

Investment basics — IV

NET ASSET VALUE

The net asset value of an enterprise is the amount by which total assets exceed total liabilities. In the business world net asset value is used in the assessment of profitability, creditworthiness and solvency. Should total liabilities exceed total assets, the net asset value will be negative, meaning that the undertaking is insolvent.

For a company net asset value represents the value of the assets available to ordinary shareholders after deducting all the debts of the concern, the loan capital and the preference capital, and after providing for any possible rights or obligations in respect of loan stock or preference shareholders. The net asset value per share is then arrived at simply by dividing the value of the net assets by the total number of ordinary shares in issue.

Net asset value may also be quite readily calculated from the liability side of the balance sheet. It is sufficient to add the issued ordinary capital and the various non-distributable and distributable reserves. However, any equity participation rights or premiums or discounts on redemption in respect of preference shareholders and holders of loan stock should be deducted from, or, as the case may be, added to the net equity figure. Also, in calculating the sum, adjustments should be made for the surplus or deficit over book values of the current market values of any investments held.

Intangible assets, such as goodwill or cost of acquisition, trademarks, patents, and development costs, make the calculation of net asset values somewhat ambiguous. At times net asset value may be calculated or reflected to show all the assets listed in the balance sheet, while at other times it may specifically exclude intangible assets. The term 'tangible net asset value' is generally used to indicate that intangible assets have been excluded from the calculation.

The means of measuring the long-term financial structure of the firm is determined by the level of shareholders' funds. Net asset value is an important feature in presenting the company to the business, social and financial communities. It is a denominator according to which profitability and creditworthiness may be determined. The net return on shareholders' funds is an important aspect for investors and analysts, while to management it provides a reflection of business prosperity and show just how effective the assets of the firm are being managed. In situations where the selling price of a product or service of the undertaking is determined largely by an external pricing commission the level of the returns on entrepreneurs' funds is an important aspect. To creditors and the providers of long-term finance the level of profitability of the concern and the ratio of shareholders' funds to total liabilities and debt are crucial in determining financial risk.

Asset values and market values

While the calculation of net asset value from the balance sheet and the measuring of profitability and creditworthiness are simple enough, their interpretation is complex. The principal difficulty lies in the interpretation of balance sheet value. Some assets may be either overvalued or undervalued, and adjustments (given suitable and agreeable means of valuation) will have to be made. Goodwill and intangible assets are other complicating factors.

For the investor the interpretation of net asset values is complicated further by the fact that the market prices of the vast majority of companies do not reflect a significant relationship to net asset values as shown by the published accounts.

It would seem that many investors pay little attention to net asset values. A high asset value in relation to the price of a share does not necessarily mean that the share is more attractive than one with a low net asset value. There are close relationships between high returns on equity funds and low asset values on the one hand, and high asset values and low returns on the other. A high net asset value in relation to the share price and a low return could suggest inefficient use of the firm's assets (a management problem and probably an attractive acquisition situation) or that the industry in which the company operates has undergone a structural change, with the result that the assets are overvalued. A high return on asset value means a profitable business, a reflection of either good management or being in a fast growing sector of the economy or both.

That market values and book net asset values for most companies have little in common is probably explained by equities being capitalised freely in the market. These capitalisations are determined by collective environmental influences, with the result that equities are quoted at high or low earnings and dividend yields that may be at a premium or a fraction of the net asset value. The divergence between net asset value and market value (capitalisations) is probably best explained by Adam Smith. In 1776 Adam Smith, in writing the 'Wealth of Nations', drew a clear distinction between 'value in use' and 'value in exchange'. A distinction is made between the value of the asset to its owner in use, and the value of that asset in the market. Net asset values represent a form of 'value in use', as these assets are being employed in producing income, while market values represent a form of value in exchange.

So far as equities are concerned, there is a good reason for this divergence between asset and market values. The average market price of a share over a period of time depends mainly on its ability to generate earnings and dividend payments. This value, which is based on future income determinations, usually does not bear any close or reasonably consistent relation to the asset value, for

future income is determined on the 'real' value of the company's assets, which at a given point in time is in effect the current market price of these assets. This means that, so far as published net asset values are concerned, these values are not really representative of present market values. (The accounting profession have in recent years recognised this deficiency and while no uniformity has been reached steps are at least being taken to recognise replacement or current cost values.)

In practice, however, even if reliable and dependable market prices are available for the entire company's assets, the conceptual problem of value in use and value in exchange would still remain, since for a concern that is experiencing boom conditions, the current market value of its assets may exceed the book value by a wide margin. Basically the market places a premium on future growth expectations. This premium over the current market values of the concern's assets is expressed as 'goodwill'. It is quite possible to define goodwill and classify it as another asset of the company, in which case net asset value and market value would be equal. However, in view of the constantly changing circumstances in the business environment and the problems associated with valuing goodwill, such an exercise may be of academic interest only and not solve the problem or 'real' net asset value at all.

