



Financial and Banking Services Market

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**SUBSTANTING THE EXPEDIENCY
OF APPLYING SPECIAL METHODS
IN VALUATION OF BANKING BUSINESS
IN UKRAINE**

Abstract

The article deals with the problem of the necessity to apply special methods for banking business valuation. The author presents and analyses main factors forming the expediency of using these methods and substantiates the need to apply special methods for thorough analysis of the object of valuation.

Key words:

Business value, effectiveness indicator, valuation of banking business, market value.

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The problem. Business valuation, being an economic indicator of its efficiency, is very important for company leaders, since to define it one should analyze long-term prospects, examine all flows of money, and be able to compare the flows of money within different periods of time, with an adjustment for corresponding risk. No other indicator is based on such exact information as the business valuation indicator does; thus, it is asserted that this indicator does not characterize instant changes, but gives a broad idea of the object's state. From the standpoint of risk, a business that is oriented at capitalization and increase of its value is more investment-attractive and reliable than the one aimed at present-day income. Proceeding from the paper [6: 120], «companies that concentrate purely on a net return in a current year or on a profit margin are suffering from short-sightedness». However, business value, the same as any other quantitative indicator, requires certain methods for its calculation. The economic literature has been discussing recently the items of the necessity to apply special methods for business valuation. The latter can be calculated on the basis of stock market indicators, where stocks are freely circulating and their price is set through demand and supply harmonization.

Analysis of recent research and publications. The problem of business value is fundamentally examined in the works of many scientists; separate aspects of its calculation are studied in the works of native and foreign researchers, namely S. Valdaytsev, A. Hryaznova, E. Damodoran, Ye. Kolbachev, T. Copeland, T. Koller, J. Murrin, K. Reshotkina, M. Fedotova, and others. Some issues of bank valuation are examined in the works of Z. Vasylichenko, A. Ivanov, O. Mendrul, I. Nikonova, R. Shamhunov, and others.

Unresolved Issues. However, in spite of a considerable number of works dedicated to business valuation in general and banking business valuation in particular, the problem has not been fully solved yet. The mechanism of business value formation and calculation, with the peculiarities of certain types of economic activity taken into account, needs further investigation. However, to solve these problems one should have prior substantiation of the expediency of special methods application in the process of business valuation, namely that of banking business.

The **objective** of this article is to analyze the current situation on the domestic stock market and to substantiate the expediency of special valuation methods application in the process of general business valuation and banking business valuation in particular in Ukraine.

Main Findings. According to the International Valuation Standards (IVS), value is defined as an economic notion with respect to price at which sellers and buyers of the available goods and services are most likely to agree. The value is not a fixed peculiarity of an object. It is an imputed price rate of certain goods and services at a given moment of time in accordance with the chosen definition

of value. From economic point of view, value reflects the market approach to the benefits the owner of the given goods or the user of the given services get as on the date of valuation [7].

Accordingly, since value is an imputed rate, there should be a certain valuation procedure used to calculate it. According to Art.3 of the Law of Ukraine «On Valuation of Property, Property Rights and Professional Valuation Activities in Ukraine» [4], valuation of property and property rights is the process of calculation of their value in accordance with the procedures provided by regulations (national standards), methodologies and other regulatory acts approved by the Cabinet of Ministers of Ukraine and the State Property Fund of Ukraine.

There exist a lot of types of value and definitions related to them. To understand and apply valuation procedures, it is important to indicate the type, definition, type/aim correspondence, since a change of value definition can substantially affect valuation rate. In most cases, words or word combinations specifying the type of value are used before the term «value» to avoid terminology discrepancies. Nowadays in Ukraine the Law provides for the following value types: market, liquidation, replacement, reproduction, residual, special, investment value, and value-in-use. In most cases it is market value (in some cases open market value) that is associated with the valuation of property and valuation of property rights [4]. In practice, in case of absence of specific restrictions, the market price is meant. What is more important, valuation should aim at a specific value type to avoid misunderstandings and discrepancies. In particular, in clause 11 of the National Standard No. 1 it is noted that «when the type of value that has to be calculated on the basis of valuation is not mentioned in regulatory legal acts on property valuation, or in agreement on property valuation, or in legal resolution, then the market value should be calculated» [8].

