Beware of "Comparable Multiples" in Corporate Valuations

One of the most common approaches to valuing companies in an acquisition or divestiture is to rely on comparable multiples. A popular benchmark is to use a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization), but other varieties include multiples of sales, book value, EBIT, and net earnings. The simple approach is to begin with an average multiple calculated from a comparable group of public companies, apply it to the company under consideration, adjust for any known aberrations, and you're just about there.

In reality, however, you're just about NOWHERE, and getting there fast! Unless you have the knowledge to convincingly demonstrate a more appropriate method, YOU may be the one leaving substantial value on the table.

There are several major flaws in the comparable multiple approach to valuations:

1. Comparable companies aren't truly comparable

Selecting a comparable group of companies is highly subjective and open to manipulation. When evaluating whether a company is truly comparable, ask the following questions: Does it have the same expected growth rate as your company? Are its investment opportunities the same as yours? Does it have similar customer bases and product lines, or is it subject to concentration risks? Does it have the same capital structure and cost of capital? How about its accounting policies, effective tax rates, and/or dividend policies – are they all the same? Are you certain it does not face any other specific risks, such as a tight labor market or management problems?

If your answer to even one of the above questions is "No" then, most likely, the comparable multiple method, alone, will not produce reliable results.

2. Multiples exclude key components of value:

Because multiples are generally applied to some level of operating results, they naturally exclude several key components of value, such as whether or not the company owns the real estate in which it operates, whether the company has any significant capital expenditure or working capital requirements in the near future, or whether it has significant assets, such as intellectual property, which have not yet begun to generate earnings, to name a few. Excluding such components will yield an incomplete analysis, and an unreliable result.

3. Market for public companies may not be efficient

Despite conventional wisdom that the public markets are always efficient, one could argue that there are many specific companies which are not efficiently valued.

For example, thinly traded companies, lacking analyst attention, may be beaten down and forgotten, notwithstanding respectable recent performances. For such companies, intrinsic values could be substantially greater than market values, which merely reflect the last sparse trade. Including them in a comparable pool may artificially depress your valuation.

Other companies, which have generated irrational market demand, may be temporarily, but significantly, overvalued, such as technology stocks were during the internet bubble. As a result, their inclusion in a comparable pool may artificially inflate your valuation.

4. Application of multiples assumes the future will repeat the past

Public company multiples are usually quoted in relation to historical (or "trailing") operating results. The fact is, however, that, in an efficient market, values generally reflect all of the considerations discussed above, on an expected future (or "forward") basis. Consequently, converting such a future-based valuation to a multiple of historical earnings will only result in a meaningful metric if that company's future is expected to mirror its past. Further applying such a multiple to your company's historical earnings can end up being a meaningless exercise, especially if your company's future is not expected to mirror its past.

Free Cash Flow Method

If the comparable multiple method is so flawed, then how should your company be valued? Consider the Free Cash Flow method of valuation.

Value, in this context, refers to the ability of an asset to generate cash flow. Therefore, the value of a company is equal to the present value of future cash flows expected to be generated by its assets … not present value of profits, not a multiple of sales, or EBIT, or EBITDA, or book value, or anything else … but present value of expected future cash flows, or discounted Free Cash Flow.

Cash flows are specific to YOUR company, thereby eliminating all the potential problems of using a pool of comparable companies. Cash flows focus on the future of YOUR company, instead of the history of other companies. Cash flows encompass all of the value drivers which do not appear in the operating statements, such as capital expenditure and working capital requirements. Cash flows neutralize the impact of aggressive accounting policies, and eliminate the effect of market inefficiencies.

The mechanics of the Free Cash Flow model are quite simple, and can be found in any corporate finance textbook. The inputs to the model, which are the forecasted results of

future investment opportunities, and the appropriate discount rates to apply to such results, are the more interesting analytical components which require some expertise.

It may sound complicated but, in the end, there are relatively few variables to consider. If the variables are properly identified and documented, you can reduce a valuation negotiation to a logical discussion of the appropriate range of each variable. If you can get the negotiation to that level, you have a much better chance for a reasonable result than if you simply debate about comparable multiples.

The Free Cash Flow method does have its own limitations, and may not be appropriate for every situation. Ultimately, any method of valuation is an inexact science, and no method should be used in a vacuum. However, the Free Cash Flow method is clearly the best method for determining the intrinsic value of a company. Use other methods for comparison and sensitivity analysis, and your result will be a more supportable valuation than would result from the strict application of potentially meaningless multiples. The extra work could bear huge returns.

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