Application Tests

- Given the firm that we are valuing, what is a "comparable" firm?
  - While traditional analysis is built on the premise that firms in the same sector are comparable firms, valuation theory would suggest that a comparable firm is one which is similar to the one being analyzed in terms of fundamentals.
  - Proposition 4: There is no reason why a firm cannot be compared with another firm in a very different business, if the two firms have the same risk, growth and cash flow characteristics.
- Given the comparable firms, how do we adjust for differences across firms on the fundamentals?
  - Proposition 5: It is impossible to find an exactly identical firm to the one you are valuing.

Valuing one company relative to others… Relative valuation with comparables

- Ideally, you would like to find lots of publicly traded firms that look just like your firm, in terms of fundamentals, and compare the pricing of your firm to the pricing of these other publicly traded firms. Since, they are all just like your firm, there will be no need to control for differences.
- In practice, it is very difficult (and perhaps impossible) to find firms that share the same risk, growth and cash flow characteristics of your firm. Even if you are able to find such firms, they will very few in number. The trade off then becomes:

Small sample of firms that are "just like" your firm

Large sample of firms that are similar in some dimensions but different on others

Techniques for comparing across firms

1. Direct comparisons: If the comparable firms are "just like" your firm, you can compare multiples directly across the firms and conclude that your firm is expensive (cheap) if it trades at a multiple higher (lower) than the other firms.
2. Story telling: If there is a key dimension on which the firms vary, you can tell a story based upon your understanding of how value varies on that dimension.

   An example: This company trades at 12 times earnings, whereas the rest of the sector trades at 10 times earnings, but I think it is cheap because it has a much higher growth rate than the rest of the sector.
3. Modified multiple: You can modify the multiple to incorporate the dimension on which there are differences across firms.
4. Statistical techniques: If your firms vary on more than one dimension, you can try using multiple regressions (or variants thereof) to arrive at a "controlled" estimate for your firm.

Example 1: Let's try some story telling
Comparing PE ratios across firms in a sector

Company Name	*Trailing PE*	*Expected Growth*	*Standard Deviation*
Coca-Cola Bottling	29.18	9.50%	20.58%
Molson Inc. Ltd. 'A'	43.65	15.50%	21.88%
Anheuser-Busch	24.31	11.00%	22.92%
Corby Distilleries Ltd.	16.24	7.50%	23.66%
Chalone Wine Group	21.76	14.00%	24.08%
Andres Wines Ltd. 'A'	8.96	3.50%	24.70%
Todhunter Int'l	8.94	3.00%	25.74%
Brown-Forman 'B'	10.07	11.50%	29.43%
Coors (Adolph) 'B'	23.02	10.00%	29.52%
PepsiCo, Inc.	33.00	10.50%	31.35%
Coca-Cola	44.33	19.00%	35.51%
Boston Beer 'A'	10.59	17.13%	39.58%
Whitman Corp.	25.19	11.50%	44.26%
Mondavi (Robert) 'A'	16.47	14.00%	45.84%
Coca-Cola Enterprises	37.14	27.00%	51.34%
Hansen Natural Corp	9.70	17.00%	62.45%

A Question

- You are reading an equity research report on this sector, and the analyst claims that Andres Wine and Hansen Natural are under valued because they have low PE ratios. Would you agree?
  a. Yes
  b. No
- Why or why not?

Example 2: Fact-based story telling
Comparing PE Ratios across a Sector: PE

Company Name	PE	Growth
PT Indosat ADR	7.8	0.06
Telebras ADR	8.9	0.075
Telecom Corporation of New Zealand ADR	11.2	0.11
Telecom Argentina Stet - France Telecom SA ADR B	12.5	0.08
Hellenic Telecommunication Organization SA ADR	12.8	0.12
Telecomunicaciones de Chile ADR	16.6	0.08
Swisscom AG ADR	18.3	0.11
Asia Satellite Telecom Holdings ADR	19.6	0.16
Portugal Telecom SA ADR	20.8	0.13
Telefonos de Mexico ADR L	21.1	0.14
Matav RT ADR	21.5	0.22
Telstra ADR	21.7	0.12
Gilat Communications	22.7	0.31
Deutsche Telekom AG ADR	24.6	0.11
British Telecommunications PLC ADR	25.7	0.07
Tele Danmark AS ADR	27	0.09
Telekomunikasi Indonesia ADR	28.4	0.32
Cable & Wireless PLC ADR	29.8	0.14
APT Satellite Holdings ADR	31	0.33
Telefonica SA ADR	32.5	0.18
Royal KPN NV ADR	35.7	0.13
Telecom Italia SPA ADR	42.2	0.14
Nippon Telegraph & Telephone ADR	44.3	0.2
France Telecom SA ADR	45.2	0.19
Korea Telecom ADR	71.3	0.44

PE, Growth and Risk

Dependent variable is: PE

R squared = 66.2% R squared (adjusted) = 63.1%

Variable	Coefficient	SE	t-ratio	Probability
Constant	13.1151	3.471	3.78	0.0010
Growth rate	121.223	19.27	6.29	≤ 0.0001
Emerging Market	-13.8531	3.606	-3.84	0.0009

Emerging Market is a dummy: 1 if emerging market

0 if not

Is Telebras under valued?

- Predicted PE = 13.12 + 121.22 (.075) - 13.85 (1) = 8.35
- At an actual price to earnings ratio of 8.9, Telebras is slightly overvalued.
- <u>Bottom line</u>: Just because a company trades at a low PE ratio does not make it cheap.

Example 3: An Eyeballing Exercise with P/BV Ratios European Banks in 2010

Name	PBV Ratio	Return on Equity	Standard Deviation
BAYERISCHE HYPO-UND VEREINSB	0.80	-1.66%	49.06%
COMMERZBANK AG	1.09	-6.72%	36.21%
DEUTSCHE BANK AG -REG	1.23	1.32%	35.79%
BANCA INTESA SPA	1.66	1.56%	34.14%
BNP PARIBAS	1.72	12.46%	31.03%
BANCO SANTANDER CENTRAL HISP	1.86	11.06%	28.36%
SANPAOLO IMI SPA	1.96	8.55%	26.64%
BANCO BILBAO VIZCAYA ARGENTA	1.98	11.17%	18.62%
SOCIETE GENERALE	2.04	9.71%	22.55%
ROYAL BANK OF SCOTLAND GROUP	2.09	20.22%	18.35%
HBOS PLC	2.15	22.45%	21.95%
BARCLAYS PLC	2.23	21.16%	20.73%
UNICREDITO ITALIANO SPA	2.30	14.86%	13.79%
KREDIETBANK SA LUXEMBOURGEOI	2.46	17.74%	12.38%
ERSTE BANK DER OESTER SPARK	2.53	10.28%	21.91%
STANDARD CHARTERED PLC	2.59	20.18%	19.93%
HSBC HOLDINGS PLC	2.94	18.50%	19.66%
LLOYDS TSB GROUP PLC	3.33	32.84%	18.66%
Average	2.05	12.54%	24.99%
Median	2.07	11.82%	21.93%

The median test…

- We are looking for stocks that trade at low price to book ratios, while generating high returns on equity, with low risk. But what is a low price to book ratio? Or a high return on equity? Or a low risk
- One simple measure of what is par for the sector are the median values for each of the variables. A simplistic decision rule on under and over valued stocks would therefore be:
  - Undervalued stocks: Trade at price to book ratios below the median for the sector,(2.07), generate returns on equity higher than the sector median (11.82%) and have standard deviations lower than the median (21.93%).
  - Overvalued stocks: Trade at price to book ratios above the median for the sector and generate returns on equity lower than the sector median.

How about this mechanism?

- We are looking for stocks that trade at low price to book ratios, while generating high returns on equity. But what is a low price to book ratio? Or a high return on equity?
- Taking the sample of 18 banks, we ran a regression of PBV against ROE and standard deviation in stock prices (as a proxy for risk).

