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Editorial on Business Valuation through Simulation

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Editorial

For some time, simulation-based business valuations have been discussed as an alternative to CAPM-based business valuations. The advantage of simulation-based business valuation is that it captures the company's specific risk position through unbiased planning. This allows for the calculation of a company value that reflects the company's actual risk situation. The simulation-based company valuation is particularly suited to the valuation of medium-sized businesses, start-ups, and companies in crisis, as well as the incorporation of country-specific risks in the company valuation. A CAPM-based company valuation, on the other hand, calculates a company's risk through the capital market route under the assumption of perfect capital markets and is particularly suitable for the valuation of publicly traded companies. For some time, simulation-based business valuations have been discussed as an alternative to CAPM-based business valuations [1,2].

The Only in perfect and complete capital markets does a company's value correspond to the market price; thus, business valuation techniques are required to assign a value to future cash flows classified as higher risk. The most common and important method for this purpose is the Discounted Cash Flow (DCF) method. A utility function is not required for the DCF method. It is based on ideal market calculations in a fully functional capital market.In recent years, "semi-investment-theoretical" valuation methods, also known as simulation-based methods, have been developed based on the fundamental ideas of investment-theoretical valuation theory. In practise, these methods are used to assess investments and companies, as well as to determine ratings, risk-bearing capacity, and risk coverage. The simulation-based methods, like investment theory valuation methods, do not require the assumption of a perfect capital market, but they are far more practical. The DCF methods, which are commonly used in valuation practise, can be used with simulation-based methods. Instead of information on (historical) stock return fluctuations, such as the CAPM's beta factor, company-specific information from risk analysis and risk aggregation is used to calculate unbiased planned values of cash flows and risk-adequate returns. Furthermore, they make no mention of the formulas used in the certainty equivalent method and the risk premium method to arrive at identical company values. The necessary formulas are derived in this paper. They demonstrate how simulation risk information, as well as simulated insolvency probability and growth rate, is factored into the terminal value formula.

Furthermore, the certainty equivalent of each period will be included in the formula through a retrograde valuation in the certainty equivalent method in order to discount with the risk-free interest rate. The application of the formulas presented here is demonstrated in a practical valuation case to increase the acceptance of simulation-based business valuation in practise. A simulation-based business valuation is based on information about the company's risks, which are determined through risk analysis. In this case, the distinction is made between the risks hedged and unhedged in the company, rather than between systematic and unsystematic risks as is customary in the CAPM. These risks are modelled within the business plan using appropriate distribution functions and serve as the foundation for unbiased business planning. Following a Monte Carlo simulation, the risk measures for the aggregated risks are chosen within the context of a risk analysis. These risk measures serve as the foundation for risk analysis in a simulation-based business valuation [3-5].

Because of the growing imperfections in capital markets and the growing influence of risk management in businesses, some valuation approaches have emerged in recent years that, on the one hand, derive the risk scope of companies through risk analysis and, on the other hand, take into account the imperfections of real markets. Investment-theoretical valuation theory and simulation-based valuation theory are two of these approaches. The investment-theoretical valuation theory assumes that a decision-preferences maker's can be described as a neoclassical decision function. However, in practice, the valuation with so-called "total models" presupposes a simultaneous optimization of all action options, which necessitates unrealistic demands on the level of information.

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Conflict of Interest

None.

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