



## Understanding Relative Valuation April 2012

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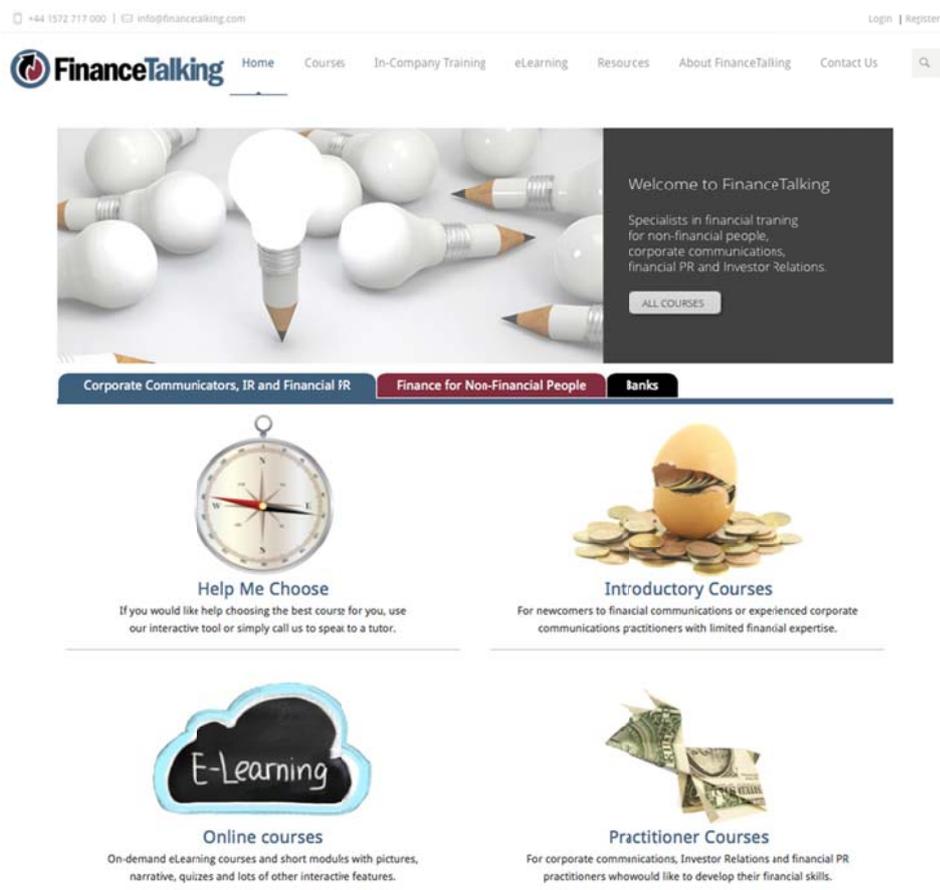
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Our assignments range from graduate training programs through to helping large in-house media relations, investor relations and internal communications departments and IR training for new board directors.

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The screenshot shows the FinanceTalking website homepage. At the top, there is a navigation bar with the following items: Home, Courses, In-Company Training, eLearning, Resources, About FinanceTalking, and Contact Us. Below the navigation bar is a large banner image featuring several lit lightbulbs and pencils. The banner text reads: "Welcome to FinanceTalking. Specialists in financial training for non-financial people, corporate communications, financial PR and Investor Relations." Below the banner are three tabs: "Corporate Communicators, IR and Financial PR", "Finance for Non-Financial People", and "Banks".

Below the tabs are four featured course categories:

- Help Me Choose**: If you would like help choosing the best course for you, use our interactive tool or simply call us to speak to a tutor. (Icon: Compass)
- Introductory Courses**: For newcomers to financial communications or experienced corporate communications practitioners with limited financial expertise. (Icon: Egg on coins)
- Online courses**: On-demand eLearning courses and short modules with pictures, narrative, quizzes and lots of other interactive features. (Icon: E-Learning sign)
- Practitioner Courses**: For corporate communications, Investor Relations and financial PR practitioners who would like to develop their financial skills. (Icon: Money)

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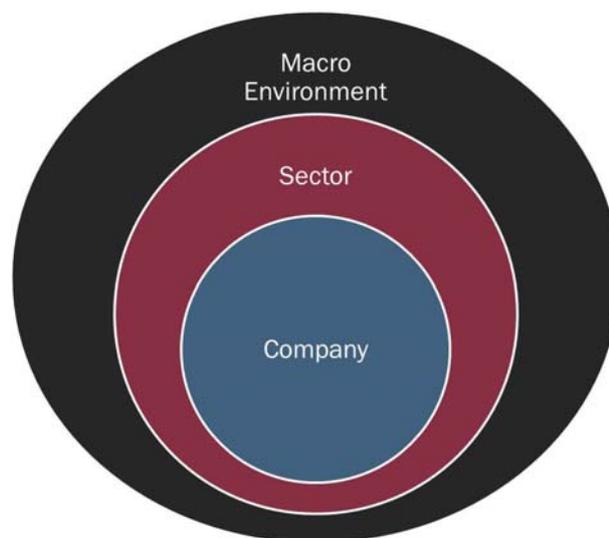
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# 1 Valuation Essentials

Valuation is largely a function of supply and demand. If investors are interested in the company and find the shares attractive at the current price, the price will tend to increase. If investors have no interest in a company or they believe the shares are over-valued, the share price is likely to fall.