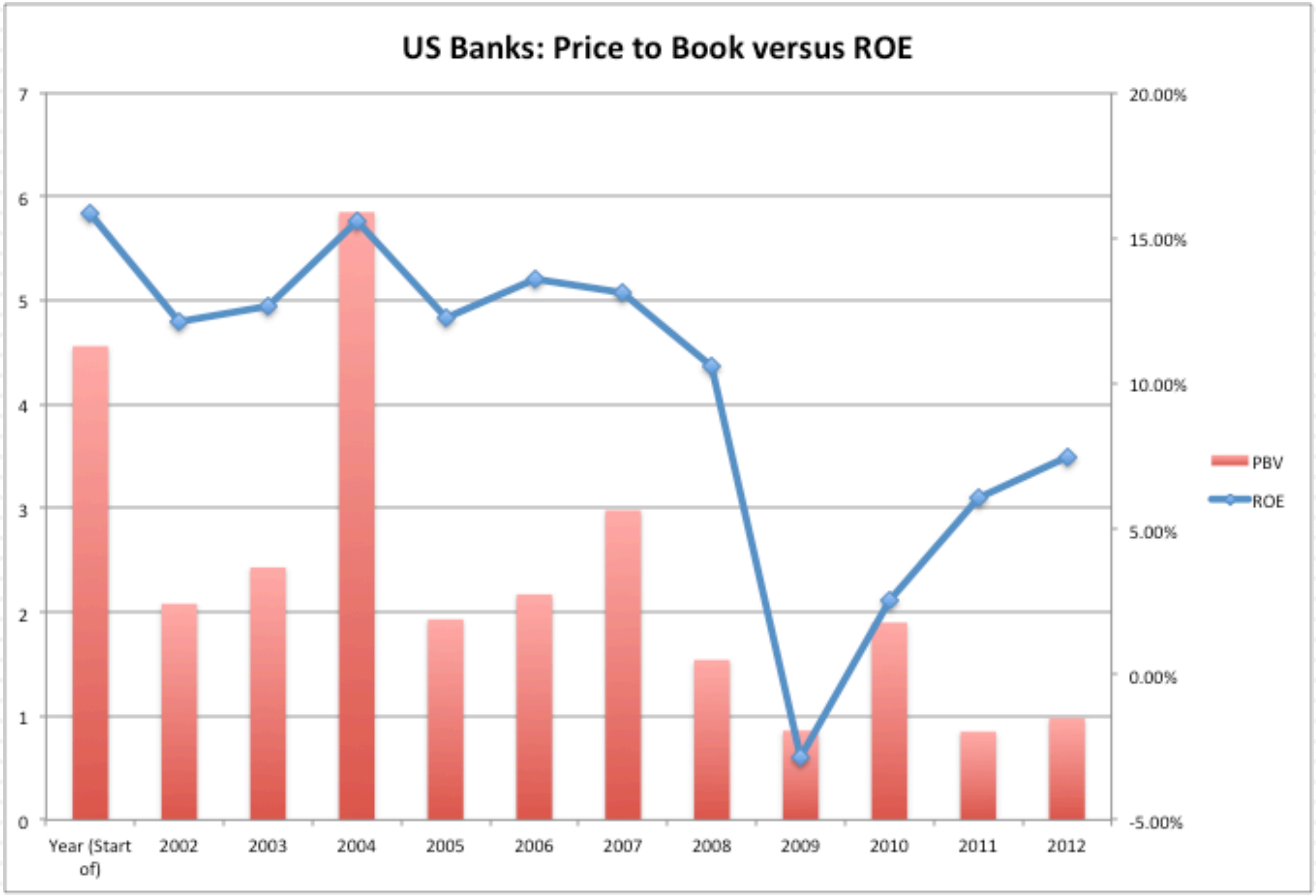
PBV =	2.27	+	3.63 ROE	-	2.68 Std dev
	(5.56)		(3.32)		(2.33)

R squared of regression = 79%

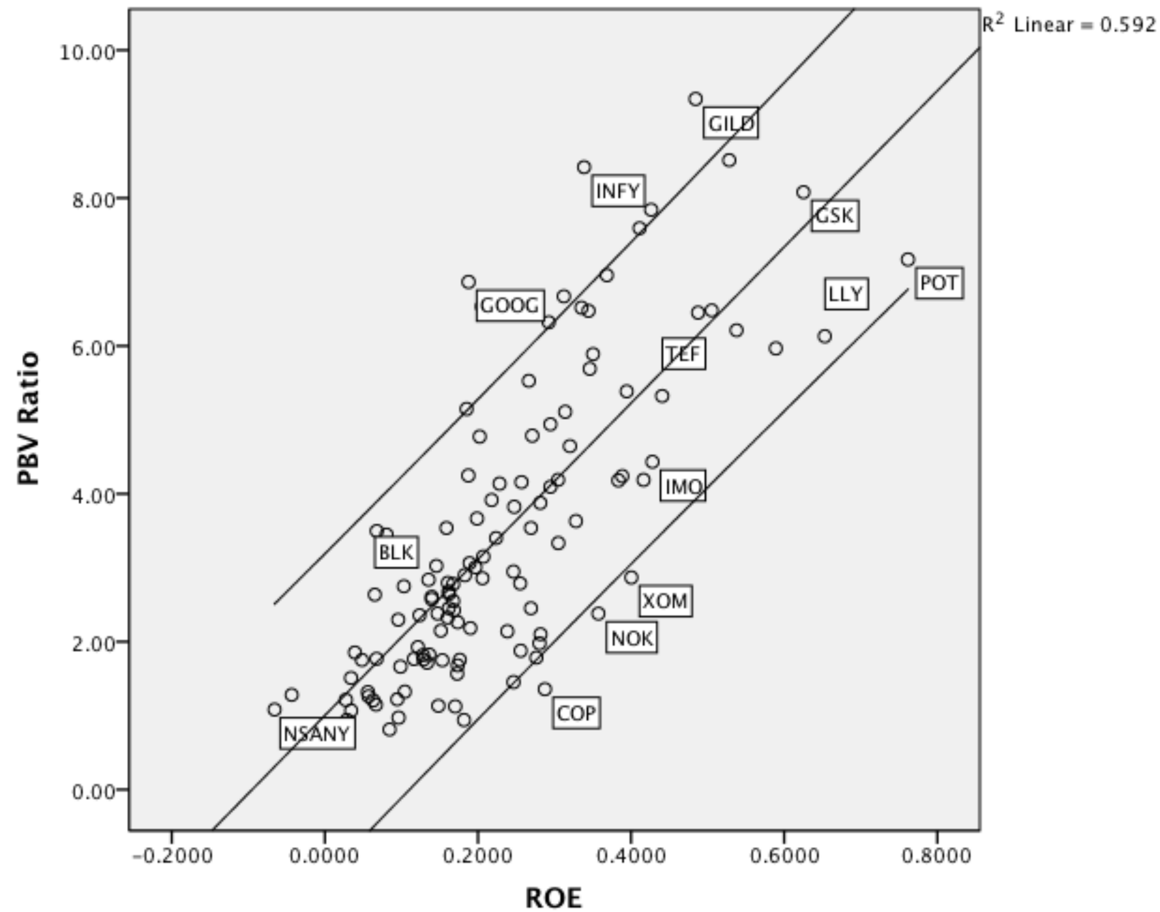
And these predictions?

