

# 1. Introduction

## 1.1 Background and Motivation

The software industry is booming in Sri Lanka. There are many software development companies emerging in the market. However most of them failed to grow and become large-scale players in the industry. The major factor that would refrains these companies growth potential is because they do not consider the factors that would help to add more value to the business. Further Investors and venture capitalist firms do not identify the value of these IT business ventures and what factors to be considered in valuing an IT business. Therefore these small and medium size Software companies do not have a good market demand from investors and not lucrative as traditional business ventures who are performing well in the stock market.

If there are proper ways of measuring the value of intangibles in Software development business ventures, the IT industry will have more opportunities to add value for the country as a high foreign exchange gain source. This will help the country as a whole since software exports add more value to products than value addition from apparel and agricultural products. Growth and stability in the IT industry will generate more wealth to the country and create more job opportunities in the high-end segment in the job market.

ICTA and Software Export Association of Sri Lanka plan to achieve one billion dollar exports in IT and BPO industry in the year 2012. To achieve this target existing players need to form mergers and alliances and joint ventures with foreign partners to access technology, to gain or transfer business domain knowledge and market access. Therefore it is an advantage for local players to identify the value of their business before entering into new partnerships. Bargaining power of local players will increase if they know the value of their business.

Development in the IT sector will create more economic prosperity and increase the standard of living of the general public. It will help to get the attention of the developed countries to invest in the IT industry in Sri Lanka.

## **1.2 Problem Statement**

What are the factors affecting the business valuation model for software companies in Sri Lanka?

### **Problem Justification**

The software development companies do not properly value their businesses. These companies are facing issues determining share value when they go for initial public offering or to estimate the value of business to determine offering price for mergers and acquisitions.

Investors who are willing to invest in software business ventures are looking for traditional factors such as book value, past performance. There is a lack of knowledge of what factors do they have to evaluate before investing. There were many valuation methods practicing in the business world. However local software development companies are facing a problem of lack of information to support for such calculations. Further are these methods sufficient enough to measure intangibles of a software company?

## **1.3 Objectives**

1. Critically analyze each of the existing valuation methods in practice with respect to measuring the value of intangibles of Software development businesses.
2. Identify what factors are to be considered in determining the value of Software Development business ventures.
3. Identify the degree of correlation between each factor and value of business.
4. Develop a model that will accurately measure the value of a Software Development business ventures.

## **1.4 Importance and benefit of study**

1. Software development companies can work on more prominent factors that are affecting the value of business. Prioritize resource allocation on critical activities that help to add more value for the business and thereby increasing the long-term stability of the company. This will help to maximize the shareholder wealth.
2. Potential employees and Investors can look for the factors which more accurately represent the value of a software company and how the value is accumulated over a period of time.
3. Senior management awareness of business value and easiness and practicality of measuring such value will encourage more joint ventures, alliances and mergers in the local Software industry. This will help increase the stability of the Software industry in Sri Lanka and facilitate potential for growth. This in turn helps to create more job opportunities in the up-end stream of the labour market.
4. Software companies can raise funds for future developments through the stock market. This is a more cost effective financing method than debt financing. Being listed in the stock exchange will provide many ancillary benefits for small-scale Software development companies. They will earn more recognition among the business community. Recognition will help to recruit best people from the competitive local software labour market.
5. The research will help Software businesses to justify their cost of investments in intangibles comparing it with the value of these intangibles and there contribution to adding value to the business.

## **1.5 Scope of the Research**

The research under this context will consider all the offshore software development companies registered under Software Exporters Association of Sri Lanka and incorporated on or before the year 2005. Sales from local operations should be less than 10 % of the total sales and products revenue portion should be less than 30% of the overall revenue for those who are with product presence. The value of business considered as the present value of future pre tax cash flows.