According to the IVS and the National Standard No. 1, market value is defined as an imputed money rate of property at a valuation date. A concerned buyer and a seller exchange property on the basis of commercial agreement after marketing analysis carried out, both sides acting wisely, reasonably, and willingly. Market value is an objective valuation of property rights to a certain property at a certain date. According to the essence of the market this stands for a generalizing activity and motivation of a large number of members and not a separate view or investment interest of a certain person. Market value is an imputed rate calculated in accordance with the regulatory legal acts and corroborated by market data [7].

Unfortunately, a concerned person does not always dispose of the information about market of certain goods and the possibilities for its valuation by means of market analysis. This explains the existence of special approaches to business valuation. According to S. Valdaytsev, it is reasonable to apply these approaches in the following cases:

- the firm under valuation is closed, i.e. its shares are not quoted on the stock market (the firm is not a joint stock company but either a limited liability company or a closed company);

- the firm under valuation is formally opened, however it is not included in the listings of any of the stock markets because it does not meet their requirements (due to its size, financial reporting availability, etc.); and at the same time their constant quoting on the OTC market is not performed;
- the firm is a public limited company that is quoted on a reputable stock market, however, its shares are insufficiently liquid (they are rarely the object of contracts), thus one cannot rely on the present market value of these stocks;
- the whole financial market in the country is either insufficiently liquid or greatly dependent upon short-term autonomous economic factors, and as a result, market value of stocks quoting is not fair [2].

In Ukraine nowadays banking business functions in the following forms: public limited company, closed company, cooperative bank and limited liability company. According to the Law of Ukraine «On the Changes in Certain Legislative Acts of Ukraine Concerning the Procedure of Establishment of Banks and the Amount of their Authorized Capital» [3], banks in Ukraine can be established only in the form of either a public limited company or a cooperative bank. Banks that have been established in the form of a closed company or a limited liability company should adjust their forms of business activity to the requirements of the given Law within three years from the day the Law had been enacted.

Further it is worth analyzing the necessity for special methods application for valuation of banking business in Ukraine on the basis of the requirements mentioned above. The first task is to define the type of business entity under valuation. Table 1 shows the dynamics of functioning of the banks and their forms of business activity in Ukraine during the last 5 years.

Table 1

Dynamics of commercial banks' functioning in Ukraine

Indices	Years				
	2002	2003	2004	2005	2006
The quantity of banks that have the NBU's license to perform banking transactions	157	158	160	165	170
of which in the form of:					
Public Limited Company	94	94	92	92	91
Closed Company	42	39	40	41	44
Cooperative Bank	1	–	–	–	–
Limited Liability Company	20	25	28	32	35

Table 1 shows that during the last five years more than a half of banks have been functioning in the form of public limited companies, i. e. their value can be hypothetically calculated on the stock market on the basis of their stocks quoting. Practical ways to get this kind of information and calculate fair price on the Ukrainian Stock Market are further analyzed. As for other banks, i. e. those functioning in the form of closed companies and limited liability companies, one comes to a conclusion that it is impossible to value them if no special valuation methods are applied.

For further examination, the situation on the Ukrainian stock market should be analyzed with the aim to define the possibility to value banking businesses using information on quoting of banks' stocks. We can succeed in case the stocks of a public limited company are sold on the market and have a certain market price. In this case, it is possible to calculate the value of the stocks by multiplying their quantity by the price of a single stock. This indicator is widely used and is called «market capitalization of stocks». One can assume that this is the value of the company and no further calculations are needed [1].

According to W. Sharp stock market functions as a mechanism of financial assets exchange, facilitating the cooperation between the buyers and the sellers of securities. Calculation of a security price, i.e. the calculation of the market price that reflects all the available information on a specific security, is one of the basic functions of the given market. The sooner the price is calculated the more effectively the capital is distributed on the stock market. When describing usual market functioning, it is assumed that every member knows the exact quantity of securities he will buy or sell at each of the available prices. All the members at their meetings, one way or another, set prices on goods, harmonizing supply and demand [10].