Name	PBV Ratio	Return on Equity	Standard Deviation	Predicted PBV	Under/Over (%)
BAYERISCHE HYPO-UND VEREINSB	0.80	-1.66%	49.06%	0.89	-10.60%
COMMERZBANK AG	1.09	-6.72%	36.21%	1.05	3.25%
DEUTSCHE BANK AG -REG	1.23	1.32%	35.79%	1.36	-9.26%
BANCA INTESA SPA	1.66	1.56%	34.14%	1.41	17.83%
BNP PARIBAS	1.72	12.46%	31.03%	1.89	-8.75%
BANCO SANTANDER CENTRAL HISP	1.86	11.06%	28.36%	1.91	-2.66%
SANPAOLO IMI SPA	1.96	8.55%	26.64%	1.86	5.23%
BANCO BILBAO VIZCAYA ARGENTA	1.98	11.17%	18.62%	2.17	-9.12%
SOCIETE GENERALE	2.04	9.71%	22.55%	2.02	1.37%
ROYAL BANK OF SCOTLAND GROUP	2.09	20.22%	18.35%	2.51	-16.65%
HBOS PLC	2.15	22.45%	21.95%	2.49	-13.71%
BARCLAYS PLC	2.23	21.16%	20.73%	2.48	-9.96%
UNICREDITO ITALIANO SPA	2.30	14.86%	13.79%	2.44	-5.72%
KREDIETBANK SA LUXEMBOURGEOI	2.46	17.74%	12.38%	2.58	-4.79%
ERSTE BANK DER OESTER SPARK	2.53	10.28%	21.91%	2.05	23.11%
STANDARD CHARTERED PLC	2.59	20.18%	19.93%	2.47	5.00%
HSBC HOLDINGS PLC	2.94	18.50%	19.66%	2.41	21.91%
LLOYDS TSB GROUP PLC	3.33	32.84%	18.66%	2.96	12.40%

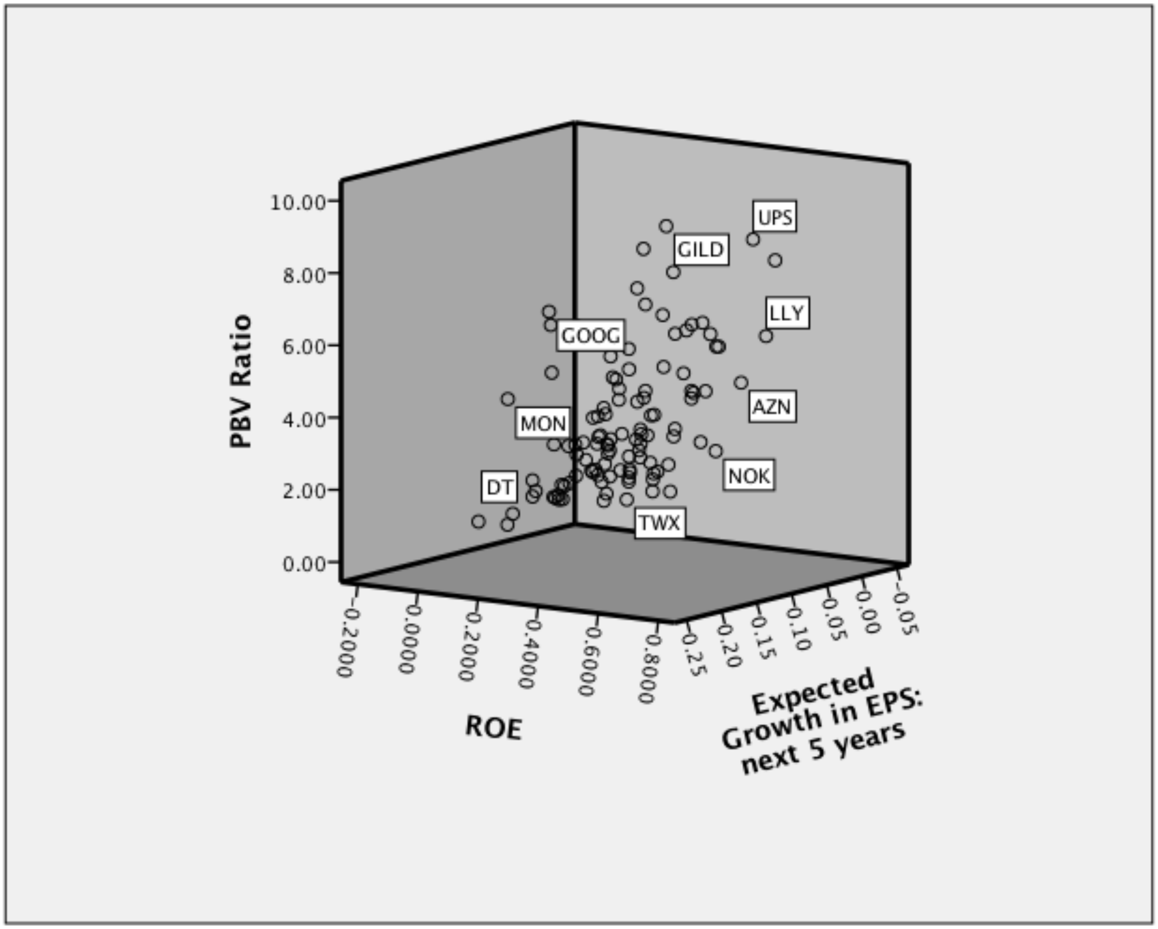
A follow up on US Banks



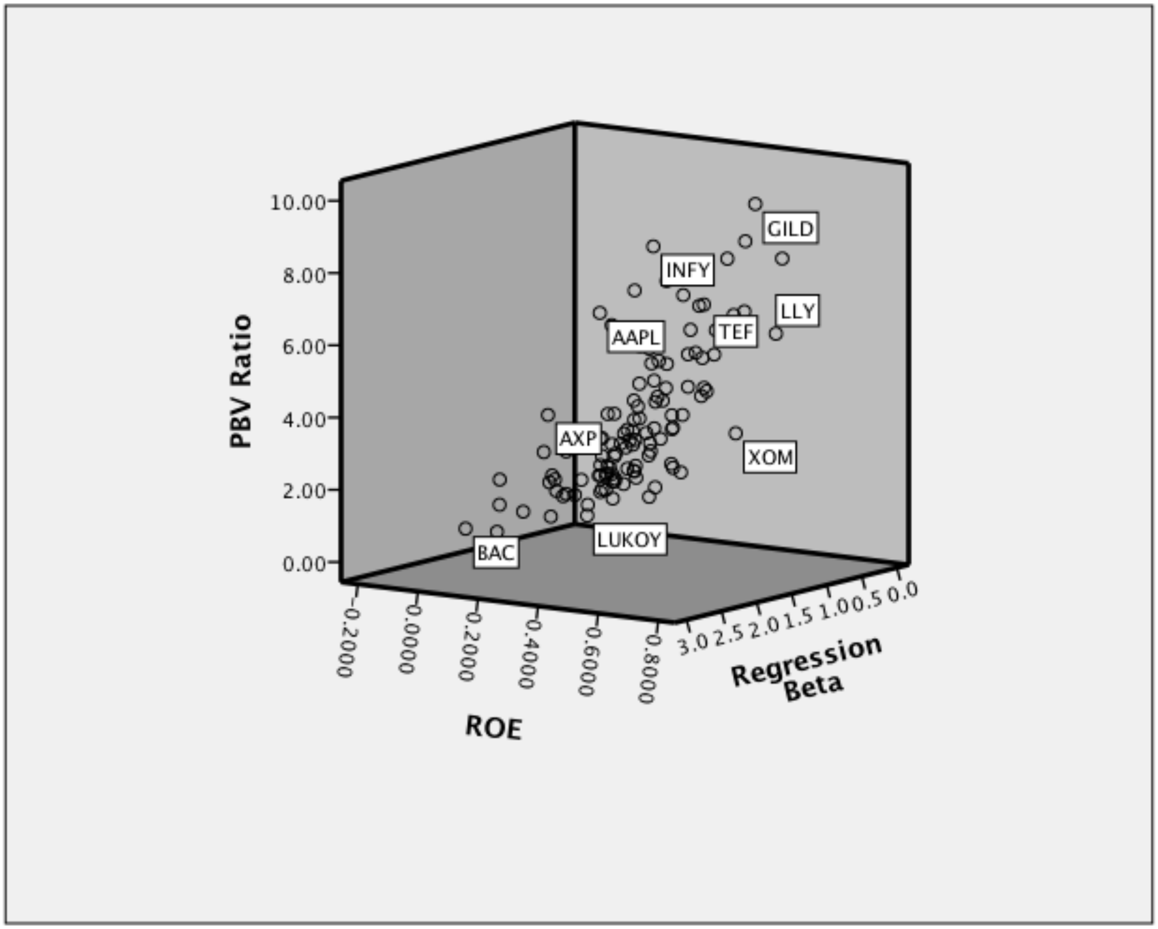
Example 4: A larger sample
Price to Book versus ROE: Largest firms in the US: January 2010



Missing growth?



