

West Hungarian University  
Faculty of Economics  
Chair of Economics Institute

"Theses of Doctoral Disertation (PhD)"

**Valuation of Medium and Small Ventures**

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Sopron  
2003

## **1. 1. The Object of Research**

By the end of the 20<sup>th</sup> century major economical and social changings went on in Central and Eastern European countries including Hungary. The socialist system based on planned activity and co-operative property changed into a capitalist system. The long transformation process was fulfilled by the change of regime. During the privatization process from the early '90s the socialist economical system was replaced by the market economy, the change over of the economical activity logistics occurred. The expansion of the market economy can be seen in the number of registered companies, number that became ten times bigger, big monopoly stock companies settled down, the foreign active capital investments appeared. The universal order established in Yalta collapsed because of economical reasons. By the end of the century the scientific and technical development came to a new stage when the exaggerated state economy advantages existing in the '50s ran out and its disadvantages amplified rapidly.

The change over in Hungary as well as in other East European countries wasn't smoth. The industrial and agricultural productivity was dramatically declined by building up the market economy, by the metamorphosing companies, by the loss of eastern markets and by inflation.

After the low altitude flying from the early '90s a relative prosperity came, the export started to grow. The relative revalorization of the Hungarian currency meant a higher increase of inflation rate in case of domestic prices than in case of export income calculated in foreign exchange. This is how the inflation was higher in case of raw materials and pover sources used for domestic purposes than the increase of their prices produced by exporting them and converted into Hungarian currency. Despite this process the

enterprises went on exporting because further reductions of production would have cost more than continuing a losing production.

The wood industry from the early '90s was characterized by a smaller dynamism in comparison with the great majority of the industry. According to the theory of industrial life cycle the wood industry – was not on the rising up side of the cycle but on the descending one. Thus, the investments and modernization of this branch of industry decreased. In case of many companies the R+D (research +development) activity was given up or at least the number of developers and producers decreased. The pessimistic outlook of the early '90s did not prove to be right. From the mid '90s on the furniture industry started developing considerably. The stretching force of growth was given by the increase of export sales.

The office furniture production and sales was considered an uprising branch since the early '90s. The appearance of the computer and of a wide range of modern infrastructural equipment induced the designers to progress. The modern office furniture that is in concordance with the spirituality of the epoche meets perfectly all the ergonomical points of view that came into being.

Besides technical development, a great change appeared in the office workplace demands. Instead of one or two seat offices there will be the so called agile offices where mobility will have a major role. One phase of the mobility is when a desk is used by more people, only the containers belong to a certain person. The remote work, the work done at home, demands appropriate furnishing for 'work' and also to fit the atmosphere of the home from aesthetical point of view.

In Hungary, which is building up a market economy, due to property transformation a lot of new questions appeared connected with economical

life. One raised question as a problem to be solved is how much the value of a venture is, how the prices can be established. At least, can it be established at all in case a company is going to be sold partly or as a whole, shareholdings appear on the market or on the stock, what the sum is that can be paid for, whether the price fits the value.

The greatest fault of the company legislation from 1989 was that it could not show any market accountancy, balance techniques, evaluation of property besides the regulations of modern Kft-Rt. (Ltd.). The balance of ventures did not express anything regarding the real value of the venture, the real value of it was worked underhand among the deformed Hungarian market conditions. The venture bookings showed a great underestimation of the property in connection with the previous Hungarian endowment and official price system. The immovable properties were mentioned having 0 or a very low value.

The value of arable land was low, too, in concordance with the previous pricing system of agricultural and foodindustry products.

The foreign investor was right when asking why the price of a company or immovable is so different from the value mentioned in the booking of it.

Analysing the history of the company evaluation theory we came to the conclusion that there are more than one concepts of value. The value as concept definition, had a similar way as any other definition in the history of economics theory.

From the objective evaluation way of looking existing between the two world wars, during the '90s it led to the subjective evaluation method. In the enterprise mission is expressed the idea that the most important aim is to maximalize the property values. The measurement of the invested capital into an enterprise and the determination of the maximalized mood of refund is the analysis of the shareholder value creation analysis. To enable

determine the property value, first you have to determine the value of the enterprise then you have to subtract the value of credits.

