

# Picking one Multiple

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- This is usually the best way to approach this issue. While a range of values can be obtained from a number of multiples, the “best estimate” value is obtained using one multiple.
- The multiple that is used can be chosen in one of two ways:
  - Use the multiple that best fits your objective. Thus, if you want the company to be undervalued, you pick the multiple that yields the highest value.
  - Use the multiple that has the highest R-squared in the sector when regressed against fundamentals. Thus, if you have tried PE, PBV, PS, etc. and run regressions of these multiples against fundamentals, use the multiple that works best at explaining differences across firms in that sector.
  - Use the multiple that seems to make the most sense for that sector, given how value is measured and created.

# A More Intuitive Approach

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- Managers in every sector tend to focus on specific variables when analyzing strategy and performance. The multiple used will generally reflect this focus. Consider three examples.
  - In retailing: The focus is usually on same store sales (turnover) and profit margins. Not surprisingly, the revenue multiple is most common in this sector.
  - In financial services: The emphasis is usually on return on equity. Book Equity is often viewed as a scarce resource, since capital ratios are based upon it. Price to book ratios dominate.
  - In technology: Growth is usually the dominant theme. PEG ratios were invented in this sector.

# Conventional usage...

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Sector	Multiple Used	Rationale
Cyclical Manufacturing	PE, Relative PE	Often with normalized earnings
Growth firms	PEG ratio	Big differences in growth rates
Young growth firms w/ losses	Revenue Multiples	What choice do you have?
Infrastructure	EV/EBITDA	Early losses, big DA
REIT	P/CFE (where CFE = Net income + Depreciation)	Big depreciation charges on real estate
Financial Services	Price/ Book equity	Marked to market?
Retailing	Revenue multiples	Margins equalize sooner or later

# Relative versus Intrinsic Value

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- If you do intrinsic value right, you will bring in a company's risk, cash flow and growth characteristics into the inputs, preserve internal consistency and derive intrinsic value. If you do relative value right, you will find the right set of comparables, control well for differences in risk, cash flow and growth characteristics. Assume you value the same company doing both DCF and relative valuation correctly, should you get the same value?
  - ▣ Yes
  - ▣ No
- If not, how would you explain the difference?
- If the numbers are different, which value would you use?
  - ▣ Intrinsic value
  - ▣ Relative value
  - ▣ A composite of the two values
  - ▣ The higher of the two values
  - ▣ The lower of the two values
  - ▣ Depends on what my valuation "mission" is.

# Reviewing: The Four Steps to Understanding Multiples

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- Define the multiple
  - ▣ Check for consistency
  - ▣ Make sure that they are estimated uniformly
- Describe the multiple
  - ▣ Multiples have skewed distributions: The averages are seldom good indicators of typical multiples
  - ▣ Check for bias, if the multiple cannot be estimated
- Analyze the multiple
  - ▣ Identify the companion variable that drives the multiple
  - ▣ Examine the nature of the relationship
- Apply the multiple