PBV, ROE and Risk: Large Cap US firms



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Bringing it all together… Largest US stocks in January 2010

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.819[a]	.670	.661	1.19253

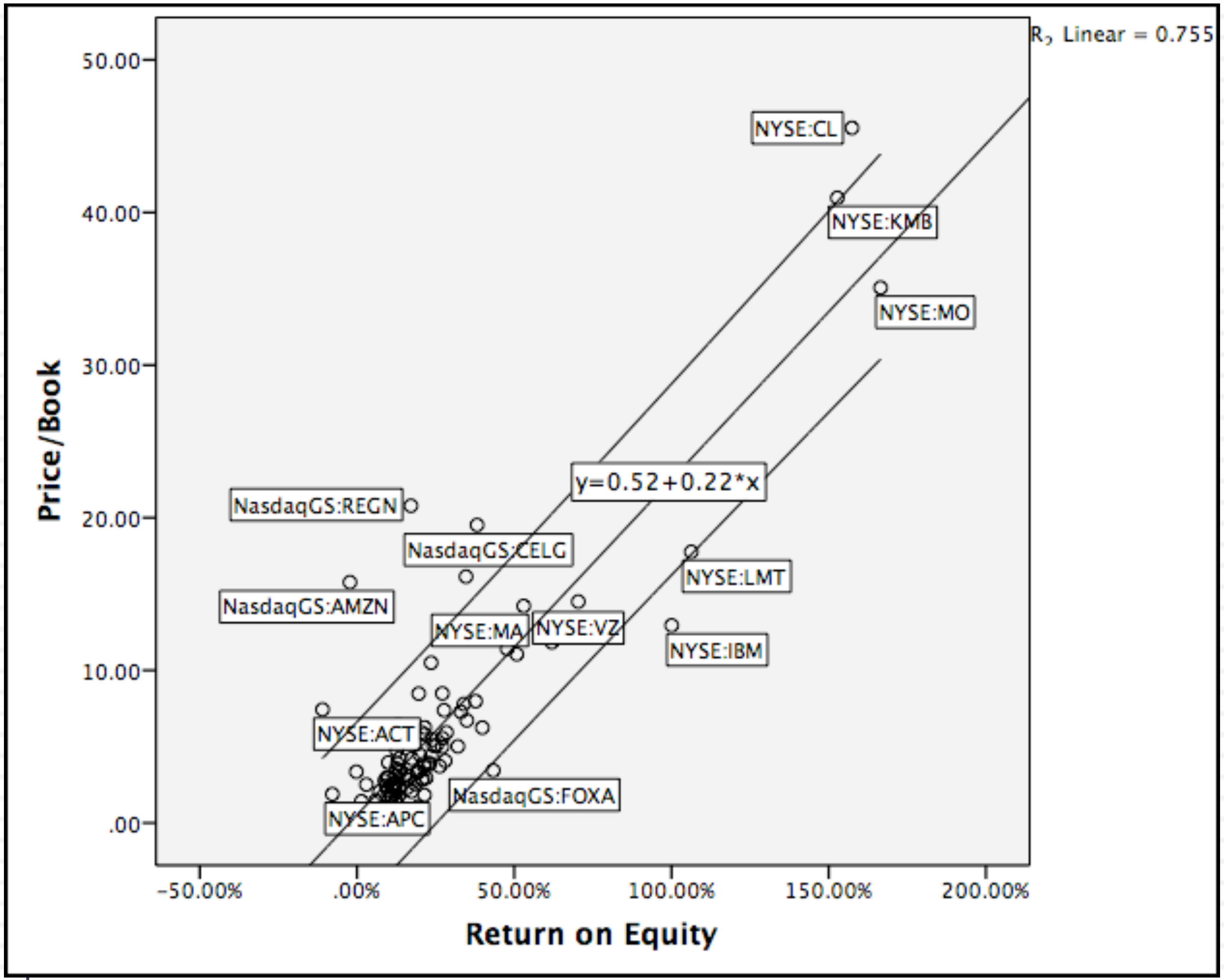
a. Predictors: (Constant), ROE, Expected Growth in EPS: next 5 years, Regression Beta

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.406	.424		.958	.340
	Regression Beta	-.065	.253	-.015	-.256	.799
	Expected Growth in EPS: next 5 years	9.340	2.366	.228	3.947	.000
	ROE	10.546	.771	.777	13.672	.000

a. Dependent Variable: PBV Ratio

Updated PBV Ratios – Largest Market Cap US companies Updated to January 2015



Example 5: Overlooked fundamentals? EV/EBITDA Multiple for Trucking Companies

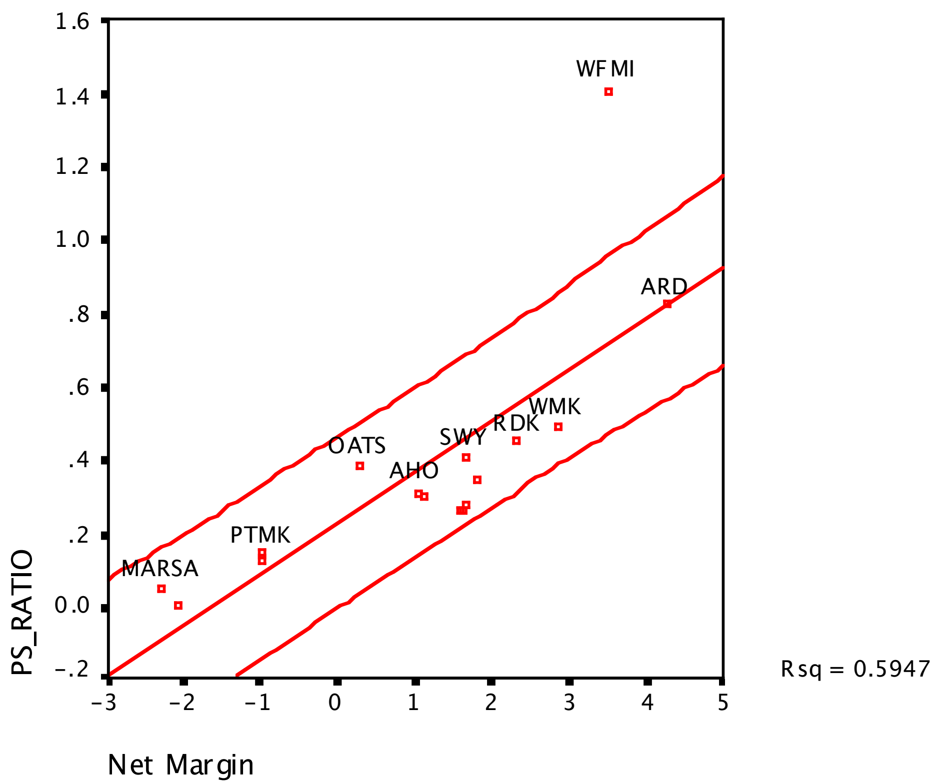
Company Name	Value	EBITDA	Value/EBITDA
KLLM Trans. Svcs.	$ 114.32	$ 48.81	2.34
Ryder System	$ 5,158.04	$ 1,838.26	2.81
Rollins Truck Leasing	$ 1,368.35	$ 447.67	3.06
Cannon Express Inc.	$ 83.57	$ 27.05	3.09
Hunt (J.B.)	$ 982.67	$ 310.22	3.17
Yellow Corp.	$ 931.47	$ 292.82	3.18
Roadway Express	$ 554.96	$ 169.38	3.28
Marten Transport Ltd.	$ 116.93	$ 35.62	3.28
Kenan Transport Co.	$ 67.66	$ 19.44	3.48
M.S. Carriers	$ 344.93	$ 97.85	3.53
Old Dominion Freight	$ 170.42	$ 45.13	3.78
Trimac Ltd	$ 661.18	$ 174.28	3.79
Matlack Systems	$ 112.42	$ 28.94	3.88
XTRA Corp.	$ 1,708.57	$ 427.30	4.00
Covenant Transport Inc	$ 259.16	$ 64.35	4.03
Builders Transport	$ 221.09	$ 51.44	4.30
Werner Enterprises	$ 844.39	$ 196.15	4.30
Landstar Sys.	$ 422.79	$ 95.20	4.44
AMERCO	$ 1,632.30	$ 345.78	4.72
USA Truck	$ 141.77	$ 29.93	4.74
Frozen Food Express	$ 164.17	$ 34.10	4.81
Arnold Inds.	$ 472.27	$ 96.88	4.87
Greyhound Lines Inc.	$ 437.71	$ 89.61	4.88
USFreightways	$ 983.86	$ 198.91	4.95
Golden Eagle Group Inc.	$ 12.50	$ 2.33	5.37
Arkansas Best	$ 578.78	$ 107.15	5.40
Airlease Ltd.	$ 73.64	$ 13.48	5.46
Celadon Group	$ 182.30	$ 32.72	5.57
Amer. Freightways	$ 716.15	$ 120.94	5.92
Transfinancial Holdings	$ 56.92	$ 8.79	6.47
Vitran Corp. 'A'	$ 140.68	$ 21.51	6.54
Interpool Inc.	$ 1,002.20	$ 151.18	6.63
Intrenet Inc.	$ 70.23	$ 10.38	6.77
Swift Transportation	$ 835.58	$ 121.34	6.89
Landair Services	$ 212.95	$ 30.38	7.01
CNF Transportation	$ 2,700.69	$ 366.99	7.36
Budget Group Inc	$ 1,247.30	$ 166.71	7.48
Caliber System	$ 2,514.99	$ 333.13	7.55
Knight Transportation Inc	$ 269.01	$ 28.20	9.54
Heartland Express	$ 727.50	$ 64.62	11.26
Greyhound CDA Transn Corp	$ 83.25	$ 6.99	11.91
Mark VII	$ 160.45	$ 12.96	12.38
Coach USA Inc	$ 678.38	$ 51.76	13.11
US 1 Inds Inc.	$ 5.60	$ (0.17)	NA
Average			**5.61**