A company's share price in the market usually represents a commodity value for the shares. However, if a purchaser is attempting to build up or purchase a strategic stake or even buy the whole company, the price per share is likely to be much higher (as the purchaser needs to persuade more shareholders to sell).

## 1.1 Context for Valuation



Valuation of individual companies takes place in a much bigger picture environment – that of the global economy as a whole. You can easily pick up on what's going on in the macro environment by reading the Wall Street Journal or the Financial Times each day.

Valuation also takes place in the context of the sector. To learn more about the sector you should read as much investment bank (sell-side) research as you can. You should also read your competitors' financial reports and listen to their earnings calls etc.

Market participants – analysts, investors and the media – will see everything in the context of this big picture; and they will judge the credibility of corporate communications accordingly.

## 1.2 Key Concepts in Valuation

- **Valuing investments is all about the future**, not what has happened in the past. It is the future returns that will benefit the new investor so that is what they are interested in. Past returns have already gone to past investors. We can liken investing to driving a car. We always have our view focused on the road ahead. We check the rear view mirror from time to time, but most of our time and energy is directed towards anticipating what will happen next. It is the same with investing.
- Investors rely on management to give them **guidance** on the future. If that guidance turns out to be wrong, this throws doubt on the quality of management. Managements' track record in giving guidance - meeting or beating targets is therefore very important in investment decision-making.
- **What counts is cash.** Investment is about making money. You would only be interested in investing if you thought you would get additional cash back at some point. Depending on the type of investment, you might expect your original investment back plus a little extra by way of interest, ie an **income return**. Alternatively, you might be expecting to be able to sell your investment at a profit, creating a **capital return** in which case income may be less important. Similarly, investors appreciate that in order to pay higher dividends, companies need to generate more cash. So internal cash flow generation is a very important driver of value.
- **Risk and return are inextricably linked.** If you put your money in the bank, you regard it as relatively safe – in effect, risk-free. You will receive interest and you know that you will get your money back. However, there are alternative investment opportunities. You could put the money into shares instead. Shares are more risky - there is no guarantee that you will get your money back, nor is it certain that the shares will pay dividends. So the shares would only be attractive to you if you thought that they would give you a significantly higher return than leaving your money in the bank and taking no risk.
- **Investors always consider the 'opportunity cost'** – the return that they have effectively passed up by settling for a particular investment. The opportunity cost is what the investor could have received for an alternative investment with similar risk characteristics. Very simply, if an investor decides to put money in one bank rather than another, then the opportunity cost is the interest rate that he or she would have earned in the bank that was rejected.
- **Investors also value liquidity** and will factor this in to a valuation. This is the ability to get your money back at a reasonable price at any time. For example, we are generally prepared to accept a lower interest rate from the bank on an instant access account than from a term deposit. Similarly, small company shares may be much more difficult to sell than the shares of a large company or liquidity may be restricted due to the size of the company. As a result, they will tend to trade at a lower price.

## 1.3 Equity Research and Valuation Process



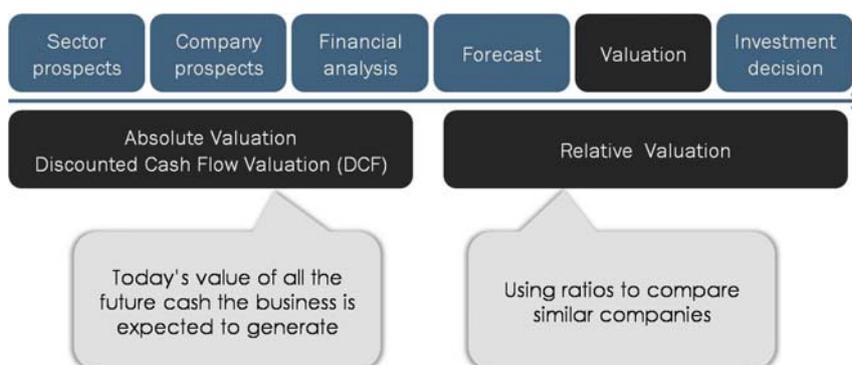
The time line above shows you the process that analysts go through to decide whether to buy shares or not.