The enterprise value determination is done by different methods. According to one of them the enterprise value can be calculated based on property means. This method does not take in consideration the orientation of the enterprise towards the future and its capacity of producing income. If we take in consideration the fact that the enterprise is going to run on in the future, then the evaluation is based on the capacity of producing income. It cannot become real only with the help of property means, it does not consider the enterprise to be a property heap.

Despite all these, in some cases the real property is to be estimated. When a venture is not able to run further on and reaches the close down point, the agreement with the creditors cannot be put into practice but a wind up and definitive settlement procedure is being done. In both cases we cannot take in consideration the future capability of the enterprise when using the estimation procedure. In this case the property estimation is the next method of estimation which takes in consideration the existing means of production and the production of the enterprise and does not take in consideration the future means combinations.

In case of working enterprises the output valuation is the right way to follow. The determination of output valuation means such a balance price that comes out of the discounted enterprise incomes having in view the risks of capital expenses upon them. You can ask 'What do you mean by capital expenses?'. The capital expense is that sum that is expected by the investor as a reachable output as anywhere else. As a result of this, the capital expense is an alternative expense or else an alternative income but we can call it a transfer income, too.

This way of evaluation or category of values appeared based on the development of company finance, stock and enterprise theories. There is expressed the idea that the strategy, as a means of forming the future, produces values or destroys them.

The aim of the present thesis is to find the answer to the way in which the estimation flow goes on, what factors are present, what external and internal effects we have to have in view and whether the definition flow is objective or subjective.

The specialists in economics and managers have to think over why a value is a value, how can it be approached, whether the value of an enterprise can be transformed into a numerical item.

There is no need to explain the timeliness of the writing up of the subject. In Hungary who has joined the market economy, there is often a problem regarding the base capital proportion, in case of newly established companies, how big the share exchange proportion should be or how the winding up and definitive settlement values take shape e.g. to satisfy the creditors.

After defining the company value the next subject of analysis is whether we can become a successful branch on the extended EU market. What the value producer and value preservation factors are, competitiveness factors needed for producing the highest property values and by this the Hungarian furniture industry branch to be able to reach lasting market shares.

## 2. ANTECEDENTS AND METHODS APPLIED

The members of the University of Economics and State Administration – Undertaking Economics Chair in Budapest deal with the analyses of company evaluation problems but in case of some specific areas many researchers and economists take part, too.

In the existing economical relationship the need of further development of the subject appeared as a new requirement because it is important to know what value a company represents from economical point of view, on the other hand in practice, it is very important to know the value of a company regarding the allocated investments and the assumed risks.

According to the established research assumptions the future activity of the Hungarian companies is based on the modernization partly done already, partly to be done and the process of intercalation into the world economy. The reveal of the main competitiveness factors was done starting with the industrial branch level with the determination of the company competitiveness elements. The analysis of the subject was rendered by the fact that there were no quantitative and qualitative national data at disposal. Besides this it has been found that the existing industrial data do not cover entirely the reality. They present a heaping because in many cases they contain the further sales (import) data, too.

A representative inquiry was needed for carrying out the analysis and with the help of it a detailed analysis of the office furniture branch became possible. A relatively small number (11) of office furniture industry ventures but with a major role within the branch were analysed from the economical activity side.

The chosen research method was having deep interviews followed by questionnaire inquiries. Unfortunately, the small number of answers received did not allow a computerised valuation. The strong and weak areas of the branch were turned up through the analysis of the industrial branch. From environs modifications judgement point of view the factors that cause uncertainty inside company activity were taken in view. The role of the government and economic policy, the relation possibilities with the competent ministries, the stability of the internal politics, the trustfulness of the financial market, the legislation and the legal harmonization efficiency with the Union were considered major points. Regarding the analysis of the competitiveness I tried to reveal the advantages and disadvantages of the production competitiveness and to establish the connection between the output indexes usage and usefulness.

Besides the branch analysis the present thesis also contains a concrete company valuation. FALKO Kft. in Sopron as one of the office furniture branch representatives provided data for the present thesis. The analyse was based on five years' balance and result reports as well as on accountancy reports.

