
Valuation: Lecture Note Packet 2

Relative Valuation and Private Company Valuation

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The Essence of relative valuation?

- In relative valuation, the value of an asset is compared to the values assessed by the market for similar or comparable assets.
- To do relative valuation then,
 - Need to identify comparable assets and obtain market values for these assets.
 - Convert these market values into standardized values, since the absolute prices cannot be compared. This process of standardizing creates price multiples.
 - Compare the standardized value or multiple for the asset being analyzed to the standardized values for comparable asset, controlling for any differences between the firms that might affect the multiple, to judge whether the asset is under or over valued

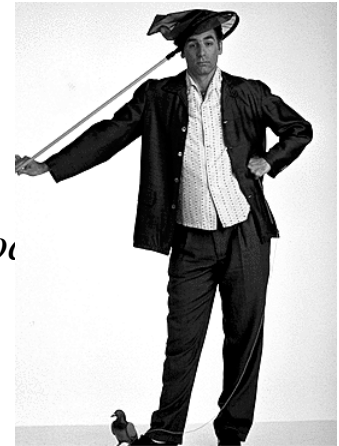
Relative valuation is pervasive...

- Most valuations on Wall Street are relative valuations.
 - Almost 85% of equity research reports are based upon a multiple and comparables.
 - More than 50% of all acquisition valuations are based upon multiples.
 - Rules of thumb based on multiples are not only common but are often the basis for final valuation judgments.
- While there are more discounted cashflow valuations in consulting and corporate finance, they are often relative valuations masquerading as discounted cash flow valuations.
 - The objective in many discounted cashflow valuations is to back into a number that has been obtained by using a multiple.
 - The terminal value in a significant number of discounted cashflow valuations is estimated using a multiple.

Why relative valuation?

“If you think I’ m crazy, you should see the guy who lives across the hall”

Jerry Seinfeld talking about Kramer in a Seinfeld episode



Michael Richards
Photo: George Lange

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“ A little inaccuracy sometimes saves tons of explanation”

H.H. Munro

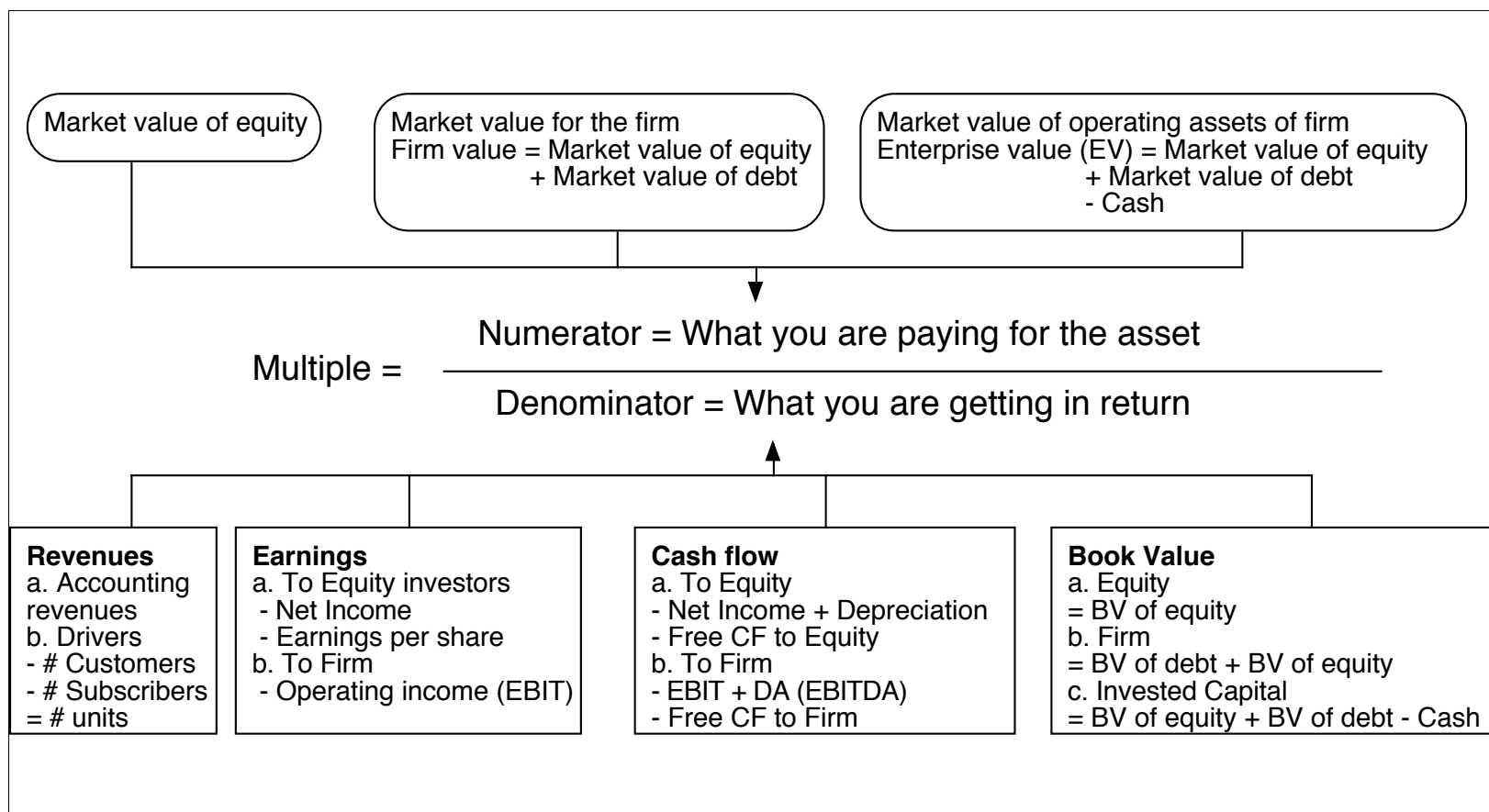
“ If you are going to screw up, make sure that you have lots of company”