A Test on EBITDA

- Ryder System looks very cheap on a Value/EBITDA multiple basis, relative to the rest of the sector. What explanation (other than misvaluation) might there be for this difference?

- What general lessons would you draw from this on the EV/EBITDA multiples for infrastructure companies as their infrastructure ages?

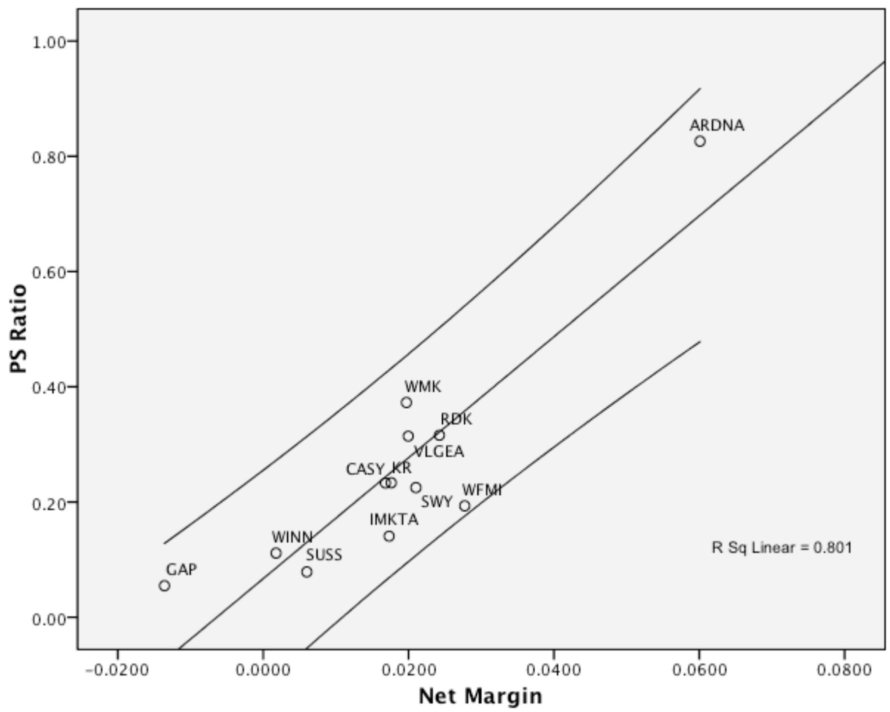
Example 6: Relative valuation across time
Price to Sales Multiples: Grocery Stores - US in January 2007



<u>Whole Foods</u>: In 2007: Net Margin was 3.41% and Price/ Sales ratio was 1.41

Predicted Price to Sales = 0.07 + 10.49 (0.0341) = 0.43

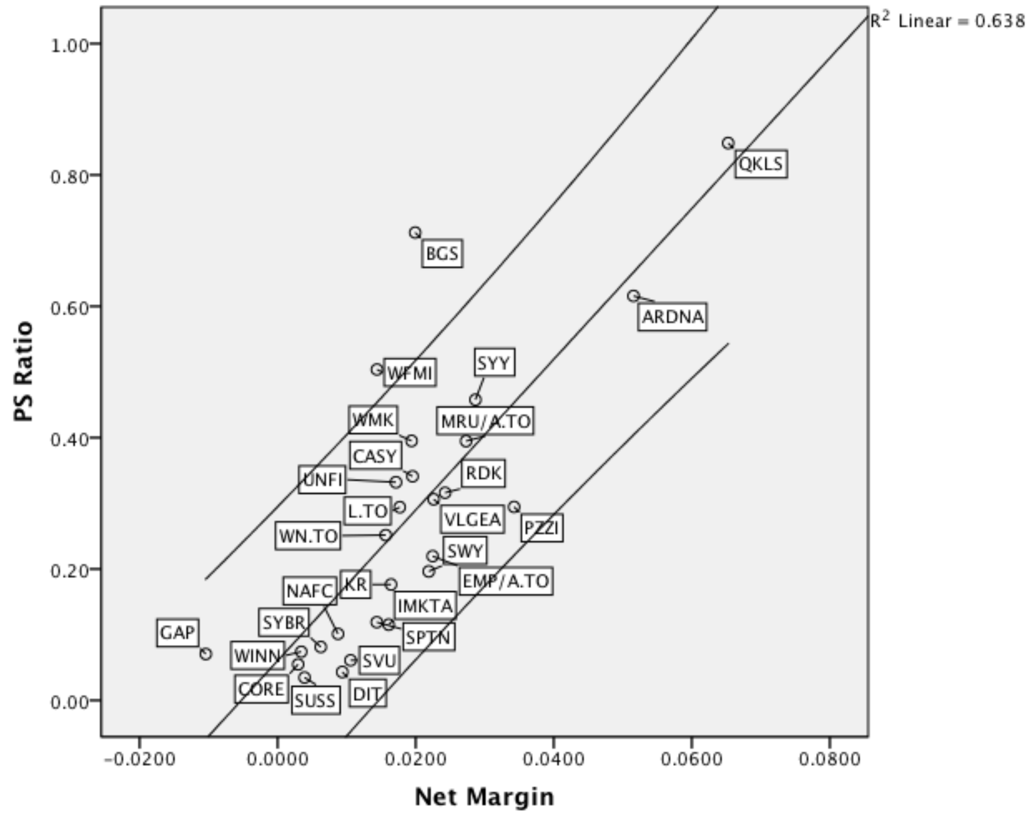
Reversion to normalcy: Grocery Stores - US in January 2009



Whole Foods: In 2009, Net Margin had dropped to 2.77% and Price to Sales ratio was down to 0.31.