The data at our disposal enabled us choosing the cash-flow valuation from the many different company valuation methods. According to this the output of the company value, the future discounted cash income values are considered to be the present value. When establishing the company value you need more estimation values to be fixed. According to our expectations regarding our EU joining I had to take in consideration the production decline based on a prior checking up with the company managers. When having an optimistic and pessimistic estimation of the future results I forecasted an income decrease of 8% and 15%. The inflation rate of the



following years was established to be 4.5% to let calculations and comparisons be done easier.

When analysing the future cash-flow the special literature suggests to have in view a period of about 10 years. I thought that the forecasting has become more difficult since we appeared on the EU market taking in consideration the new economical environment. Therefore I examined the output estimation of the company for a period of only 5 years, the rest of the period was taken in consideration as a rest value.

The continuously issued articles, essays and books in the special literature provided a great help in effectuating the research aims.

### **3. The New and Modern Results of the Thesis**

1. Since the EU has been founded the different branches in Hungary have been tried to be organized into a homogeneous system. In case of wood industry, during the latest statistical grouping the 'conversion of timber' and 'furniture production' were separated as branches. This system was taken over – as obligatory offer – by the Hungarian statistics system. During my research I came to the conclusion that the professional analysis of trend setting up deal with the major index calculations (ventures, number of employees, production, domestic and export sales income, industrial and consumers' price index), its trend set up but during the analyses they do not deal with the causes of difficulty inside the branch.
2. The company produces goods and services that meet the users claims and can be sold at a price that makes a positive output. As a result of the process the company can increase the investors' wealth, it produces an owner value.  
  
During the company operation analysis I proved that the company managers do not exploit in a businesslike way the existing possibilities in case of value oriented firm management. The value forming factors (increase of return from sales, function result rate, investments, capital expenses, increase rate) do not deal with the analysis of the numerical effect upon the company value. In this way it is very difficult to reach value formation, preservation and realization.
3. The cash-flow report is part of the company account which shows the financial changes of a venture during a certain period of time. We can see that the companies do this but inspite of it they do not make

decisions based on the cash-flow data however the liquidity insurance is a priority for each company management.

4. I stated that the companies do not make a detailed analysis while analysing the invested capital returns (ROI) to increase the product portfolio. A rank order of the ROI manufacturers would be needed to enable form an optimum product portfolio which would help the company to reach competitiveness advantage. You can deduce in the same way that they do not determine the in-cash and out-cash flow elements fact that could show which are the products to be strengthened and which are the ones to be eliminated.

5. During my research I tried to get a view at the risk treatment activity of companies. The forecast and treatment of risks in Hungary – having a less developed capital market – is much more difficult to follow as in the countries with developed capital market.

I stated that the examined companies do not deal much with the risk treatment and its forecast neither at macro level nor at market level. The risk factors such as the profitability, wealth, financial situation, refunds, management level, suppliers, subcontractors, technology are not analysed in detail.

6. The marketing research level of the companies was the subject of my investigations. However we can say that market research is not a plaster for all sores, it facilitates the clearheadedness, it helps in taking decisions.

It could be ascertained that the market research ends by building up databases and analyses of the competitors' balance and results. My point of view is that there is not too much and deep marketing activity in case of companies.

7. Joining the EU demands from the Hungarian companies to re-evaluate their competitiveness on the Union market. The traditional, unit strategy way of thinking must be replaced by another attitude. My research to analyse the co-ordination of organizational units let me deduce that the company managers are not capable to see the company in a centralized way. They bring dissipation in their decisions, the result of diversification is the lack of overall view.
8. I stated that companies operating in a strategical unit attach their employees to a certain unit, they consider the people with the proper gift the property of a certain section. Inside the company there is no competition for people between the unit managers. This means rigidity and unexploited capacity in case of machinery as well as in case of grey matter.
9. During the interviews had with the company managers I concluded the well-known fact that the Hungarian economy has a great difficulty of funds. This fact obstructs the development of the companies and through them the development of the whole economy. Procuring the needed capital for product and production development to increase competitiveness represents a great problem for the Hungarian furniture industry, too.
10. I made the evaluation of the company based on the international methods adopted to the Hungarian furniture industry branch, using the Hungarian finance legislation. The other way of analysis that has been working for a long time in market economy relations, the usage of indexes that cannot be found in the Hungarian practice caused great difficulties.

The theoretical approaches show a highlighted priority towards the usage of beta, the systematic risk factors. The index shows the connection between the company and market risks and has its own role in capital cost calculations.