At the moment, 10 institutions in Ukraine have the license of the State Commission on Securities and Stock Market (SCSSM) to perform professional activity on organization of trade on the securities market, namely:

a) stock markets:

- Closed Company «Ukrainian Stock Market» (USM);
- Closed Company «Luhansk Stock Market» (LSM);
- Public Limited Company «Donetsk Stock Market» (DSM);
- Closed Company «Ukrainian International Stock Market» (UISM);
- Closed Company «Ukrainian Interbank Exchange Market» (UIEM);
- Closed Company «Prydniprovsk Stock Market» (PSM);
- Closed Company «Crimea Stock Market» (CSM);
- Public Limited Company «Kyiv International Stock Market» (KISM);

б) trade and information systems:

- affiliate «Technical Centre of the FFTS» (First Fund Trading System);
- affiliate of the association «South-Ukrainian Trade and Information System» – «Pivden-Server»» (SUTIS).

According to the Ukrainian Stock Market analysis performed by Robert L. Smith, the International Adviser of the Capital Markets Development Project, the existing number of trade organizers exceeds the needs of the market [9]. This conclusion follows from the fact that the trading volume reflects obvious disproportion existing on the stock market, although the distribution of issuing bodies, whose securities are included in the listing at trade organizers, is more or less balanced. This is illustrated in Figures 1 and 2.

The market liquidity is very low; moreover, the majority of the securities agreements are concluded outside of organized markets and TIS. According to experts, 90% of agreements are concluded on the non-regulated market. In 2005, as well as in the recent years, free circulation of public companies' stocks, apart from controlling interest, accounted for approximately 4% of market capitalization; that, in turn, has been reducing the market liquidity to a larger extent.

Most of additional stock issues are distributed either among the existing stockholders or among the other counterparts according to predefined conditions in order not to come into the public market. Recently, some Ukrainian companies performed initial public offerings (IPOs) at international exchanges, having calculated their market value, and thus raised less expensive borrowed capital [9].

Figure 1.

Distribution of the issuing bodies, the securities of which are included in the listing at trade organizers, by June 30, 2007, %

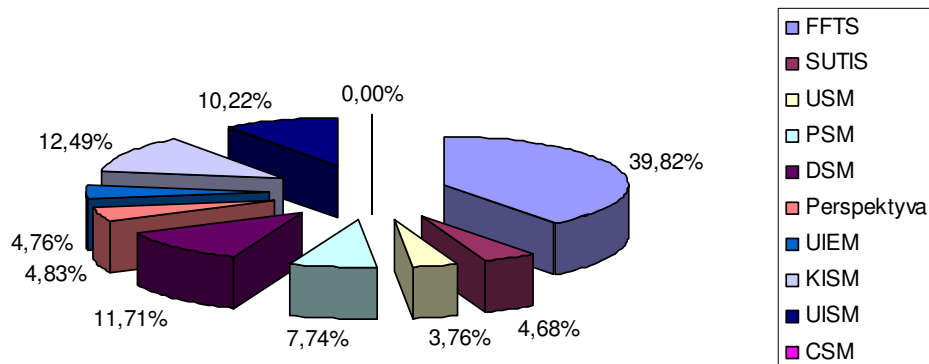


Figure 2.

