Alternative valuation methodologies

The three basic factors which generally affect the value of a company’s shares are its earnings, its dividends, and the value of its assets. The final value may be a combination of these factors. Their relative importance will depend on the objectives of the purchaser, and the size of the shareholding being acquired.

One commonly encounters various valuation methodologies, and these fall broadly into two distinct categories:

(i) market based methodologies, comprising:

- the capitalised earnings basis; and
- the dividend yield basis;

(ii) intrinsic valuation methods, including:

- the discounted cash flow ("DCF") basis; and
- the net asset basis of valuation.

I briefly describe the key principles behind each of these approaches below.

Market based methodologies

The market approach uses either comparable companies or comparable transactions as the basis for preparing a valuation. The comparable companies approach uses the values of public companies similar to the company looking to be acquired as a benchmark for determining fair market value.

The theory with the comparable companies approach is that the market is an efficient evaluator of a company's worth, since the price of exchanged securities is a reflection of available information in addition to the supply and demand created by rational buyers and sellers. Therefore, a company's worth in the marketplace is an expression of the market's valuation appraisal of that company.

When buyers and sellers use this approach, a peer-group of publicly traded companies is compiled, multiples are applied, and a valuation is calculated based on a variety of factors.

The comparable transactions approach is similar to the comparable companies method, except that the benchmark is recently acquired companies. A portfolio of recently acquired or divested companies similar to the subject company is compiled and the multiples that were implied in these companies' purchase prices are used to determine the subject company's value.

Capitalised earnings basis

A company's ability to generate returns to its shareholders is dependent on its ability to trade profitably. Consequently, the value of a company will commonly be assessed by reference to a multiple of those profits.

Under this basis, the valuation of the target company is derived from multiplying its maintainable (or recurring) earnings by an appropriate multiplier, such as a Price/Earnings ("P/E") ratio which would be applied to post tax earnings, or lower multipliers applied to some measure of pre-tax earnings (such as earnings before interest, tax, depreciation and amortization ("EBITDA")). P/E ratios and EBITDA multiples are generally determined by reference to comparable companies or comparable transactions.

The appropriate multiple will depend on a number of factors, including the following:

(i) margins (demonstrating the efficiency of the company to extract profit from its business relative to its peers);

(ii) the quality and/or sustainability of its earnings; and

(iii) realistic growth prospects.

In broad terms, the multiple reflects risk; the lower the perceived risk in the underlying earnings of the subject company, the higher the multiple that will be applied. Consequently, a cost-efficient business with a long-term history of steady growth and a stable client base would ordinarily attract higher multiples than a low-margin business with a volatile earnings history and an uncertain client base.

Dividend yield basis

A valuation under this basis is derived based on the dividends paid or payable by the target company, by reference to the yield an investor might expect on an equivalent investment. This basis is most useful for "pure investments" for minority shareholders, where the primary value is the dividend stream.

Obviously where there is no track record of dividends being paid then this approach would not be appropriate.

Intrinsic valuation methods

Intrinsic valuation methods rely on factors specific to the subject company being valued, rather than a relative approach based on the market valuation of similar companies.

Discounted cash flow ("DCF")

The essence of this method of valuation is to determine the present value of the company by reference to the future cash flows expected to be generated by it.

This approach is effectively a refinement of a capitalised earnings valuation but, rather than estimating a single figure as "maintainable annual earnings", forecasts are made for each of the years for which results can reasonably be foreseen (generally between five and ten). An appropriate discount rate is then applied to each year's projected cash flows to arrive at the net present value of those cash flows.

A DCF approach is most often used in the acquisition of capital assets or in respect of capital projects where returns can be predicted with reasonable certainty. Generally, in the case of a company, profit forecasts are made and budgets are set only a year in advance, and longer-term predictions are often proved wrong.

Net asset basis

Under the net asset basis, the valuation is based on the aggregate realisable value of the assets of the business, less the value of its liabilities. The method is typically used for investment trusts and property companies, where the purpose of business is essentially to hold assets. It is also appropriate for businesses facing financial difficulty that may be faced with imminent closure. Usually the net asset basis of valuation provides an indication of the minimum value of a business.

Final comments

Most often, we are asked to perform an assessment of the "market" value of a company or an individual shareholding. This assumes a hypothetical purchaser, and a willing seller. Clearly, this is not always the case; in reality, the seller might be a reluctant one, or the purchaser might be a trade buyer and prepared to pay a premium above market value in order to make a strategic acquisition. In these cases, a "market" valuation might not be appropriate.

As to which valuation basis best applies will obviously depend on the specific circumstances of each business being valued and the also the purpose of the valuation.