VALUATION

Book Value and Market Value

The Book Value (BV) of an asset refers to its – heavily regulated and commonly backward-looking - accounting value. On the other hand, the Market Value (MV) of an asset refers to the price an investor pays for it in the public or private capital markets.

For publicly trading assets, such as shares, the MV is constantly changing. The BV, however, is more or less frequently published in interim or financial statements.

Despite the fact that the ratio of the MV to the BV is a widely used valuation benchmark for analysts and investors, MV and BV have actually nothing to do with each other, as they are based on entirely different concepts.

On the asset side of a firm´s balance sheet assets are usually accounted for at historical cost or the historical price paid when acquired, with all having happened in the past. Hardly ever will the BV of assets increase, much rather decline: Fixed assets for example decline by the amount of depreciation, inventory by redundancy over time, as well as acquired stakes in other firms, if not generating as much value as had originally been anticipated.

Also, as far as the passive side of a firm´s balance sheet is concerned – alas: the firm´s funding structure – both, equity and debt are disclosed at BV. The equity, for example, - composed of shareholder equity, additional paid in capital, and retained earnings – refers entirely to past, historical events. The shareholder equity is the nominal capital of number of shares outstanding multiplied with the face value of a share, which can in essence have any nominal currency amount of choice – EUR 1, US$ 5 or 10 or SFR 0.1 or anything else. The additional paid in capital is a premium, defined as the difference between the capital per share raised in the course of a share capital increase over the nominal value of a share (as shares are usually issued at a MV / BV of more than 1). And, finally, the retained earnings position is simply the historical accrued portion of the net income of a firm which was not paid out as dividends (latter being cash leaving the firm and ending up directly in shareholders´ pockets).

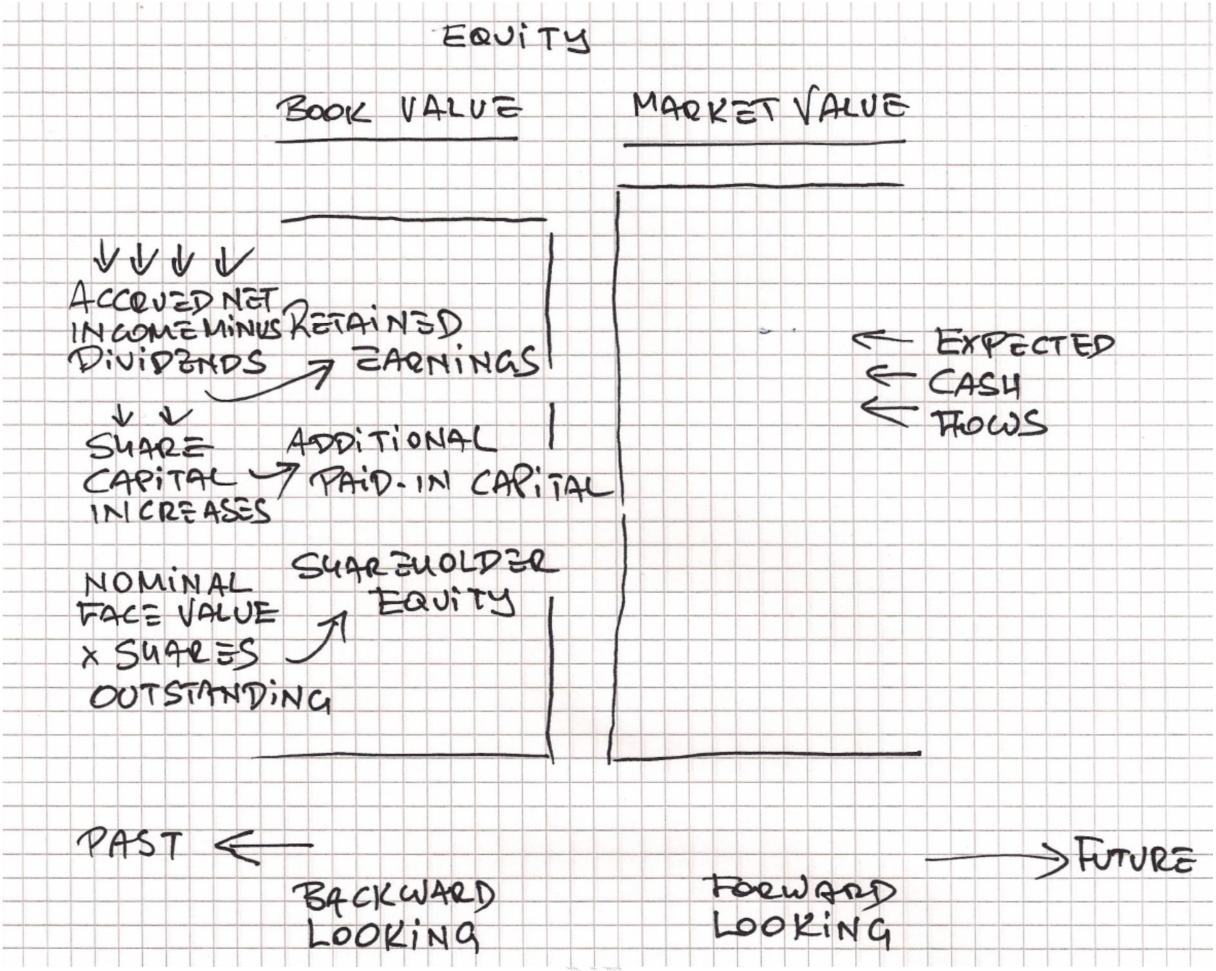
In regards to debt, its book value in principle equals the nominal value or the value which a firm owes to its creditors.

The disclosure of BVs in balance sheets is heavily regulated by local or global accounting standards, the most prominent of them being the International Accounting Standards (IAS) and the United States Generally Accepted Accounting Principles (USGAAP).

MVs, on the other hand, reflect the value of what an asset is or may be worth at this very moment. The MV of a share is – if publicly traded - the price on the stock market. The MV of a debt instrument is – if publicly traded, such as bonds – the price on the bond market. Thereby, investors will value an asset by its future value generating potential. - This is the entirely opposite approach taken by the historical, backward-looking representation of assets in accounting standards-driven balance sheets.

In regards to shares, for example, investors will estimate the firm´s potential of generating future net income and cash flows. In regards to fixed income instruments, such as bonds, investors will assess whether the issuer will be able to meet its obligations and with which certainty. Based on these assessments and – not least – the actual supply and demand for a certain security, prices will be set in the markets.

In assessing within a Corporate Finance context balance sheet structures, cost of capital, discount factors or else, it is the MV of the assets which is relevant: Only the MV reflects the investor´s point of view, regardless whether this individual holds stocks, fixed income instruments or some sort of hybrid instrument.


EQUITY
BOOK VALUE
MARKET VALUE
ACCRUED NET INCOME MINUS DIVIDENDS
RETAINED EARNINGS
SHARE CAPITAL INCREASES
ADDITIONAL PAID-IN CAPITAL
NOMINAL FACE VALUE x SHARES OUTSTANDING
SHAREHOLDER EQUITY
EXPECTED CASH FLOWS
PAST
BACKWARD LOOKING
FORWARD LOOKING
FUTURE