The undeveloped Hungarian economical terms did not make possible the establishment of beta book in which – in case of developed countries – you can find the undiversifiable risk estimation of the companies that are present on the market. Not having this at disposal, the theoretical methods could not be applied during the estimation procedure, the capital cost calculations can be done based on the balance and result reports at disposal.

The indexes included in the calculations, the EBIT (Earning Before Interest and Tax), the income of a company obtained from normal business activity before paying tax and interest, the NOPLAT (Net Operating Profit Less Adjusted Taxes), the net results corrected by tax do not have equivalent in the Hungarian accountancy. To calculate them, the expenses must be broken down according to direct and indirect expenses, for functioning it is needed a strict return from sales determination.

#### **4. Practical Utilization of Results**

During the subject investigations, the knowledge of problems and the empiric analyses, it became evident that the competitiveness situation of the Hungarian furniture market needs improvement.

The European Union brings growing markets, sources of development, growth and increase chances for those companies which take advantage of the opportunities given by the Union and the native economics environment. The chances do not automatically lead to success. The European Union's market, however not in all cases but many times, - as generally the relevance in the market competition -, demands the compliance with the environment. Those ventures can be successful which consider the compliance efforts to be a precedential investment and they are already preparing themselves for entering the EU market.

Based on my thesis I will sum up my proposals to be executed in practical life as follows:

1. The basis of the information system inside a company is given traditionally by the accountancy system. The applied accountancy does not entirely mirror the reality because it is done under the influence of the momentary interests and needs. The property value formation as the basic aim of the company is leading oriented, supports decisions and takes in consideration the future outlooks, demands the creation of a different leading accountancy considering the existing ones. The 'traditional' and leading accountancy does not mean that the companies need two different accountancy systems but besides the accountancy legislations the objective, realistic analyses must have a major role and can support the statistical and operative decisions.

2. In case of production co-ordination the advantage in competition can be realized by establishing flexible manufacturing systems. Among the aims of the company there must be the formation of such technology that has tools which can be easily converted for manufacturing different goods and so the company can follow – with a minimum investment – the needs of the changing market. The advantages of flexible production systems can be used in a much wider area according to the needs of the domestic and global environment. This technology has two basic –but not in connection with the technology – conditions: the production co-ordination must know the needs of the area and the purchasing must follow these in a flexible way.
3. During the last years great changes went on in many industrial branches regarding competitiveness. Perhaps the most important of these is that the market competition has become more sharpened. The new way to follow is the application of modular product and technological improvement strategies which guarantee a wider range of goods, the fast appearance on the market in case of goods manufactured by the latest technology, a lower level of costs for product design and realization. One of the most evident advantages of the modularity is the rapid configuration capacity of the new product range and inside a given modular product architecture smaller costs can be reached by 'mixing and joining' elements. The modular approach clarifies the technological capability and system of a company. With the help of it can be discovered those hidden narrow cross-sections which decrease the possibilities of planning and materializing new products.
4. The successful companies are always established by managers but the employees' work contribute in great proportion to the success. Instead of building up organizational strategic business units, the project way of

thinking has to get in the foreground. The production realization in project upgrades the time factor and ensures a target oriented, reconciled, efficient execution of the investments, the research development, the production and product planning or the new product introduction on the market. All these are such tasks that are done more efficiently by the projects organized for these purposes than the traditional, difficult and in many cases bureaucratic collaborative functional organizations.

5. As a result of the production flow that happens in the projects we have to have in view the particularities of the innovation. The ritm of innovation is getting faster therefore, there is less and less time at disposal to realize the market scores. The really successful renewal appears as a result of the innovation chain: for a really innovative product you need more and more often new materials, new technical equipment, the sales of it requires new marketing sollutions and all these demand a radical change in the activity of the suppliers, the manufacturers, the selling units and the users.
6. In the globalization epoque the business risks of ventures have suddenly increased: the global innovative supply appears rapidly on the markets, the demand may change, the companies that enter the market can basically upset the existing balance. The risks are grown by the fact that the companies have to answer to defend the threat in a period of time that becomes shorter and shorter and in a more and more intensive way. For risk treatment the companies have to build up so called chain effect analises. When building up the risk chain we must define the value of the foreign capital and cash-flow, the value of the exalted economical growth, the critical values of the national currency in case of



devaluation and revaluation which can lead to the collapse of the input market, to the export regression and as a result of this the whole region will suffer an economical regression.

