How do you value a company?

How do you value a company?

- The starting point for answering this question is to ask what is a company worth?
- The problem is that there is no answer to this question
- Or rather, there is no single answer to this question

- What is a company worth?

How do you value a company?

- Depending who you ask you will get a different answer
- Depending what method you use, you will get a different answer
- So valuing a company is a process of trying to narrow down a range of different answers

- There is no single answer…

How do you value a company?

- Our first problem is that markets are not efficient
- What ever the Efficient Market Hypothesis says, it is clear that the information available to the market is imperfect
- Some people have more information than others
- Some people have more appetite for risk than others
- Some people are buyers and some people are sellers - two different prices right there

- Markets are not efficient

How do you value a company?

- You may think that all you have to do is look up the share price of a company and you can find out what is it worth?
- But market price is not the same as value
- In imperfect markets, some companies are under valued and some are over valued
- Value does not equal price

How do you value a company?

- Value investors such as Warren Buffett recognise that markets are imperfect
- They compare the financial information to the price in the market and look to identify companies with certain characteristics which, in their view are undervalued by the market

- Warren Buffet understands value

How do you value a company?

- So where do we start trying to understand how to value a company?
- We need to understand that Company Valuation is a process through which we attempt to estimate the range of economic value a business may have to its owners
- Valuation is no more than an estimate

How do you value a company?

- Asking why we want to value a business will tell us a lot about its value
- Fair Market Value is sought by buyers and sellers to arrive at a price for a transaction
- Investment Value is what a particular investor is prepared to pay
- Intrinsic Value is the in-depth measure of potential economic value

- Valuation is a function of purpose

How do you value a company?

- If we believe a company has long term potential, we will value it on a going concern basis - we expect it to make profits in the future
- We may be more pessimistic and feel that the company's assets should be sold in an orderly way to unlock its value - an orderly disposition
- Or perhaps we are only interested in liquidating the assets as quickly as possible, which would place a much lower value on those assets

- Value is a function of potential

How do you value a company?

- The starting point for valuation is the financial statements of the company
- We can turn to ratio analysis to understand these numbers in a way that makes Comparative Valuation with other companies possible
- Ratios also tell us about historic trends
- Price and Earnings ratio enable us to compare the relative market value of the company

- Start with the Financial Statements

How do you value a company?

- It is important to understand the purpose of the three financial statements
  - Income Statement
  - Balance Sheet
  - Cash Flow
- They aim to show a true and fair position of the company
- This has nothing to do with valuation
- Accounting principles adjust the numbers
- Profits do not equal Cash
- So we need to make sure that we focus on Cash Flow and not profit when looking to understand valuation

- Need to focus on Cash Flow

How do you value a company?

- We have already seen that the market can give us an indication of a company's value - if that company is publicly traded
- We can also look at the financial statements of the firm and consider the value of its assets - ranging from going concern to liquidation
- And we can study the cash flow of the business to appraise the value from the historic and future income of the firm

- Income, Asset and Market

How do you value a company?

- Income, Asset and Market

- Lets look at these three approaches to valuation in more detail…
- Lets start with the Income Approach

How do you value a company?

- The income approach forecasts the future stream of cash flow or earnings from the business and using a discount rate, converts the future value to a present value
- This is commonly referred to as Discounted Cash Flow or DCF

- Discounted Cash Flow

How do you value a company?

- The Discount Rate is derived from the Capital Asset Pricing Model
- The Discount Rate is a measure of the risk that the investor is prepared to pay for the investment today in order to benefit from the future cash flows
- The higher the Discount Rate, the higher the expectation of risk and the lower the value

- Discount Rate and CAPM

How do you value a company?

- The components of the Discount Rate as set out in the Capital Asset Pricing Model are:
  - Risk Free Rate - Government Bond Rate
  - Risk Premium - in addition to the risk free rate (market risk)
  - Beta - reflecting the company or asset specific risk
- Discount Rate and CAPM

How do you value a company?

- When valuing the whole firm the discount rate needs to be adjusted for the balance between debt and equity as these have different costs of capital and therefore different discount rates
- Debt interest is also tax deductible which reduces the cost of debt by 1 - Corporate Tax Rate
- The WACC must be applied to the company's net cash flow from total invested capital (debt and equity)

- Weighted Average Cost of Capital

How do you value a company?

- This approach starts with the presumption that the value of a firm is the sum of its parts
- Asset value in the balance sheet, adjusted for depreciation and revalued to fair market value where applicable
- Fixed and Intangible assets
- Intangible asset valuation highly subjective. More likely to be taken as the difference between fixed assets and market capitalisation
- Net book values may be adjusted if the company is in financial distress
- More useful in asset rich companies such as property investment companies, not so much in technology companies

- Asset based Valuation

How do you value a company?

- The market approach assumes that in a free market the balance of supply and demand will correctly price an asset
- This also assumes that information in the market is efficiently distributed and investors act in a logical rather than emotional way

- Market based Valuation

How do you value a company?

- Comparable Companies valuation is a method where a peer group of "comparable companies" is used to value either a private or a public company
- The average of the peer group valuation ratios, such at EBITDA multiple or P/E multiple is used to derive a range of values for the company being valued
- In the case of a public company this may help to identify whether the market is under or over valuing the company

- Comparable Companies or "Comps"

How do you value a company?

- In this approach a group of historic M&A transactions is used as the valuing benchmark
- The deal values are used to derive ratios which are then applied to the company being valued
- This approach is fundamentally historic and does not take account of acquisition premiums paid in the deal for control of the target company
- Identifying a suitable peer group and its underlying financial information can be problematic

- Precedent Transactions

How do you value a company?

- These market based valuation approaches are often used by investment bankers
  - Initial Public Offerings
  - M&A Advisory
  - Fairness opinions
  - Restructuring
  - Share buybacks
- Applications of Valuations

How do you value a company?

- DCF Terminal Values

- Multiples and ratios also have a role when deriving the terminal value in a DCF
- The assumption is a sale of the business at the end of the cash flow periods (5 or 10 years) and a profit multiple (EBITDA or PE) is used
- The alternative approach is to assume the perpetual growth of the firm into the future
- Neither approach is particularly satisfactory but they are easy to apply
- Beware, terminal value can often be a significant proportion of a valuation

How do you value a company?

- Company valuation is clearly a complex topic
- You will never arrive at a finite number
- There is always the possibility of further analysis, updates and argument
- Its a process not a journey to a terminal destination

- A Process not a Destination

How do you value a company?

- I hope you found this discussion of Company Valuation helpful
- To learn more look out for my Company Valuation course, over 8 hours of detailed company valuation tuition based on over 30 years of investment banking experience

- Company Valuation Course

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