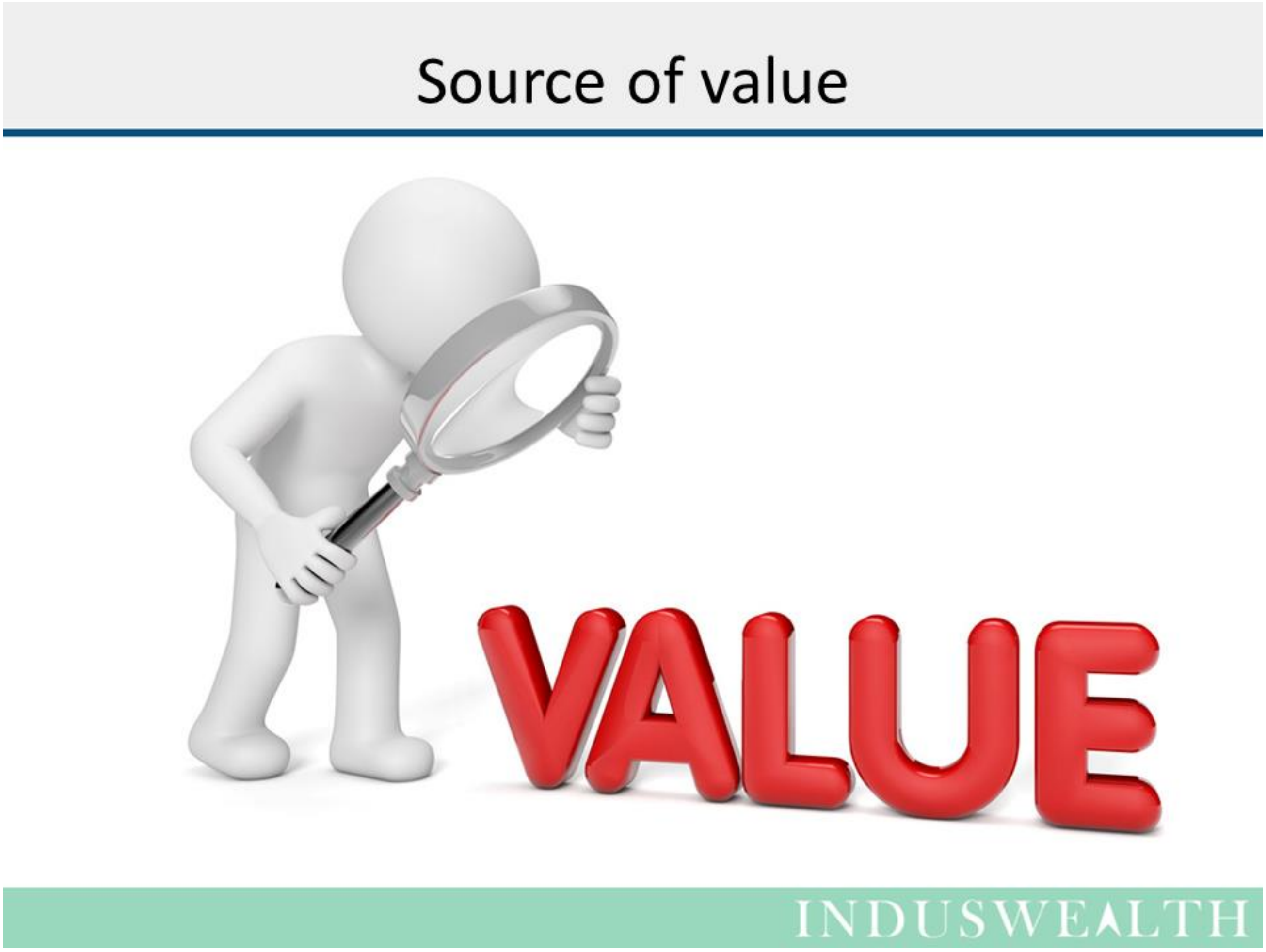
Source of Value



When I teach valuation in a B-School, I ask them how they would value the business of the tea vendor who is operating just outside their school. I always start the course with this example as most students are familiar with it (based on the number of hours they spend at that tea shop).

Initially there is a thoughtful silence where people are potentially contemplating the deep implications of the question. **I reassure them that in valuation all answers are invariably incorrect, the objective is to minimize the margin of error.** Immediately various numbers are bandied about, I very diligently try and make a note of as many of them as I can. The variation in the numbers is interesting, some are ready to pay less than what the person makes in a few months while some others are ready to pay princely sums which may justify one starting a tea shop outside a B-school rather than joining one as a student!

My next question is to ask about the reason why they ready to pay these sums – again there are some interesting answers start pouring out that are typical of B-school grads (lots of jargon). The answers include Brand, Assets, IP (!!!), etc., we just stop short of getting deep into international finance and forex. Again many of the answers are noted down.

As a next step we work on establishing a common understanding that the tea vendor has limited or no brand value as such. He has very limited assets (which include the stove and the cart), he may be paying a minimal rent or no rent for using the space. Though making tea may be quite an alchemy this may not qualify as intellectual property.

Then we get down to the brass tacks of estimating how many cups of tea the vendor sells in a day, the cost of various ingredients, and possible profit he could be making on a daily basis. These profits are then extrapolated to identify the yearly profits (thanks to the calculators on mobile phones).

Once we establish the yearly profits – we review our answers and soon some are ready to pay the vendor 6 months of profits to walk away from his bread and butter, and others are ready to pay him up to 10 years of profits.

Next question is how we would value the business if the vendor never made any profits, again we have a variety of answers, which of course includes the typical B-school answer that is “always correct” - “it depends”. We try and dive a bit deeper into “it depends” – and usually come out with a question about future profitability of our generous tea vendor who is not making any profit currently.

In an attempt to move beyond “it depends” we try and figure out how we would value the business if there were no prospects of making any profits in the future as well. At this time many are not too happy to buy this business as it looks like too much work. When we look at valuation most are not interested in paying anything for this business.

We then take a step back to look at what is that we are valuing when we are valuing a business. Some old answers like Brand do come back but we put those aside agreeing that these were already discussed. The conversation veers into profitability. To establish which profitability we are discussing – we try and discuss the case where the business was profitable till today but will not make any profits in the future. Most students are annoyed that the nature of profitability changed that morning – and again seem reluctant to pay anything for the business. Most seem not to care too much about the past profits.

We discuss the future for a bit and agree the future profits are not guaranteed – for instance the B-school may decide to chase out the tea vendors from the campus. Most students feel that the purpose of having the B-school may not remain if they get rid of the tea vendor, they also feel that it would take a very brave school management to do that. Hence they are ready to take a chance on putting a value on the business of the tea vendor despite the uncertainty

Typically a consensus emerges that **a business is valuable only if it has a potential to generate profits.** We agree that the future profits have a bit of uncertainty hence we are calling it potential to generate profits. (Although most are certain about the future profits of the tea vendor outside their school).

Having achieved this breakthrough, I only have to reinforce the concept of **“Value = potential to generate profits”** in the rest of the course.