BASIC PRINCIPLES OF FINANCIAL VALUATION DISCOUNTING

Valuation by Comparables

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VALUATION BY COMPARABLES

Practitioners often refer to “comps”

Comparable transactions or prices

Quick, easy, and dangerous!

ASSUMPTIONS FOR "COMPS"

1. You can identify close comparables
2. You have a value–relevant ratio
3. The market values comps similarly

COMPARABLES IN USE

$$(\text{Price}/\mathit{Attribute}\ ) * \mathit{Your\ Attribute} = \mathit{Price\ of\ your\ asset}$$

Examples of attributes:

- P/E ratios
- Earnings Yield
- Dividend Yield
- Return on Assets
- EBITDA multiples

P/E RATIOS

Price–to–earnings ratio is popular

How much a dollar of current earnings costs?

“Trades at X times earnings”

P/E RATIOS: EXAMPLE

Value Lowes Corporation by comps

	Home Depot	Lowes
E (earnings)	\$6.80	\$2.46
P/E	25	--
Comp value	--	\$61.60

Comp value of Lowes = $P/E_{\text{Home Depot}} * E_{\text{Lowes}}$

= 25 * \$2.46 = \$61.60

Lowes actual price in the market = \$74 (about 20% different)

OTHER COMMON COMPS

Return on Assets or Equity (ROA/ROE)

Return on invested capital (ROI)

Dividend yield

PEG ratio (P/E ratio over Growth in E)

MEASURING COMPS

Comps rely on historical averages

Trailing 12m, most recent Q, past 3 years…?

Negative earnings, negative prices?

COMPS VS. DCF

- Both can provide useful information
- Executed correctly, both are valid
- Comps often used (and abused) in practice
- Both require forecasts
- DCF is more appealing in theory and more accurate, but requires much more work
- Comps can be a good quick-and-dirty valuation, but be careful!