Chapter 7
Valuation of Negative Earning Firms

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ABSTRACT

This book mostly concentrates on firms with positive earnings, but this chapter focuses on the negative earnings firms or firms with very low earnings. It is easier to value a positive earning firm than a company with negative earnings. Analyzing negative earning firms has always created problems for researchers and analysts. In case of a negative earning firm, growth rates cannot be predicted or used in the valuation of firms. When current income of the firms is negative, growth rate will make it more negative. Tax computation becomes more complicated and the Going Concern Assumption does not apply properly. Authors start with complications in valuing negative earning firms, discuss the causes of negative earnings, and whether the problem is short-term, long-term, or cyclical in nature. Finally, authors provide the appropriate valuation technique for each case.

INTRODUCTION

Start-ups and early-stage companies with negative earnings, and experiencing seasonal or structural financial problems, do not allow use of traditional valuation concepts as it is unclear how and when the company will produce positive cash flow for their investors. To value such companies, it is critically important to have a more in-depth analysis and understanding of external and internal forces that affect a firm's ability to generate positive cash flow. It is quite clear, zero positive cash flow eventually equals

no value! The dot-com bubble at the turn of 21st century clearly demonstrated that when the business hype finally ends, start-ups and early-stage companies must produce a financially successful business and revenue model that can generate cash flow.

Start-up and early-stage companies are generally valued on a prospective basis, with the underlying managerial assumption that the business model of the company being valued will eventually succeed (and hence, generate positive cash flow). As far as a firm is predicted to survive, negative profitability is, by definition, a transitory state since investors have an abandonment option and will not allow losses to continue indefinitely (Jenkins, 2003). Therefore, this study elucidates the model of mean-reversion of profitability to reflect the expected future profitability of loss firms. That is in fact what investors are betting on, especially for a company like Uber.

One of the keys to success and to achieving the valuation placed on a start-up and early-stage companies is the ability to raise sufficient capital to cover the operating losses until profitability is reached. One of the most significant issues in valuing a start-up or an early stage company is sufficiency of capital to achieve the business plan. Undercapitalized start-ups and early-stage companies by their nature are doomed and the valuations placed on them are subject to scrutiny. (Joos and Plesko, 2005).

Valuation and Complications of Negative Earning Firms

A valuation is a method of calculating the true worth of a business or of a firm for a number of reasons. One of the most important reasons can be associated with providing information to the investors who are looking for return on their investments made, or on the investments that will be made in future.

A business valuation process involves varying data such as value of inventory, equipment and property, liquid assets in hand, share price, market capitalization, and projected earnings, among others. There are several methods of business valuation and the choice of method adopted is contingent upon a number of factors such as the purpose of valuation, size of business, etc. A valuation of a business or a company may be conducted by adopting different approaches such as valuation using market value of business, valuation using return on investment of a business, valuation using the value of assets of a firm, valuation by applying discounting of cash flows, etc. (David, 2018).

It is easier to value a positive earning firm than a company with strangely low or negative earnings. Analyzing negative earning firms have always created problems for researchers and analysts. One of the main causes of negative earnings may be attributed to the overall deterioration in the wealth of the company. A newly established firm also faces the problem of negative earnings in initial years of business. Also, seasonal impact on business may also result in a negative earning for various forms of businesses.

Companies that are losing value lead to many issues for analysts who are endeavoring to evaluate them. However, none of these issues are theoretical, they are critical from an estimation perspective. Generally, it is simpler to take an existing profitable business on a higher profitable growth but it is very difficult to convert an unprofitable business into profitable one. The risk to lose, or total failure, is very high in the negative earning firms. It is advisable to normalize the abnormally high expenses of negative earning firms by comparing it to the previous year figures. In such a case a clear distinction should be made between losses and expenses.

In case of a negative earning, growth rates cannot be predicted or used in the valuation of firms. When current income of the firms is negative, growth rate will just make it more negative. Tax computation becomes more complicated and the Going Concern Assumption does not apply properly because running losses for long time exposes the firm to ultimate bankruptcy.

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