7. The involvement of liquid sources is needed to defend the acute lack of capital. For a great number of ventures that stand in need of this the involvement of risk capital represents the solution. The characteristic of risk capital financing is that it does not have such refund obligations as in case of credits. Inside the office furniture branch the investment of risk capital associations do not only provide financial resources for the companies but also other kind of support such as marketing, human resources management, finance, strategy concept formation and execution.
8. The project company production demands the revaluation of the employees' professional skills. It could be efficient and time could be saved by setting up a 'knowledge capital chart' in which the eventual multiskillness is mentioned. In this way the accumulated knowledge at the company can be followed accurately, where can the needed knowledge be found, in whose head, in which department, on which shelf, in which part of the database.
9. The 'enrichment of the activity sphere' can increase the labour efficiency done in project. If the employee is skilled in more than one job, the intensity of performance can be increased, especially when the existing equipment ensures possibilities of exploiting their knowledge. In case the company has short term plans, such trade learning must be supported which fit the profile of the company, in case of long term plans the company profile diversification alternatives can be vertical or

horizontal. The multiskillness study could be supported by reducing working time and by shouldering the costs partly or entirely.

10. The marketing activity done at companies must be reformed. In the midst of unforeseeable recessive flow, the company managers in Hungary and all over the world would like to get a more accurate guidance to enable them avoid wrong decision takings. They claim more information and advice.

Our marketing conception must be transformed. The market research must transform into such modern market research, advisory and media conglomerate that can provide services from basic research level up to decision taking preparations for customers. The future is preserved for these complex marketing, data supply information realms.

11. The connection between the financial process and marketing needs new ways of forming. I can imagine professionals trained at post-university level who are familiar with both areas. They have to possess knowledge in accountancy, finance analyses, trade economy and of course marketing. Through this connection of the sciences during education, such specialists will appear who 'matematize' the marketing area and by this they give the bases of company finance decisions connected with the marketing research results.

12. The globalization and our joint to the EU, the technical development constrain paradigm change in business economy. The previous rigid paradigms may bring a decrease of competitiveness of the company or more than that, it can lead to bankruptcy.

As a result of the paradigm change there must happen the work and quality discipline, the continuous work intensity, high professional

quality and the transformation time scale of values. The development of abilities for change, decision taking, the development of communication ability, the more efficient participation in team work, the compliance with basic moral precepts influence the entire scale of values, the identity and the culture of a company.

13. The determination of the company value must be enlarged to the customer segment side approach. The customer expects better quality, lower costs, shorter delivery times, more flexibility, higher level of services because its satisfaction increases in case of realizing higher values than the input, the expenses. The estimation of a company from customer point of view completes the evaluation of income producing capacity and both together give a more comprehensive view upon the real value of the company.

We do not have to think that joining the EU will mean an automatic promise and guarantee. It is true that some elements of the business environment do not change and other changes will appear in the long run after the jointment. The presence on the Union market is something new, it produces a more sharpened competition. This new situation demands conscious compliance of the ventures. There will be areas where new discipline must get on and in a certain way there will be different rules in use.

The present thesis tries to show the way to enable us accomodate and gain.

### **Publications regarding the subject of dissertation**

#### Valuation of Companies

3<sup>rd</sup> International Conference of PhD students. University of Miskolc  
13-19 August 2001  
pp. 381-384

#### The Human Resource as a Company Value and Competitive Base in the 21<sup>st</sup>

Micro CAD 2002  
International Scientific Conference  
7-8<sup>th</sup> March 2002 Miskolc  
pp. 67-71

#### Is manpower a company value element?

Human Resource Illustration  
Personel Management Periodical Review  
01/2002  
Publisher: Mont Humán Menedzser Iroda Kft  
pp. 42-46

#### The Capital of the Society

Economy and Society  
02/2002 Budapest  
Prognosis 2000 Foundation  
pp. 208-220

#### Factors that Affect Venture Competitiveness

Total Marketing or Marketing Fulfilment  
University of Miskolc- Marketing Institute  
2003 Miskolc  
pp.184-204