Understanding Valuation Multiples - Priyam Chandan

Q) What are Valuation Multiples?

Q) How does Valuation Multiples Differ for Different Companies and why?

Q) Are there any consistencies we have to follow while we consider different valuation Multiples?

Valuation Multiples - Valuation Multiples are used to understand if companies are overvalued, undervalued or fairly valued. They compare the market value of the company and another financial metric such as earnings, or revenue. They provide a view about how the company is valued in the market and is used in relative valuation instead of intrinsic valuation.

Common Valuation Techniques are:

- EV/EBITDA
- P/E
- P/B
- EV/SALES

Advantages

- Relatively Simple than intrinsic.
- Reflects Market Mood.
- Less prone to misleading assumptions.

Limitations

- Relative, not Intrinsic.
- Can reflect Mispricing across the entire sector.

How Does Valuation Multiples Differ Across Different Companies?

After I valued different companies with different valuation multiples, I understood the logic behind why it's important to consider different valuation multiples for different companies, for different sectors etc and why a standard one does not work in each case.

- **<u>EV/ Sales</u>**

Suited for high growth companies.
Businesses with low or negative profits.

Logic is that Revenue is the earliest observable value driver when profitability has not yet stabilized. Using profit-based multiples would distort valuation at this stage.

- **EV/ EBITDA**

Suitable for mature operating businesses.
Capital intensive companies

EBITDA approximates operating cash generation before capital structure and accounting effects, making it useful for comparing firms with different leverage levels.

- **P/E**

Profitable, Stable companies
Businesses with predictable earnings

P/E multiple takes into account, the net income of the company which is post tax and interest, and it is the earnings left for the equity shareholders which is why its an equity multiple. The logic is that P/E should be ideally used when a company has stable earnings and is not too heavily reliant on debt as interest has already been paid off in this multiple and profits can be heavily affected by high leverage.

- **P/B**

Financial institutions (banks, NBFCs, insurers)

In Banks and financial institutions, book value represents the **core economic capital used to generate returns.** Hence for banks, it makes sense to use P/B as the multiple as the price the market is offering for its earnings, are closely related or similar to the balance sheet value.

Are there any consistencies we have to follow while we consider different valuation Multiples?

Valuation Consistencies are basically making sure that all the elements in a valuation model align.

By align I mean, For eg, **FCFF** cannot be discounted at Cost of Equity, its the cash that belongs to debt holders as well, hence has to be **discounted at WACC.**

Numerator, Denominator Consistencies - The most important consistency that has to be followed is making sure the Value measure (Numerator) and the value driver (Denominator) are consistent.

Enterprise value (Numerator - Value measure) has to be aligned only with items that **are Pre debt** such as EBITDA, Revenue, EBIT etc. This is because EV accounts for all the capital providers (Debt and Equity).

On the other hand, valuation multiples like P/E, P/B are **Equity value multiples,** they should only be aligned with items that are post tax (Net income). Because **Equity value multiples** accounts only for Equity shareholders.

Investments in Unconsolidated Affiliates and Minority Interest

Minority Interest

Let's say a company owns more than 50% of another company, the subsidiary is fully consolidated but the parent does not own 100%.

There is a financials mismatch as:
100% of subsidiary EBITDA is included, but the equity value is only representing the parent's share.

Hence, to make sure that the Numerator and Denominator is consistent, we calculate EV by:

Market Cap + Debt + Minority Interest (NCI) - Cash (Now has subsidiary equity as well)

Scenario 2 : Unconsolidated Affiliates / Associate Investments

Let's suppose a company owns < 50% of another firm, hence earnings are not consolidated. If we use Enterprise value as our value measure in our multiple, then we need to make certain adjustments.

The current scenario is that the EV includes the value of the associate, and the EBITDA doesn't include the associate company's earnings, hence there is a mismatch.

In order to match the Numerator and Demominator, we need to make certain adjustments.

EV = Market Cap + Net Debt - Value of associates investments.

EBITDA = Reflects EBITDA of the parents only.

In Short: Before Choosing a Valuation Multiple, Consider the Following

- **Match the multiple to the business model**
  Early-stage or loss-making firms → Revenue-based multiples
  Mature, profitable firms → Earnings or cash flow-based multiples

- **Use EV multiples for operating performance**
  EV should be paired with pre-debt metrics like Revenue, EBITDA, or EBIT since it reflects both debt and equity holders.

- **Use equity multiples only with equity earnings**
  P/E and P/B must be aligned with net income or book value, as they represent returns available to equity shareholders only.

- **Avoid profit-based multiples when earnings are unstable**
  If margins are volatile or negative, P/E or EV/EBITDA can mislead valuation conclusions.

- **Ensure numerator–denominator ownership consistency**
  If EBITDA includes 100% of a subsidiary, EV must include minority interest.

- **Remove non-operating investments when earnings exclude them**
  Subtract associate investments from EV when their earnings are not consolidated.