Trading volume at trade organizers, January through June 2007, millions of UAH

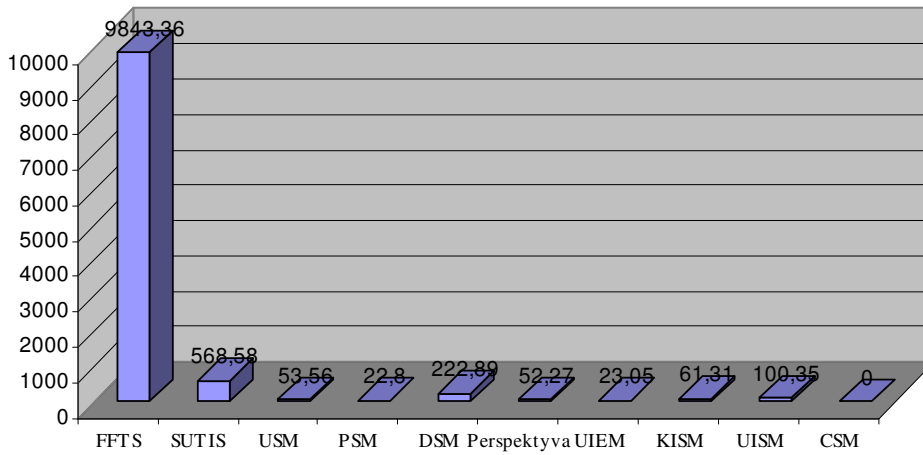


Figure 3.

The quantity of securities included in the different level of quoting list of trade organizers

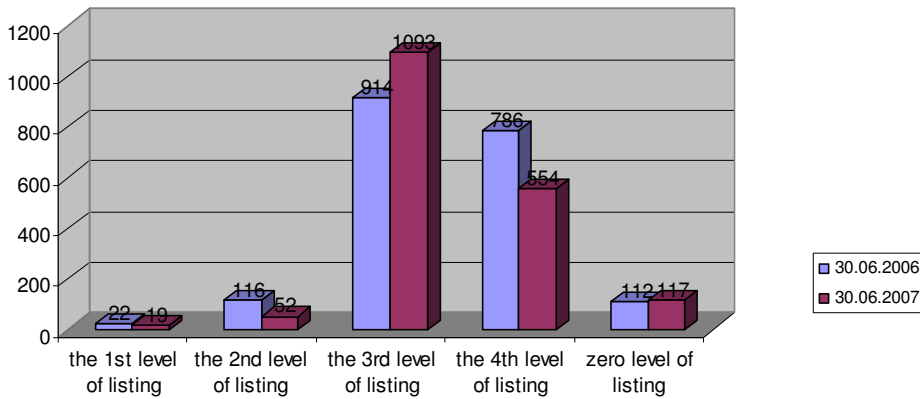


Figure 3 shows that according to the SCSSM data of June 30, 2007, the largest number of securities (by kind, type and category) are included into the 3rd and the 4th levels of listing [5].

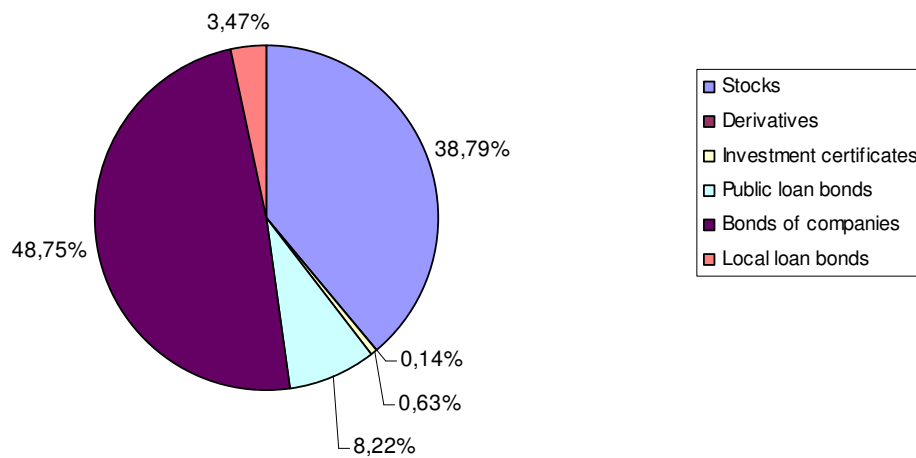
According to Standard & Poor's classification, Ukrainian Securities Market is defined as a frontier market, i.e. it is of the lowest classification of stock markets index of this rating agency, rated a little lower than the category of new markets. This category includes more than 20 countries that are grouped according to their geographical position into European, African, Asian and Latin American countries. The group of European frontier markets includes Ukraine and the following neighboring countries: Romania, Slovenia, Slovakia, Croatia, Bulgaria, Estonia, Lithuania and Latvia. Standard & Poor's considers that according to the S&P index FFTS is the leading Ukrainian Stock Market [9]. Thus, because of insufficient liquidity of the Ukrainian Stock Market the matter of both the fair market value calculation of banking business and that of any other business on the basis of stocks quoting data on the market are imputed.