Predicted Price to Sales = 0.07 + 10.49 (.0277) = 0.36

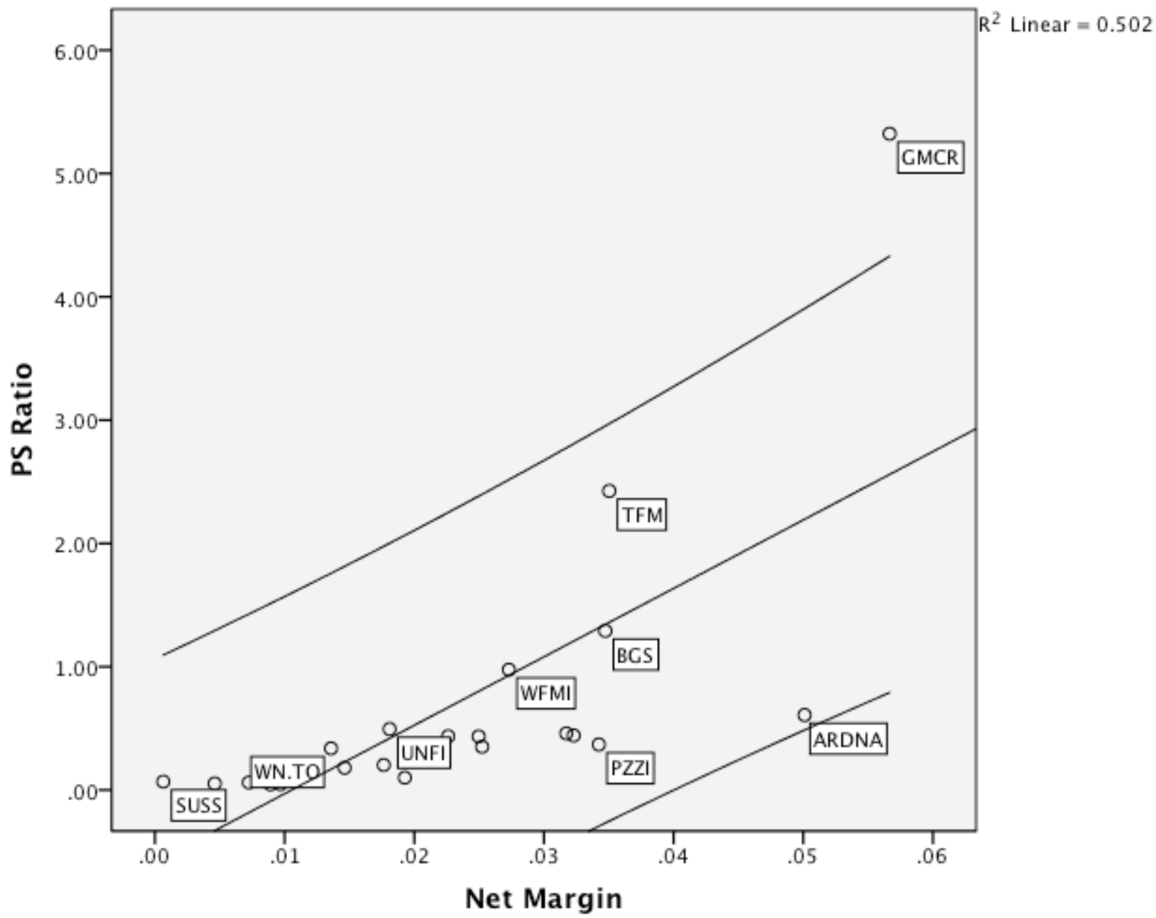
And again in 2010..



<u>Whole Foods</u>: In 2010, Net Margin had dropped to 1.44% and Price to Sales ratio increased to 0.50.

Predicted Price to Sales = 0.06 + 11.43 (.0144) = 0.22

Here is 2011…

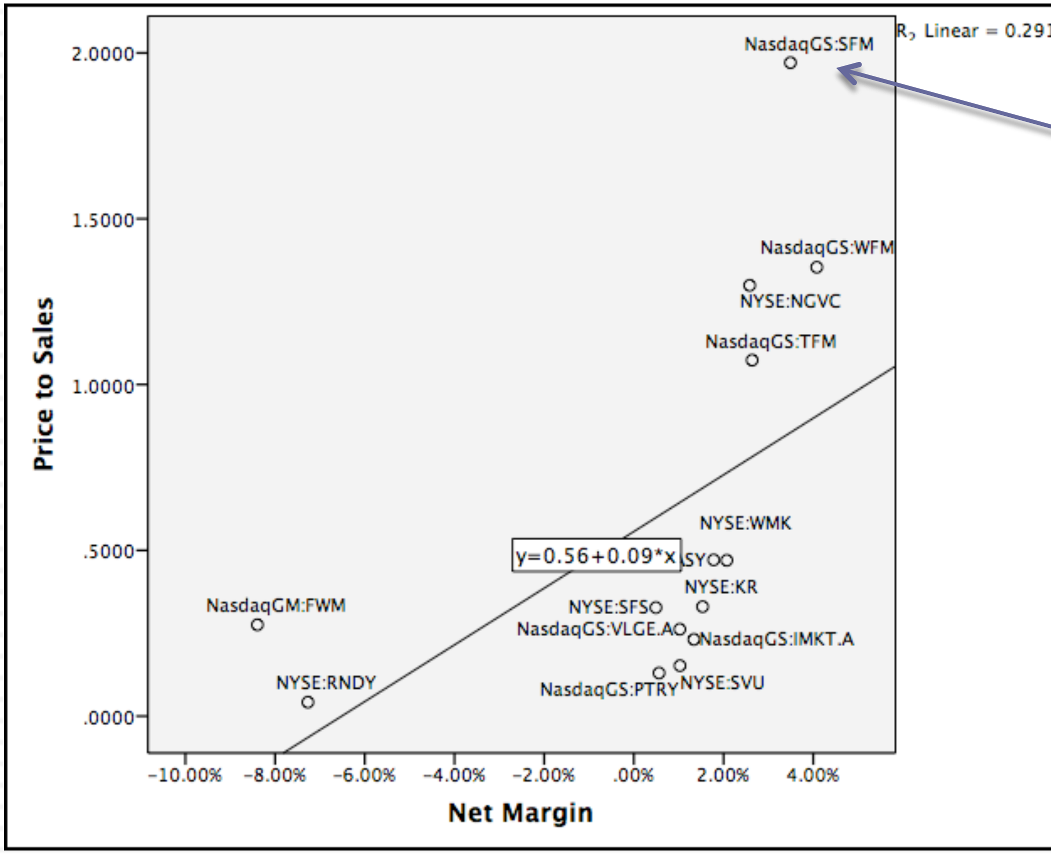


PS Ratio= - 0.585 + 55.50 (Net Margin) R^2= 48.2%

PS Ratio for WFMI = -0.585 + 55.50 (.0273) = 0.93

At a PS ratio of 0.98, WFMI is slightly over valued.