Ex-portfolio manager

So, you believe only in intrinsic value? Here's why you should still care about relative value

- Even if you are a true believer in discounted cashflow valuation, presenting your findings on a relative valuation basis will make it more likely that your findings/recommendations will reach a receptive audience.
- In some cases, relative valuation can help find weak spots in discounted cash flow valuations and fix them.
- The problem with multiples is not in their use but in their abuse. If we can find ways to frame multiples right, we should be able to use them better.

Multiples are just standardized estimates of price...



The Four Steps to Understanding Multiples

- Define the multiple
 - In use, the same multiple can be defined in different ways by different users. When comparing and using multiples, estimated by someone else, it is critical that we understand how the multiples have been estimated
- Describe the multiple
 - Too many people who use a multiple have no idea what its cross sectional distribution is. If you do not know what the cross sectional distribution of a multiple is, it is difficult to look at a number and pass judgment on whether it is too high or low.
- Analyze the multiple
 - It is critical that we understand the fundamentals that drive each multiple, and the nature of the relationship between the multiple and each variable.
- Apply the multiple
 - Defining the comparable universe and controlling for differences is far more difficult in practice than it is in theory.

Definitional Tests

- Is the multiple consistently defined?
 - **Proposition 1: Both the value (the numerator) and the standardizing variable (the denominator) should be to the same claimholders in the firm. In other words, the value of equity should be divided by equity earnings or equity book value, and firm value should be divided by firm earnings or book value.**
- Is the multiple uniformly estimated?
 - The variables used in defining the multiple should be estimated uniformly across assets in the “comparable firm” list.
 - If earnings-based multiples are used, the accounting rules to measure earnings should be applied consistently across assets. The same rule applies with book-value based multiples.

Descriptive Tests

- What is the average and standard deviation for this multiple, across the universe (market)?
- How asymmetric is the distribution and what is the effect of this asymmetry on the moments of the distribution?
- How large are the outliers to the distribution, and how do we deal with the outliers?
 - Throwing out the outliers may seem like an obvious solution, but if the outliers all lie on one side of the distribution, this can lead to a biased estimate.
 - Capping the outliers is another solution, though the point at which you cap is arbitrary and can skew results
- Are there cases where the multiple cannot be estimated? Will ignoring these cases lead to a biased estimate of the multiple?
- How has this multiple changed over time?

Analytical Tests

- What are the fundamentals that determine and drive these multiples?
 - Proposition 2: Embedded in every multiple are all of the variables that drive every discounted cash flow valuation - growth, risk and cash flow patterns.
- How do changes in these fundamentals change the multiple?
 - The relationship between a fundamental (like growth) and a multiple (such as PE) is almost never linear.
 - **Proposition 3: It is impossible to properly compare firms on a multiple, if we do not know how fundamentals and the multiple move.**

Equity Multiple or Firm Multiple	
Equity Multiple	Firm Multiple
1. Start with an equity DCF model (a dividend or FCFE model) $P_0 = \frac{DPS_1}{r - g_n} \qquad P_0 = \frac{FCFE_1}{\text{Cost of equity} - g_n}$	1. Start with a firm DCF model (a FCFF model) $EV_0 = \frac{FCFF_1}{\text{Cost of capital} - g_n}$
2. Isolate the denominator of the multiple in the model 3. Do the algebra to arrive at the equation for the multiple	2. Isolate the denominator of the multiple in the model 3. Do the algebra to arrive at the equation for the multiple

Application Tests

- Given the firm that we are valuing, what is a “comparable” firm?
 - While traditional analysis is built on the premise that firms in the same sector are comparable firms, valuation theory would suggest that a comparable firm is one which is similar to the one being analyzed in terms of fundamentals.
 - **Proposition 4: There is no reason why a firm cannot be compared with another firm in a very different business, if the two firms have the same risk, growth and cash flow characteristics.**
- Given the comparable firms, how do we adjust for differences across firms on the fundamentals?
 - **Proposition 5: It is impossible to find an exactly identical firm to the one you are valuing.**