Taking into account the fact that the given research aims to substantiate the expediency of applying special methods in banking business valuation, one should primarily investigate the situation on the market of bank stocks as securities certifying property rights of their owner (stockholder) as for a public limited company, including the right to get a part of income of the company in the form of dividends, the right to get a share of the company's property in case of liquidation of the latter, and the right to manage the company.

The structure of securities sales is given in Figure 4.

Figure 4.

The structure of securities sales, January through June 2007, %

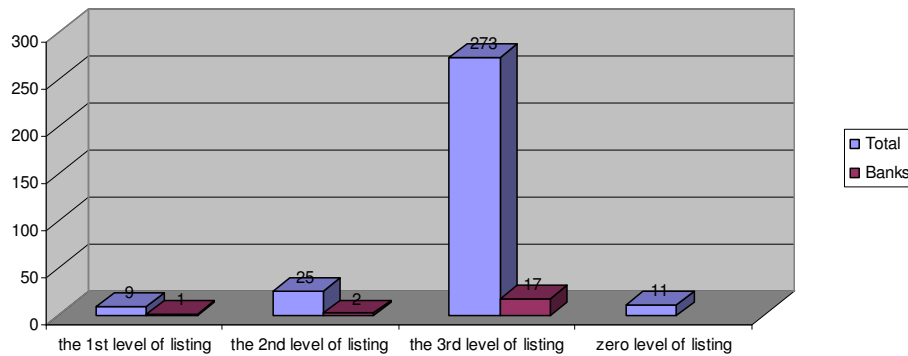


As seen from Figure 4, stocks on the Ukrainian Stock Market are traded quite well, taking the second position in trade volume after bonds of enterprises.

Figure 5 shows the number of companies according to their level of listing, the shares of which circulate on the market of the largest trade organizer in Ukraine. Obviously, banks do not take the best position not only in terms of quantity, but also in terms of quality, since most banks belong to the category characterized by the stocks of low liquidity.

Figure 5.

The number of companies, the shares of secondary distribution if which are in the FFTS listing



The analysis performed above enables to state that the national stock market meets the requirements suggested by S. Valdaytsev when substantiating the expediency of application of special methods for business valuation. However, we consider that even in the case of high liquidity of the market and high liquidity of shares of the object under valuation, the stock market data cannot be used implicitly when calculating fair market value of business. This is caused by the complexity of the mechanism of fair equilibrium price calculation and the difference in conditions the investors on the stock market are in.

The value of a security depends on its future perspectives, and these perspectives are not always clear. Any additional information concerning this perspective can lead to its re-valuation. For example, in case a well-informed investor intends to sell or buy a certain number of securities of a certain kind at a specific price, one offer to conclude agreement can stimulate other offers. Prices not only can attain market equilibrium but also serve as a source of information.

Conclusions. The fulfilled research allows us to conclude that market value is the basic type of value that meets the requirements of the largest circle of counterparts. This indicator is the most generalizing type of value that takes the largest number of factors into consideration and is oriented at a large circle of investors. Herewith, the author proves that it is not right to use price that is formed on the market of goods as a generalizing indicator.

Nowadays a significant number of banks are not open, i. e. their stocks cannot circulate on the market because of the business activity form: the stocks of only 20 banks circulate on the secondary placement market, however the respective agreements are very rarely concluded, and they have no appropriate liquidity. However, the biggest problem is that the Ukrainian securities market itself has no appropriate liquidity; it is impossible to calculate a fair market value using its data. Even the application of special methods of stock market analysis cannot change this situation since technical analysis cannot be performed due to intransparency of the market, while fundamental analysis is based on the assumption that security is not circulating on the market, implying that the fundamental analysis does not differ from the approaches to valuation of a business, the shares of which are not circulating on the market.

The facts mentioned above prove the irrationality of the implicit trust in the market and substantiate the necessity for deep analysis of objects under valuation, as well as the necessity to apply special methods for banking business valuation.

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