

# ***Valuation***

**C15.0042  
Lesson 7  
Edward M. Kerschner**

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## **Valuation multiples**

**The link between valuation multiples and value drivers - growth, return on capital, margins.**

# Valuation multiples

Valuation multiples are a key component of equity analysis their successful use depends upon a clear understanding of the factors that drive them

Objectives of this presentation:

- to explain what a valuation multiple can and cannot tell you about an equity investment
- to highlight the reasons why observed valuation multiples vary in practice
- to consider the influence on multiples of key value drivers - both in theory and in practice

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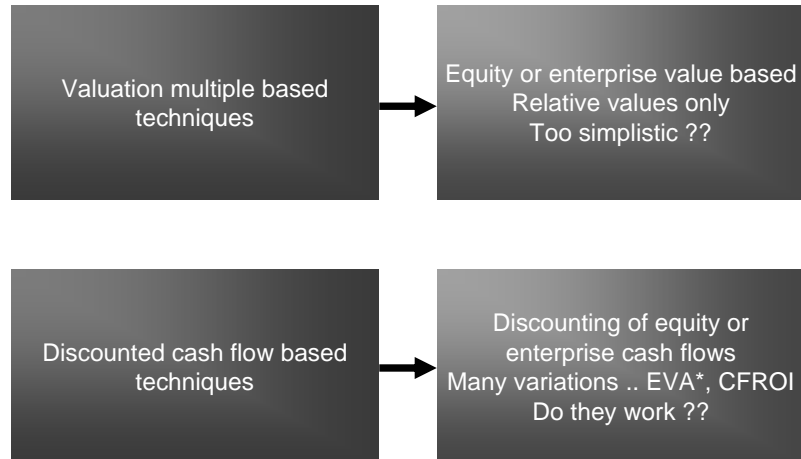
## What is a valuation multiple

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### SECTION 1

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## Alternative valuation approaches



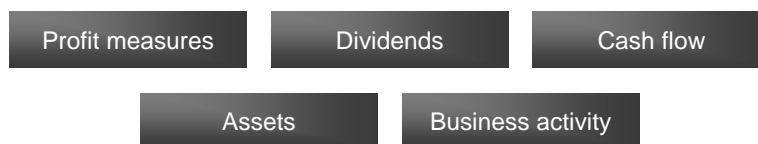
\*EVA is a registered trade mark of Stern Stewart & Co.

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## What is a valuation multiple?

- ◆ A stock's multiple simply reflects the market's interpretation of value
- ◆ Nothing more than an expression of market value relative to a key statistic which is assumed to relate to that value

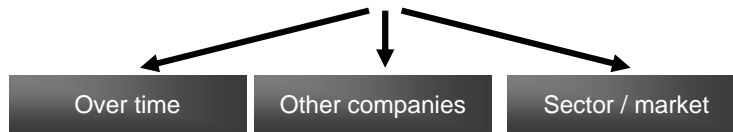
Many 'key statistics' could be used as a basis for multiples ...



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# Comparison of multiples

Multiples only useful when comparisons are made



An example ...

	Company	Sector
Value	100	1500
Key performance measure	5	100
Valuation multiple	20x	15x

Why might the company trade at a discount to the sector?

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# Are multiples useful for equity valuation?

Some practitioners (and most academics) deride valuation multiples ...

- ◆ Multiples are simple numbers and encourage simplistic interpretation
- ◆ Multiples combine many value drivers into one number and are therefore difficult to interpret
- ◆ Multiples are static
- ◆ Identifying why multiples differ is subjective

## Why do multiples vary ....

The non-steady state nature of most businesses  
Accounting policies  
The quality of the business  
Capital structure  
Business mix  
*Mis-pricing*

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## Yes, of course they are ...

Valuation is all about judgement

- ◆ Multiples give a framework for making these judgements
- ◆ Multiples focus on those key statistics followed by other investors

**DCF, EVA, etc,  
are not  
necessarily the  
whole answer ...**

“  
*Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw therefrom*

(Benjamin Graham, "The Intelligent Investor")

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## Why do valuation multiples vary

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**SECTION 2**

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## Why do multiples vary? – 4 factors

There are good reasons why valuation multiples vary  
It is not enough to say that the value of a business  
should be automatically based upon the 'sector'  
average multiple.

1. The quality of the business
2. Accounting differences
3. Fluctuations in profits
4. Mis-pricing

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## Multiples – The quality of the business

- ◆ High quality businesses deserve higher valuation multiples
- ◆ Consider differences in value drivers
  - Growth
  - Quality of management
  - New investment opportunities
  - Quality of franchise
  - etc. ....
- ◆ The problem is how to allow for those differences –
  - How much is growth worth?
  - What is the impact of a higher return on capital?

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## **Multiples – Accounting differences**

- ◆ Different accounting policies which do not affect cash flow should not affect value but do affect profit
- ◆ Profit based valuation multiples ARE affected by accounting policies

**Consider 2 identical companies except that A does not amortise goodwill while B amortises over 10 years**

	A	B
Earnings	100	80
Value	2000	?
Valuation multiple	20x	?

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## **Dealing with accounting differences**

- ◆ Restate data according to the same accounting policies
  - Difficult!!
- ◆ Focus on statistics which are less affected by accounting differences
  - Revenue
  - Cash flowx
  - EBITDA
  - OpFCF

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## Multiples - Fluctuations in profits

◆ Multiples are only meaningful if the profit used is representative of that 'maintainable' in the future - multiples vary if there are one-off profit fluctuations

◆ Consider the following ...

