Art'o'val Advisors

True Art of Valuation

Valuation Series

12 – Relative Valuation

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What is Relative Valuation?

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What is Relative Valuation?

- Relative valuation is one of the business valuation methods. The Company's value is derived by comparing the market value of the publicly listed companies or implied value of transactions operating in a similar space.
- The comparison is based on certain financial ratios or multiples, such as the price to book value, price to earnings, EV/EBITDA, etc., of the target company and its comparable companies.
- In other words, to value the target company, valuation metrics such as EV/EBITDA, EV/Revenue, PE, PB etc, and recent M&A transactions of listed companies operating in the same industry are considered.
- Based on the principle of substitution i.e. a prudent buyer will pay no more for an asset than the cost to acquire a substitute asset with the same utility.

Below are the sources to find the information:

Database	Scope
Bloomberg/ S&P Capital IQ	Information on the publicly listed companies including deal details, news and filings
Factiva	News database
Company Website	Company filings, investor report, annual report etc. of private and public companies.
Stock Exchange Website	Public target and acquirer listed on national stock exchange websites such as NSE, BSE, NYSE, NASDAQ, AXS, SSE, JPX, LSE, Euronext, etc.

Market Vs Income Vs Cost Approach

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Market Approach

Market approach determines the value by comparing subject companies and transactions with similar companies or transactions present in the market.

This method is applicable under the following situations:

- The subject company or a comparable or identical asset is traded in the active market
- Recent transaction comparable are available
- Both listed transaction and companies comparable information is available and reliable

There are two methods for market approach: comparable company analysis and precedent transaction analysis.

Income Approach

Income approach is a valuation method that discounts companies future cash flows at the present value

This method is applicable under the following situations:

- Subject company does not have similar listed companies or transactions.
- Subject company distinct from the selected listed comparable
- Future cashflows are available and reasonably projected

There are five methods for income approach: DCF, RFR, MEEM, WWM and option pricing models.

Cost Approach

Cost approach is a valuation approach that reflects the amount that would be required currently to replace the service capacity of an asset

This method is applicable under the following situations:

- Liquidation value is to be determine
- Market and income approach cannot be used
- asset can be quickly recreated with substantially the same utility as the asset to be value

There are two methods for Cost approach: replacement cost method and reproduction cost method.

Types of Relative Valuation (1/4)

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1 Comparable Company Analysis Method

- Comparable company analysis method, determine the enterprise value of a company by comparing listed companies based on similar market metrics operating in the same industry.
- Selection of comparable companies is based on various factors such as operational processes, cash flows, growth potential, risk, etc.
- Provides a market benchmark that can be used to establish a valuation for the company. The method assumes, that the companies similar in size, industry, and stature are valued in the same way.
- Seeks to identify how the public market currently values a specific group of companies with similar characteristics. The valuation is evaluated in the form of multiples of underlying earnings
- Comparable public companies analysis implied multiples helps in calculating the theoretical value that a business would likely to trade as a public company on a "fully distributed" basis

Following are the characteristics for identifying or selecting comparable companies

The comparable companies should possess operation and financial characteristics similar to subject company

- **Industry**
- **Geographic Location**
- **Line of Business**
- **Target Customers**
- **Growth Prospects**
- **Profitability**
- **Company Size**
- **Leverage**

Types of Relative Valuation (2/4)

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Steps for Comparable Company Analysis

1. Analyse target company industry, operation, size, growth and risk factor etc.
2. Identifying, selecting, and classifying comparable companies
3. Determining key financial metrics of comparable companies
4. Calculating market multiples of comparable companies
5. Applying market multiple to target company
6. Determine subject company valuation by applying median or mean of the market multiples

Key Considerations

Comparable must be publicly listed companies

While identifying and selecting comparable companies operational and financial factors such as geographic region, company size, growth and risk profile, business segment, profitability, capital structure etc should be considered.

The market multiples of selected comparable companies are analysed and any outlier are excluded from the list.

Comparable companies that nature of operations is similar to the subject company should be taken into consideration.

Types of Relative Valuation (3/4)

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2 Precedent Transaction Analysis Method

- The precedent transaction analysis is essentially a study of historical M&A transactions in an industry and is based on a few commonly used valuation multiples such as EV/Revenue, EV/EBITDA, and PE. It is an integral part of a pitch book and has a wide application in the preparation of a fairness opinion for a deal.
- These historical transaction multiples are analysed to arrive at an appropriate purchase price for the target company.
- Transaction comps are based on the final offer price therefore, gives an idea of the M&A transactions happened in the past. The deal consideration may be of cash, stock or both cash & stock.
- The price paid in comparable transactions generally includes control premium, except where the transaction involves acquisition of a non-controlling/minority stake.
- This method suffers from the limitation of data availability, transaction-related information is difficult to obtain.

Following are the characteristics for identifying or selecting the comparable transaction

- The comparable transactions should possess following characteristics:

Purchase Price Consideration

Size & Profitability of the Company

Geographic Location

Deal Closure Date

Equity Stake

Industry

Product & Services of the Company

Strategic & Financial Buyer

Types of Relative Valuation (4/4)

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Steps for Precedent Transaction Analysis

Step: 1 Identify transaction comparable.

Step: 2 Determine key transaction multiple.

Step: 3 Select and adjust transaction multiple.

Step: 4 Apply discount or premium to selected multiples.

Step: 5 Apply the adjusted transaction multiple to the subject company to arrive at the value.