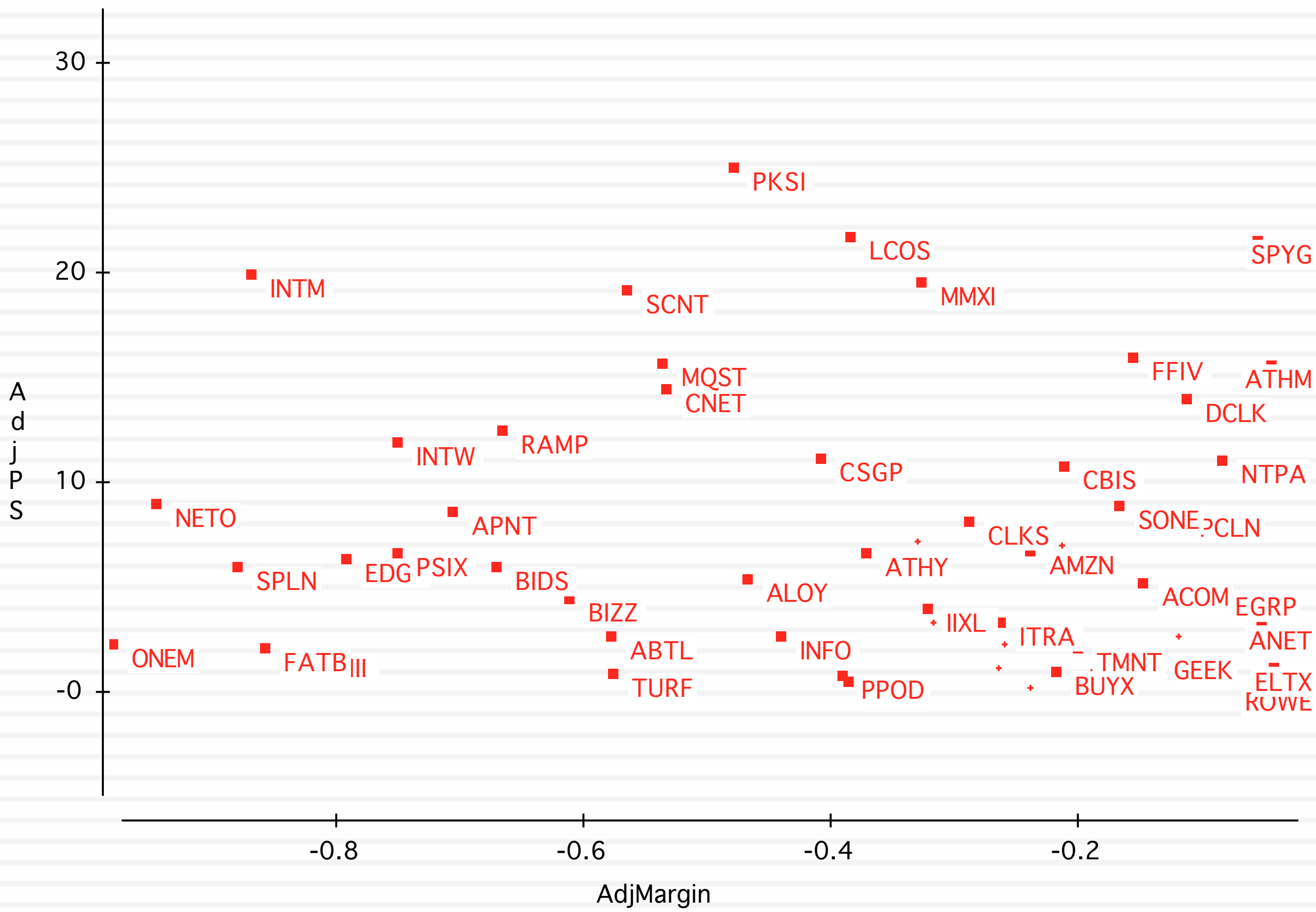
Grocery Stores: January 2015



There is a new star in town (Sprouts)

PS = 0.557 + 0.085 Net Margin
Whole Foods = 0.557 + 8.50 (0.0408) = 0.90
At 1.35 times sales, Whole Foods is overvalued (again)

Example 7: Desperation Time
Nothing's working!!! Internet Stocks in early 2000..



PS Ratios and Margins are not highly correlated

- Regressing PS ratios against current margins yields the following

PS = 81.36 - 7.54(Net Margin) R^2 = 0.04

(0.49)

- This is not surprising. These firms are priced based upon expected margins, rather than current margins.

Solution 1: Use proxies for survival and growth: Amazon in early 2000

- Hypothesizing that firms with higher revenue growth and higher cash balances should have a greater chance of surviving and becoming profitable, we ran the following regression: (The level of revenues was used to control for size)

PS = 30.61 - 2.77 ln(Rev) + 6.42 (Rev Growth) + 5.11 (Cash/Rev)

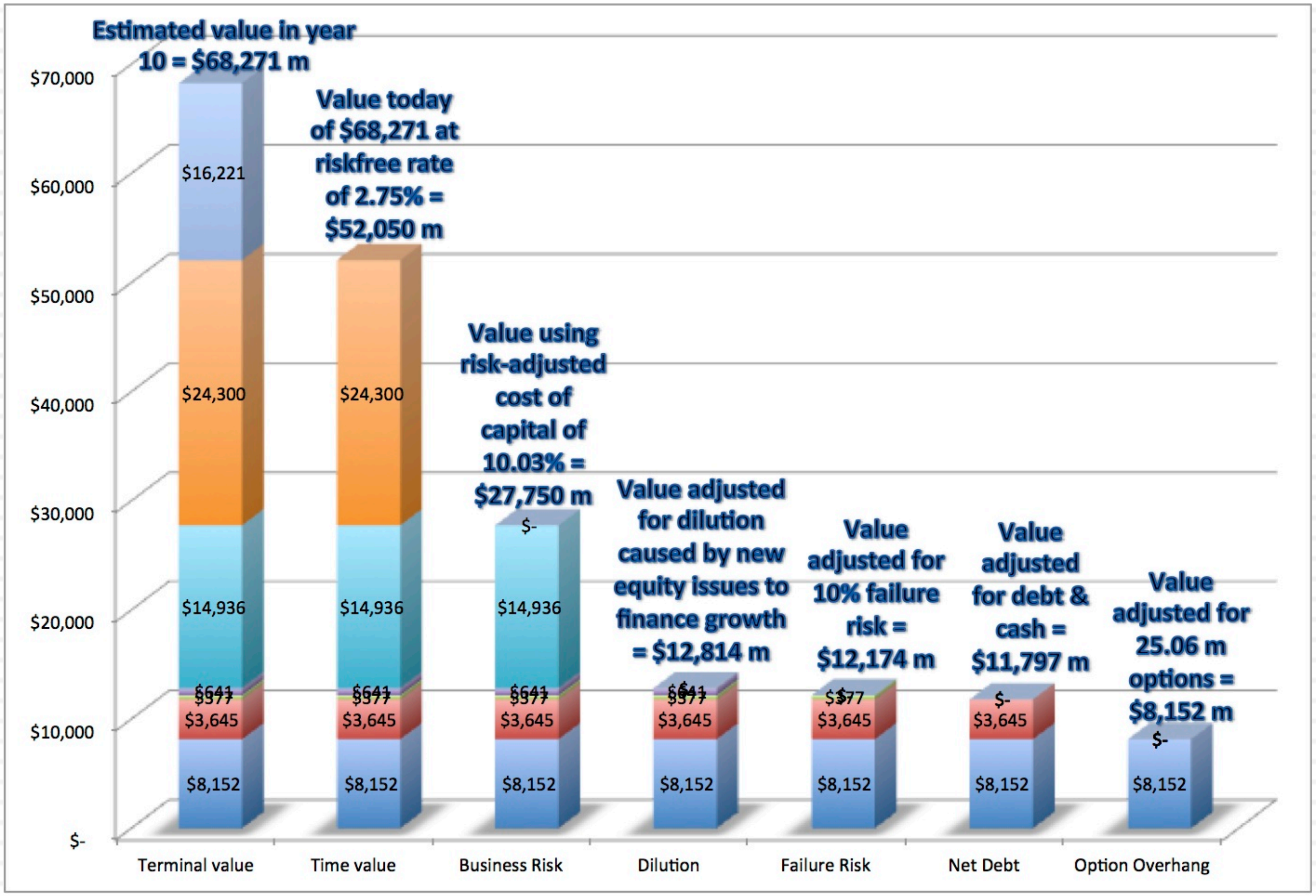
(0.66) (2.63) (3.49)

R squared = 31.8%

- Predicted PS = 30.61 - 2.77(7.1039) + 6.42(1.9946) + 5.11 (.3069) = 30.42
- Actual PS = 25.63

Stock is undervalued, relative to other internet stocks.

Solution 2: Use forward multiples
Watch out for bumps in the road (Tesla)



Solution 3: Let the market tell you what matters.. Social media in October 2013

Company	*Market Cap*	*Enterprise value*	*Revenues*	*EBITDA*	*Net Income*	*Number of users (millions)*	*EV/User*	*EV/Revenue*	*EV/EBITDA*	*PE*
Facebook	$173,540.00	$160,090.00	$7,870.00	$3,930.00	$1,490.00	1230.00	$130.15	20.34	40.74	116.47
Linkedin	$23,530.00	$19,980.00	$1,530.00	$182.00	$27.00	277.00	$72.13	13.06	109.78	871.48
Pandora	$7,320.00	$7,150.00	$655.00	-$18.00	-$29.00	73.40	$97.41	10.92	NA	NA
Groupon	$6,690.00	$5,880.00	$2,440.00	$125.00	-$95.00	43.00	$136.74	2.41	47.04	NA
Netflix	$25,900.00	$25,380.00	$4,370.00	$277.00	$112.00	44.00	$576.82	5.81	91.62	231.25
Yelp	$6,200.00	$5,790.00	$233.00	$2.40	-$10.00	120.00	$48.25	24.85	2412.50	NA
Open Table	$1,720.00	$1,500.00	$190.00	$63.00	$33.00	14.00	$107.14	7.89	23.81	52.12
Zynga	$4,200.00	$2,930.00	$873.00	$74.00	-$37.00	27.00	$108.52	3.36	39.59	NA
Zillow	$3,070.00	$2,860.00	$197.00	-$13.00	-$12.45	*34.50*	$82.90	14.52	NA	NA
Trulia	$1,140.00	$1,120.00	$144.00	-$6.00	-$18.00	*54.40*	$20.59	7.78	NA	NA
Tripadvisor	$13,510.00	$12,860.00	$945.00	$311.00	$205.00	*260.00*	$49.46	13.61	41.35	65.90
						Average	$130.01	11.32	350.80	267.44
						Median	$97.41	10.92	44.20	116.47