The position, if an acceptable basis of valuation can be agreed upon, would become far more meaningful in the case of a situation of high asset value, low returns, and a market value at only a fraction of the published book value. This situation could come about as a result of a more permanent structural change in the fortunes of a business sector. The company's assets would then be valued at market-related values and not book values or replacement costs. The situation is sure to yield a substantial decline in the assets of a company, which is easily adjusted by reducing the liability side of the balance sheet – namely shareholders' funds. Once this adjustment has been made, net asset value and market value should reflect a more coherent picture. In practice such valuations will, owing to their very nature and the opinions of all interested parties, be made on an historical basis, which could mean a substantial adjustment of solvency and debt capacity ratios. Such adjustments would therefore be very contentious and just not acceptable to many parties – as contentious as it would be if a company with high returns and low assets wrote up its 'goodwill factor' and then proceeded to raise debt capital on the increased equity.

'Real' net asset value

While the difference between book net asset value and market values is not easily resolved, the real value of the firm does lie somewhere between the two. The traditional way of valuing a company was to take the net assets and add to them an agreed sum for goodwill, which was considered to be a premium paid for income-producing assets. The modern way of determining the value of a company is first to consider earnings, which does not disregard the asset position entirely but merely places greater emphasis on the earning power of the assets. The company is therefore valued on a going-concern basis. There are exceptional circumstances where the assets have the greater potential value, but these are rare occasions and usually clear

exceptions to the rule. The main determinant of value today is the net flow of future earnings.

The real net asset value of a company can therefore be defined in terms of the financial principle that the investment value of a company (or a share) is equal to the 'present worth' of future dividends. In order to arrive at the 'present value', future profitability will have to be projected, which cannot be done without some broadly-based assumptions but which, if attempted on an intelligent basis, can often be reasonably accurate.

The investor and net asset value

In times gone by the investor paid more than passing interest to asset values in assessing share values. Although the way in which assets were valued and reported on was far less dependable than today, share or market values seemed to bear a closer relationship to asset values. This may have been due to more stable prices and calmer and less volatile business conditions associated with those times. Over the past three decades the means by which assets are measured has become progressively eroded as a result of inordinately high levels of inflation and the decline of currency values. This has resulted in the value of assets being subjected to substantial changes in component values as a result of the return function being severely distorted at times. In more recent times this could be seen clearly from the meaningful differences that existed between the book values, replacement values, and market values of the assets of firms in many sectors.

The substantial variations have resulted in a narrowing of forecasting horizons in the market place today and, together with the economic uncertainty, investors seem to be paying increasingly less attention to net asset values. Investors have found that net asset value is in reality not a meaningful guide to earnings or market price potential. While this may be so and even if the emphasis today is on future earnings potential, net asset values still have some significance if only of a secondary nature. The investor and analyst cannot afford to ignore net asset values completely. Provided their limitations are recognised, net asset values must still be considered in investment evaluation for the following reasons:

- As a measure of security for debt or preferred claims. The security of a debenture and the cover on preference shares will always require a margin of tangible net assets over a preferred claim. This asset cover should not be seen in isolation from the present and potential returns on the assets.
- Net asset value is still important in a take-over situation. The modern way of valuing a company is by looking at the expected net flow of all future earnings and dividends. This does not entirely disregard assets but merely relegates them to a secondary position. However, when it comes to acquisitions, net asset values are not ignored and for a variety of reasons and in a variety of ways are always considered in the terms of purchase. This factor does increase the market value of companies that are quoted at a large discount on net asset value and which are likely merger/acquisition propositions.

- Net asset values and earnings reflect business conditions. Asset values form an integral part of the presentation of a company for, given any amount of earnings, the larger the net worth, the lower the profitability or percentage earned on capital. Such a situation is not a favourable reflection on the company and its management. Such returns should not be seen in isolation, and industry comparisons should first be made before evaluating management performances. The converse, of course, also applies where there is a relatively low net asset value and high returns. While assets may be understated, the returns may suggest abnormal profitability and attract attention to the company in the form of new competition or, where a monopolistic condition prevails, public criticism.
- Net asset value is still a good indicator to both management and investors. A market price substantially below net asset value may suggest to the management of the company that a change is needed in business policies. The combination of present values, net asset values and market values provides a useful guide to investors. Where market values are less than present and net asset values, an undervalued investment situation exists. Should market values exceed net asset values and present values, overvaluation is implied.
- Takeover situations. The purchase of equities at only a small fraction of net asset value has certain speculative possibilities, particularly where there is little or no debt.
- Finally, in spite of the market showing little practical interest in net asset values, investors should be aware of the possible dangerous consequences of ignoring asset values altogether. There are situations in which asset values actually or probably play a significant role in determining market prices. One such situation is the purchase of equities at many times the net asset value in steeply rising markets. This is an important point that investors and analysts should assess carefully. The results of this could be seen in the latter sixties and early seventies when a large number of relatively small companies came to the market. It was then that the discrepancy between market prices and tangible asset values produced its most spectacular and ominous results.

Conclusion

There is no such thing as an absolute value of a company. Net asset value reflected in the balance sheet as being the extent to which total assets exceed total liabilities is only one facet of the entire value picture. The market today, despite its narrowing forecasting horizon, places greater emphasis on the sum of future earnings and dividend potentials. Net asset values have been relegated to a secondary position. Nevertheless, there are still a number of important reasons for not losing sight of book net asset values in assessing the potential of investments.