation techniques differ slightly between these two types.

Methods of Valuation of Shares

There are **three main methods** used for valuing shares:**A. Net Asset Value Method (or Intrinsic Value Method)**

This method determines the value of shares based on the **net worth (assets – liabilities)** of the company.

Formula:

Value per share = Net Assets – External Liabilities \ Number of Equity Shares
Steps:

1. Determine total assets (fixed + current).
2. Deduct all external liabilities (debentures, creditors, etc.).
3. Adjust for goodwill, fictitious assets, and revaluation of assets.
4. Divide the balance (net worth) by the number of equity shares.

Example:

Particulars	₹
Total Assets	10,00,000
Liabilities	4,00,000
No. of Equity Shares	10,000

Value per Share = (10,00,000 − 4,00,000) / 10,000 = ₹60 per share.

B. Yield or Profit-Earning Capacity Method

This method values shares based on the **expected future earnings** of the company.
It assumes that investors are primarily interested in the **return (dividend or earnings)** from their investment.

Formula:
Value per share = Actual Yield of Company \ Normal Yield *Paid-up Value of Share

Where:

- **Actual Yield** = Average expected dividend rate of the company
- **Normal Yield** = Market rate of return for similar companies

Types of Yield Method:

1. **Dividend Yield Method:** Based on average dividends.
2. **Earning Yield Method:** Based on average earnings after tax.
3. **Capitalization of Profits Method:**

   Value of Business = Average Profits \ Normal Rate of Return

   Then divide by number of shares to get per-share value.

Fair Value Method

This is a **combination** of the **Net Asset Value** and **Yield Method**.
It aims to strike a balance between the company's asset backing and its earning capacity.

Formula:

Intrinsic Value + Yield Value / 2
Example:

   If Intrinsic Value = ₹60 and Yield Value = ₹80,
   = (60 + 80) / 2 = ₹70 \text{ per share}

Valuation of Preference Shares

Preference shares are valued based on their **fixed dividend** and **redemption value**.

Formula (for Redeemable Preference Shares):

$$\frac{D(1 - (1 + r)^{-n})}{r} + \frac{RV}{(1 + r)^n}$$

Where:

- (D) = Annual dividend
- (r) = Required rate of return
- (n) = Years to redemption
- (RV) = Redemption value

Example:

10% ₹100 preference share redeemable after 5 years at par; market rate 8%.

$$\frac{10(1 - (1.08)^{-5})}{0.08} + \frac{100}{(1.08)^5} = ₹107.92$$

Comparison of Different Methods

Basis	Net Asset Value	Yield Method	Fair Value
Basis of Value	Assets	Earnings	Both assets & earnings
Best for	Asset-heavy companies	Service/trading companies	General purpose
Reliability	Objective	Subjective	Balanced
Simplicity	Simple	Requires estimation	Moderate

Limitations of Share Valuation

1. **Estimation Errors:** Future profits and returns are uncertain.
2. **Subjectivity:** Depends on the choice of method and assumptions.
3. **Market Factors Ignored:** Internal valuation may not match market price.
4. **Non-Monetary Factors:** Management quality, goodwill, or brand value are difficult to measure.
5. **Data Limitations:** Incomplete or outdated financial data can mislead valuation.