Read the tea leaves: See what the market cares about

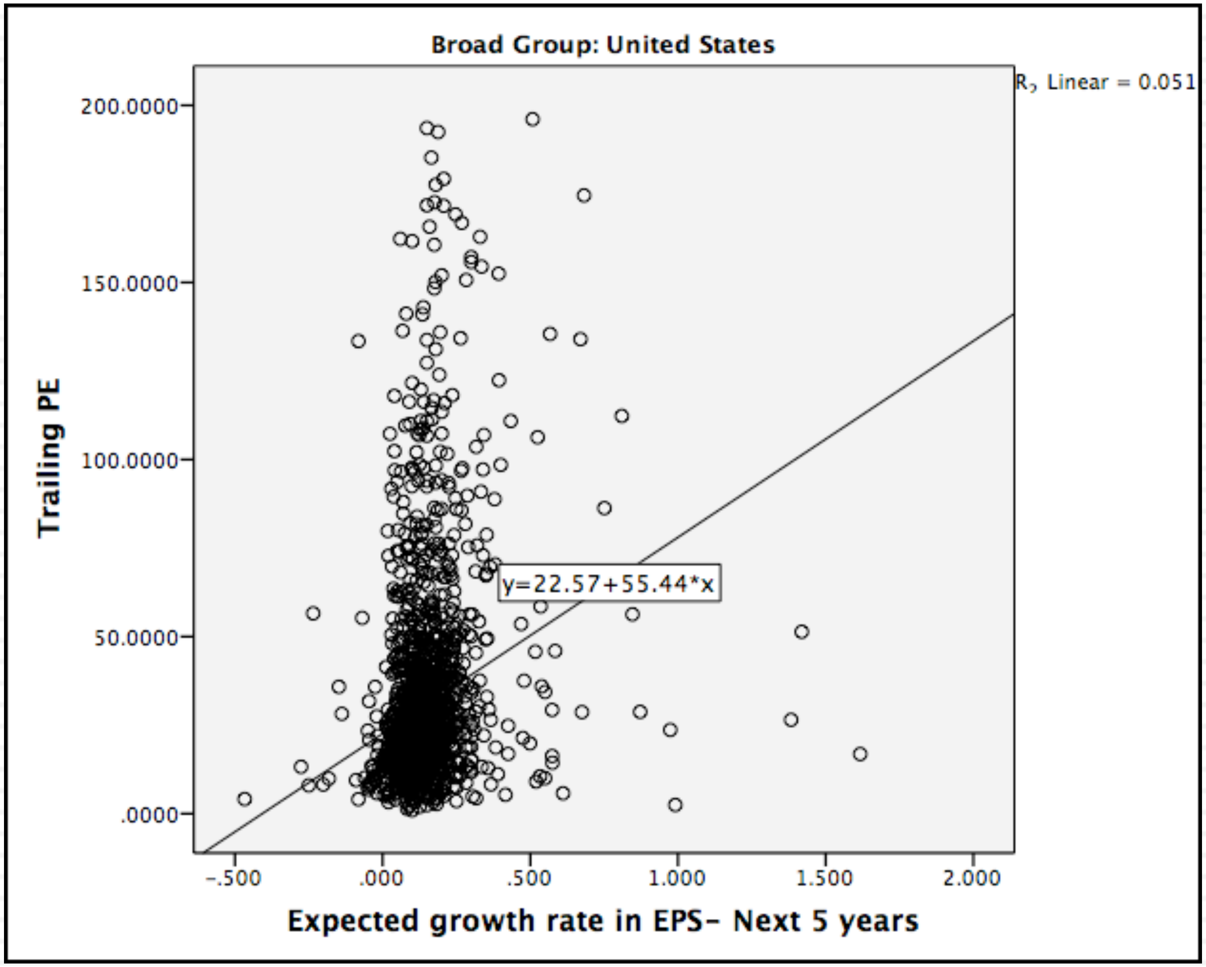
	Market Cap	Enterprise value	Revenues	EBITDA	Net Income	Number of users (millions)
Market Cap	1.					
Enterprise value	0.9998	1.				
Revenues	0.8933	0.8966	1.			
EBITDA	0.9709	0.9701	0.8869	1.		
Net Income	0.8978	0.8971	0.8466	0.9716	1.	
Number of users (millions)	0.9812	0.9789	0.8053	0.9354	0.8453	1.

Twitter had 240 million users at the time of its IPO. What price would you attach to the company?

Relative valuation across the entire market: Why not?

- In contrast to the 'comparable firm' approach, the information in the entire cross-section of firms can be used to predict PE ratios.
- The simplest way of summarizing this information is with a multiple regression, with the PE ratio as the dependent variable, and proxies for risk, growth and payout forming the independent variables.

I. PE Ratio versus the market
PE versus Expected EPS Growth: January 2015



PE Ratio: Standard Regression for US stocks - January 2015

Model Summary[a]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.597[b]	.356	.355	1002.538

a. Broad Group = United States
b. Predictors: (Constant), Expected growth rate in EPS- Next 5 years, Beta, Payout ratio

The regression is run with growth and payout entered as decimals, i.e., 25% is entered as 0.25)

Coefficients[a,b,c]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	6.479	1.204		5.380	.000
	Beta	-3.248	.840	-.108	-3.866	.000
	Payout ratio	16.772	1.290	.365	12.998	.000
	Expected growth rate in EPS- Next 5 years	98.579	4.428	.588	22.260	.000

a. Broad Group = United States
b. Dependent Variable: Trailing PE
c. Weighted Least Squares Regression - Weighted by Market Cap (in US $)

Problems with the regression methodology

- The basic regression assumes a linear relationship between PE ratios and the financial proxies, and that might not be appropriate.
- The basic relationship between PE ratios and financial variables itself might not be stable, and if it shifts from year to year, the predictions from the model may not be reliable.
- The independent variables are correlated with each other. For example, high growth firms tend to have high risk. This multi-collinearity makes the coefficients of the regressions unreliable and may explain the large changes in these coefficients from period to period.

The Multicollinearity Problem

Correlations[a]

		Trailing PE	Beta	Payout ratio	Expected growth rate in EPS- Next 5 years
Trailing PE	Pearson Correlation	1	.038*	.187**	.225**
	Sig. (2-tailed)		.031	.000	.000
	N	3307	3168	1628	1980
Beta	Pearson Correlation	.038*	1	-.200**	.085**
	Sig. (2-tailed)	.031		.000	.000
	N	3168	6841	1601	2447
Payout ratio	Pearson Correlation	.187**	-.200**	1	-.099**
	Sig. (2-tailed)	.000	.000		.001
	N	1628	1601	1629	1081
Expected growth rate in EPS- Next 5 years	Pearson Correlation	.225**	.085**	-.099**	1
	Sig. (2-tailed)	.000	.000	.001	
	N	1980	2447	1081	2574

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

a. Broad Group = United States

Using the PE ratio regression

- Assume that you were given the following information for Disney. The firm has an expected growth rate of 15%, a beta of 1.25 and a 20% dividend payout ratio. Based upon the regression, estimate the predicted PE ratio for Disney.
  - Predicted PE = 6.48 -3.25 Beta + 95.58 Growth + 16.77 (Payout)

- Disney is actually trading at 20 times earnings. What does the predicted PE tell you?

- Assume now that you value Disney against just its peer group. Will you come to the same valuation judgment as you did when you looked at it relative to the market? Why or why not?

The value of growth

Date	Market price of extra % growth	Implied ERP
Jan-15	0.99	5.78%
Jan-14	1.49	4.96%
Jan-13	0.577	5.78%
Jan-12	0.408	6.04%
Jan-11	0.836	5.20%
Jan-10	0.55	4.36%
Jan-09	0.78	6.43%
Jan-08	1.427	4.37%
Jan-07	1.178	4.16%
Jan-06	1.131	4.07%
Jan-05	0.914	3.65%
Jan-04	0.812	3.69%
Jan-03	2.621	4.10%
Jan-02	1.003	3.62%
Jan-01	1.457	2.75%
Jan-00	2.105	2.05%