	97	98	99	00E	01E
Earnings	10	12	14	3	17
Average price		200	220	260	??
Historical priced P/E	20.0x	18.3x	18.6x		

◆ What is the 2000 current priced P/E likely to be??

The price is unlikely to collapse given the recovery in 2001 – therefore the multiple SHOULD rise considerably

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## Dealing with profit fluctuations

◆ A multiple is only meaningful if the profit on which it is based is indicative of future profit potential

- Exclude exceptional items
- Use forecast rather than historical profits

◆ Where the current or subsequent years profits are still not representative of the longer term ...

- consider using forward priced multiples

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## **Multiples - Mis-pricing**

- ◆ A low multiple could indicate that the stock is simply underpriced rather than just poor quality
- ◆ If deserved differences in multiples are not fully explained by differences in:
  - business quality
  - accounting policies
  - fluctuations in profits

... then the stock may simply be incorrectly priced

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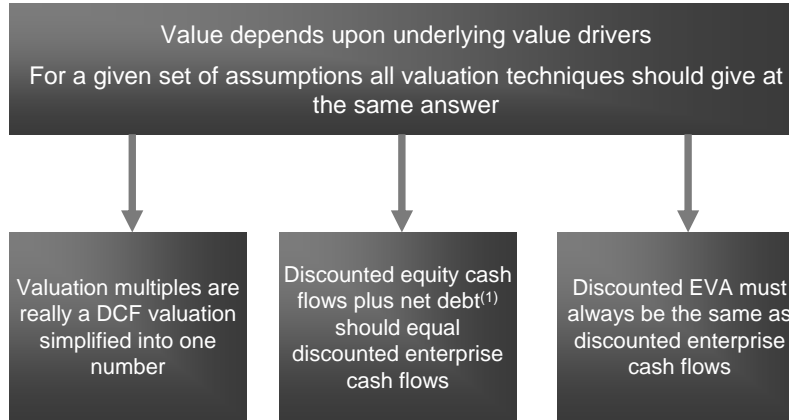
## **Multiples and value drivers**

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### **SECTION 3**

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## Remember all techniques are really the same ...



(1) And also plus the value of other non-equity claims on enterprise cash flows

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## Understanding value drivers is key

**Multiples cannot be interpreted in isolation**

Consider .....

- Growth
- Return on capital
- Margins
- Tax
- Capital investment

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## Value drivers - growth

Growth is rightly regarded by analysts as the key value driver

- ◆ Growth is reflected in short-term forecasts and therefore in prospective valuation multiples
- ◆ Multiple to growth ratios are used
- ◆ Multiples are often plotted against growth to try to ...
  - highlight the relationship between growth and value
  - identify possible mis-pricing

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## How much is growth worth?

- ◆ Growth is the most commented upon value driver...

... but how much is it worth?

- ◆ Question:

Forecast growth is 10% and the EBITDA multiple is 9.7x.

What would the multiple be if growth were reassessed at 15%?

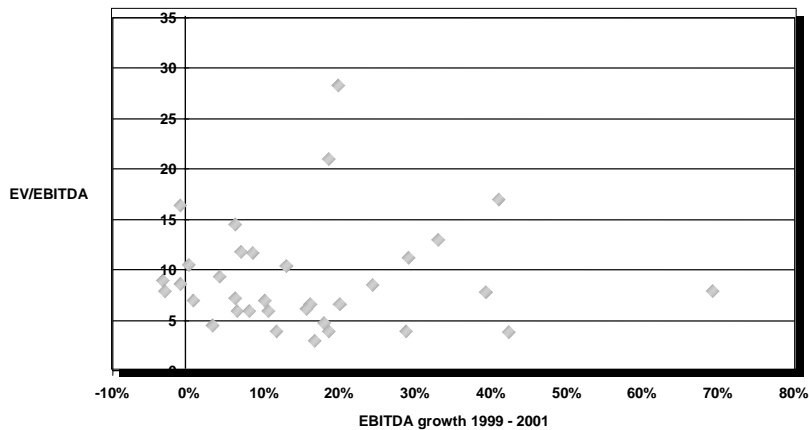
- 1) 9.7x   2) 10x   3) 12x   4) 14x   5) 16x

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# Multiples versus growth

Usually little correlation - why?

Global telecoms value versus growth



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# The quality of growth

The impact of growth on value depends upon its quality

High quality growth ...

- ◆ Requires little additional investment
  - Growth acquired through substantial additional investment does not add value and multiples should not be high
- ◆ Is sustainable
  - Growth which is 'one product based' or is unsustainable in other ways (e.g. lack of management resources) adds less value and should give a lower multiple

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## Value drivers - return on capital employed

Return on historical capital invested is irrelevant

- ◆ Because capital invested is a sunk cost !!!
- ◆ DCF values are not affected by differing levels of invested capital

Well, not quite....

- ◆ Forecast return on new investment is very important
- ◆ The return currently earned on past investment may be a guide to those future returns

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## Summary

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**SECTION 4**

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# Summary



BUT they must be interpreted with care - there are many reasons why multiples vary not just mis-pricing



Use these comparisons / charts as the starting point in analysis ... they are not the end result