Key Considerations

Any multiples outliers in the comparable transaction should be analysed and excluded from the data set.

Ensures appropriate valuation multiple such as EV or Equity Value are considered.

Selected comparable transaction companies should have similar operation to the subject company.

While selecting comparable transactions emphasis should be given to most recent transaction, subject to impact of economic factors on transaction multiple.

Relative Valuation Multiples

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Following multiples are used to standardize relative value of the company:

Earnings Multiples

- When buying an equity, price is paid, as a multiple of earnings per share generated by the company. When buying a business, it is common to examine the value of the firm as a multiple of the operating income.
- A lower multiple is better than a higher one, these multiples will be affected by the growth potential and risk of the business being acquired.

Book Value Multiples

- To estimate the fair value of the business, investors often considers the relationship between the price they pay for a stock and the net worth of the business.
- When valuing businesses, we estimate this ratio using the value of the firm and the book value of all assets or capital.

Revenue Multiples

- Price paid by the investor or acquirer as a multiple of the revenue generated by the company.
- For equity investor price to revenue ratio is determined as market value of equity divided by revenue generated by the company.
- For firm value the ratio is determined as enterprise value divided by revenue generated by the company.

Cash Flow Multiples

- Cashflow multiples measures how much a company generates cash relative to its enterprise or equity value.
- Reflects actual cash generating abilities of the company by considering cash transaction and adding back non cash transactions such as depreciation & amortization.
- A higher ratio generates the premium over the price.

When Relative Valuation is Used?

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Following are some of the financial market activities where relative valuation is applicable:

Restructuring

M&A Advisory

Share Buybacks

Fair Opinion

Terminal Value

Start-Ups

IPO / Follow on Offerings

Succession planning

Divesture

Pros & Cons of Relative Valuation

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Pros of Relative Valuation

Easy to Use

Relative valuation method is easy to use, simple to comprehend, less time consuming and easily understood by users.

Simple Calculations

The method incorporates information from comparable in a simple way and provides consistency in the valuation process by ensuring that valuation is in line with other comparative valuations.

Current Market Trends

It relies upon market information and implicitly embodies current market consensus about assumptions such as the discount rate and growth rate. Hence, it reflects the current mood of the market.

Cons of Relative Valuation

Distorted Valuation

Relative valuation consider market value of comparable company. Due to market volatility, if comparable company is overvalued or undervalued by the market, in that case considering such comparable market value can distort target company’s valuation.

Difficult to find comparable companies

Identifying comparable companies with similar growth rates, business composition, stage and riskiness of business is a difficult task and finding a perfect match is extremely challenging.

Future potentials are not considered

Relative valuation considers historical data. The method does not consider significant future potential or benefit that may arise due to beneficial circumstances such as market expansion, which may result into under valuation of a company.

Adjustments to Multiples in Certain Situations

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Controlling Interest

- When the target company has a minority stakeholder or lack of marketability, the impact of DLOM or DLOC should be deducted from the enterprise value.

Multiples Adjustment

- To achieve the fair value of the company extremely high, low and negative multiples should be examined and excluded from the comparable set.

Multiples Trend

- Consider the trend in multiples over several historical periods to determine if the recent multiples provide a reasonable basis to select the final range of multiples.

Forward Multiples

- When using forward multiples, ensure that the financial metrics for companies can be reliably projected.

Preferred Multiples by Sectors

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Sectors	P/E	P/B	EV/EBITDA	EV/EBIT	EV/Revenue	Price/FCF
Banking, Financial Service & Insurance	✓	✓		✓		
Energy			✓			
Food and Beverages	✓		✓			
Life Sciences & Healthcare			✓		✓	
Manufacturing & Distribution			✓	✓		✓
Real Estate, Building Materials & Construction	✓	✓	✓			
Software	✓					
Technology, Media & Telecommunications	✓		✓	✓		

Industry Specific Multiples

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Industries	Key Variables
Mutual Fund	Asset Under Management
Oil	EV/ Barrel of equivalent
Power	EV/MW
Entertainment & Media	EV/Per screen, EV/Subscriber
Metal	EV/Metric Ton
Textiles	EBITDA depend upon capacity utilization Percentage & per spindle value
Hospital	EV/Room
Airlines	EV/Plane, EV/passenger, EV/Aero Revenue, EV/Non-Aero Revenue
Shipping	EV/Order Book
Cement	EV/Per Ton

Common Mistakes in Relative Valuation

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Blindly Using Comparable Price Paid	• In some cases, the buyer or seller may have been in a weak negotiating position which influenced the price paid. • Such inflated market price distort the subject company value.
Selecting Inappropriate Valuation Multiple	• Selecting EV/EBIT multiple for valuing companies having negative EBIT, capital intensive companies and banking & insurance sector etc, results into fallacious valuation of the company.
Selecting Inappropriate Comparable Companies	• Selected comparable companies' characteristics such as company geography, market cap, revenue, risk, growth potential, leverage, etc dispersed to the subject company leads to distorted valuation. • For instance, subject company is operating in developed market, so the comparable companies operating in the developed market should be selected.
Selecting Older Transaction	• The value of recent transaction differs from the value of the older transactions. However, transaction are impacted by macro-economic and industry factor which affects value of the company.
Considering Same Numerator & Denominator	• While selecting valuation multiples for both trading and transaction comps, considering same numerator or denominator results into distorted valuation. • For instance, considering Price/EV or Price/FCFE, EV/Net Income, Ev/Market Cap.

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Thank You

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