Module 5 Article

Different Valuation Methods

Key Terms

- **Forecasting**: Predicting future value based on current metrics such as cash flow, share price, relevant ratios, etc.
- **Capitalization (Cap) Rate**: A percentage used to convert between market value and investment returns.
- **Fair Market Value**: The price at which an asset would be sold or bought under "perfect" circumstances, defined by both parties having knowledge about the asset and willingly participating in the trade.

There's More Than Financials

When analyzing a company, it is critical to not only look at its financials, but be able to apply them to estimate long term performance. This is what "valuation" achieves.

The three main valuation methods, DCF analysis, Comparable company analysis and precedent transactions, are used across the finance industry to evaluate companies.

Method 1: Discounted Cash Flow

DCF (discounted cash flow) analysis forecasts businesses's future free cash flow, and discounts it back to the present day based on the company's weighted average cost of capital, also known as WACC.

The purpose of DCF analysis is to determine the current true value of a company based on its predicted future performance. A DCF analysis starts a model of the company's financials, requiring significant analysis and assumptions.

A DCF model also allows analysts to make changes to their assumptions, adjusting for various business climates to see how it will impact the company in the future. When evaluating a large company, analysts will split into different components and conduct distinct analyses on each part. Eventually these are combined into a "sum-of-the-parts" analysis.

Overall, DCF analysis is the most detailed and thorough approach to valuation modeling, though it also takes the most work.

Method 2: Comparable Company Analysis

Comparable company analysis is a relative valuation method in which the present value of a company is compared to that of other similar companies. This is achieved through analyzing published trading multiples for various industries.

Typically, EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is the most commonly compared metric, however others exist such as Price To Earnings and EV/EBITDA. This valuation method gives an actual observable value against other companies. This is the most common valuation methodology since the ratios used are easy to calculate and based on current information.

For Comparison's Sake: Say Company X trades at 5 times their P/E ratio and Company Y has a P/E ratio of $10. If these companies have similar attributes and are comparable companies then Company Y should be valued at $50 per share.

Method 3: Precedent Transactions Analysis

Precedent Transactions Analysis is another form of relative valuation in which the company is compared to businesses that have sold or been acquired in the same industry. The values used include the entire cost of acquiring the business.

The value derived from this methodology is useful for M&A transactions. However, these analyses can easily become dated and no longer reflect the market since companies are not sold everyday and the market is always shifting. This methodology is less common than DCF or the comparable transaction method, however, is sometimes used in tandem with the latter.

The Bottom Line

For a quick understanding to begin analyzing a company, a comparable or previous transaction analysis may be in your best interest. If you are looking to dive deep into the valuation and be very detailed, DCF analysis is the way to go.