Workshop III: Comparative Valuation

- Valuation
  - Intrinsic
  - Market Based
  - Sum of Parts
  - Options
- Market Based Valuation
  - Identifying Similar Companies
  - Valuation Multiples
- Questions
Valuation

- Valuation
  - Intrinsic
    - Price is the present value of all the future cash flows generated by the security discounted back to today. Can discount FCFF, FCFE, EVA, CFROI, Net income, etc.
  - Market Based
    - Price is whatever you can sell it for!
  - Sum of Parts
    - Company is split into different segments; each valued separately
  - Options
    - Company is viewed as a series of real options, each valued separately

- The Envelope Example: How much is an envelope that I say contains a $20 bill worth?

Comparative Valuation

- Market-based Valuation methods
  - Aka CompCo’s,
  - When looking at the price of an apple, look to see how other apples are priced in the market
  - Law of One Price: Assets / Firms with similar attributes should have similar prices

- Two key Issues
  - Identifying similar companies (apples)
  - Identifying means of comparison (which multiples to use)
Comparative Valuation: Pros and Cons

- **Benefits:**
  - Simple to calculate and explain
  - Does not require as much projection of future cash flows
  - Does not have as many explicit assumptions, such as risk-premium or beta
  - Implicitly incorporates a ‘market discount rate’.

- **Shortfalls:**
  - Definition of a comparable firm is subjective
  - Does not say if industry as a whole is ‘cheap’ or ‘expensive’ (eg tech boom)
  - Potential for bias (eg consolidation / acquisition plays)

Identifying Similar Companies

- Comparable companies should have similar risks, similar size, similar businesses, similar growth prospects, similar capital structures, similar industries, similar….I’m sure you get the picture.

- **Difficulties:** sometimes this is not easy
  - Monopolies (Microsoft)
  - Companies across industries (Marriott)
  - International Companies (Silicon Motion)
  - Special Situations: merger rumours, pending bankruptcy, etc.
Equity vs Enterprise Value Multiples

- Use of Accounting Multiples
- These can be Enterprise Value Multiples (including both Debt and Equity)
  - Example: EV/Sales, EV/EBITDA, EV / FCFF
- These can be Equity Multiples
  - Price/Earnings, Price/FCFE, PEG

We must match the numerator with the denominator on an equity / enterprise basis!

Eg: Equity numerator / Equity denominator or EV numerator / EV denominator. NOT Equity numerator / EV denominator

Comparing Multiples

- Multiples can use LTM / TTM numbers of forward numbers. Again, we must be consistent when comparing different companies.
- The infamous ‘Price Earnings Ratio’.
  - Price can be current price, 52-week average, 52-week high
  - Earnings can be forecasted for the next fiscal year, can be LTM / TTM. They can be diluted or undiluted, adjusted or unadjusted for special items / one time charges.
- We must be consistent!
Common Multiples

Different multiples tell us different things:

- **EV/Sales**: Does not incorporate any firm-specific information about pricing policies, production efficiencies or selling efficiencies.
- **EV / Gross Margin**: Incorporates information about firm’s pricing policies and production efficiency.
- **EV / EBITDA**: Incorporates all operating aspects of the firm and ignores accounting conventions (depreciation) that may distort cash strength; ignores capital structure. One of the most useful multiples.
- **EV / FCFF**: Although hard to calculate, this is a very useful ratio.
- **Price / Earnings**: Measures how much one is willing to pay for a dollar of current earnings for a certain firm.
- **PEG**: Standardizes price earnings ratio by a growth rate; useful at seeing how ‘expensive’ the growth of a firm is.

### Comparative Valuation of Outback Steakhouse (as of 10/13/2005)

<table>
<thead>
<tr>
<th>Comparables</th>
<th>TTM Total Enterprise Value Multiples</th>
<th>TTM Equity Market Value Multiples</th>
<th>Market Cap (thousands)</th>
<th>Debt/Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005 Est</td>
<td>2005E</td>
<td>TTM</td>
<td>TTM</td>
</tr>
<tr>
<td>Appleby’s</td>
<td>1.5</td>
<td>1.4</td>
<td>8.2</td>
<td>10.7</td>
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<tr>
<td>Brinker International</td>
<td>0.9</td>
<td>0.9</td>
<td>7.7</td>
<td>13.0</td>
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<tr>
<td>Darden</td>
<td>1.0</td>
<td>0.9</td>
<td>7.5</td>
<td>11.0</td>
</tr>
<tr>
<td>McDonalds</td>
<td>2.4</td>
<td>2.2</td>
<td>9.7</td>
<td>12.9</td>
</tr>
<tr>
<td><strong>Mean</strong></td>
<td>1.47 x</td>
<td>1.35 x</td>
<td>8.26 x</td>
<td>11.92 x</td>
</tr>
<tr>
<td><strong>Median</strong></td>
<td>1.27 x</td>
<td>1.16 x</td>
<td>7.92 x</td>
<td>11.97 x</td>
</tr>
<tr>
<td>Outback Steakhouse (current)</td>
<td>0.79</td>
<td>0.73</td>
<td>6.87</td>
<td>9.73</td>
</tr>
<tr>
<td>Implied Share Price</td>
<td>$66.26</td>
<td>$66.52</td>
<td>$42.50</td>
<td>$43.35</td>
</tr>
</tbody>
</table>

**Current Share Price** $35.11

- **Backing out Share Prices:**
  
  Average (Price / Earnings) * Target Firm Earnings = **Justified Price**
  
  Average (EV / EBITDA) * Target Firm EBITDA = Justified Enterprise Value
  
  **Justified Price** = (Justified Enterprise Value − Total Debt + Cash) / # shares outstanding
Questions?

- Workshop I: Financial Markets
- Workshop II: Financial Accounting
- Workshop III: Market Based Valuation
  Workshop IV: Intrinsic Discounted Cash Flow Valuation
  Workshop V: Analyzing Companies
  Workshop VI: Effective Presentations

Additional Workshops: Options, Alternative Investments, Excel Modeling, Efficient Markets, Investing Strategies