It is also very similar to the process used by private equity investors (funds which invest in private companies) and by companies when they are making acquisition decisions.

The first step is to evaluate the prospects for the sector - this sets the context for evaluating the company prospects. Financial analysis is aimed at establishing a trend which will make it easier to forecast. Because valuation is about the future, it is the forecast, and the certainty of that forecast, that will determine the company's value.

There are two valuation methodologies

- Absolute valuation – determining the value of the business by reference to the future cash flows that it is expected to generate, and
- Relative valuation – using ratios to compare similar companies to determine whether the business is under or over valued by comparison.



This briefing paper will only consider relative valuation.

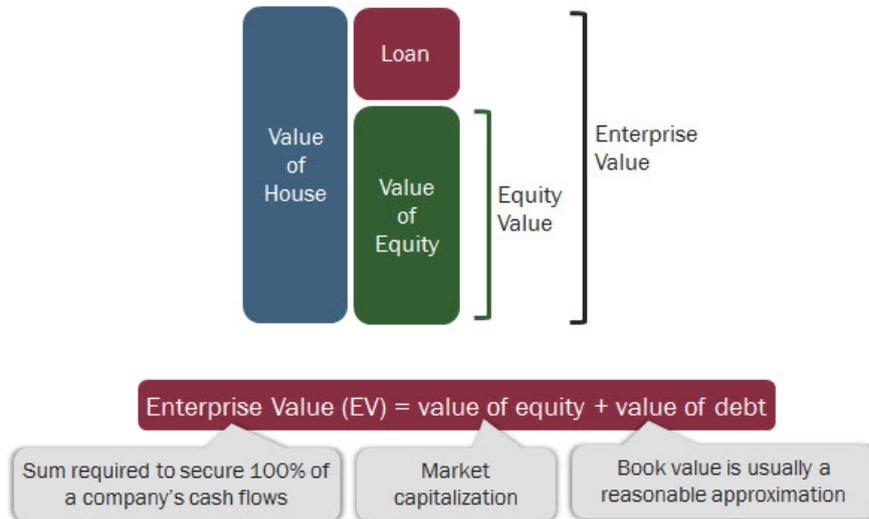
## 1.4 Equity or Enterprise?

Before we go on to look at relative valuation in more detail, there's an important concept that we need to understand, which is whether you are valuing the enterprise or equity.

To see what enterprise value is all about, we need to delve a little deeper into what it is that we are trying to value – a company's shares – its equity. We tend to take the equity value (market capitalization) as the value of a company. However, if we apply the same concept to our house – we can clearly see that, if we have any mortgage, the value of the house does not equate to the value of the equity. The equity is what we have left after selling the house and paying off the loan. You can also see that the value of the enterprise (the house in this case) is the same as the value of the equity and the debt.

Exactly the same applies to a company. The value of the enterprise is the value of the equity (the market capitalization) plus the value of debt. You could think of enterprise value as being the amount you'd have to pay to secure 100% of a company's cash flows.

Equity or Enterprise?



We'll be looking at some multiples that value the equity and some that value the whole enterprise.

1.5 What Makes a Company More Valuable?

First of all, a growing company will have higher future cash flows which will make it more valuable. However, growth must be sufficiently profitable – the return on the investors' capital must be high enough.

The company must also be good at managing risk to minimise the chances that the investors' money will be lost.

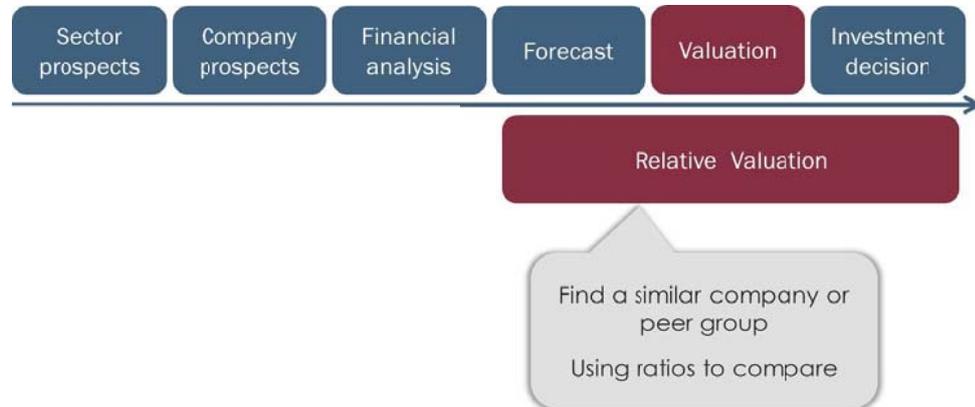
Finally, the company must be good at delivering on its promises.

All of this should then be reflected in the price that investors are prepared to pay for the shares.

What Makes a Company More Valuable?



## 2 Introduction to Relative Valuation



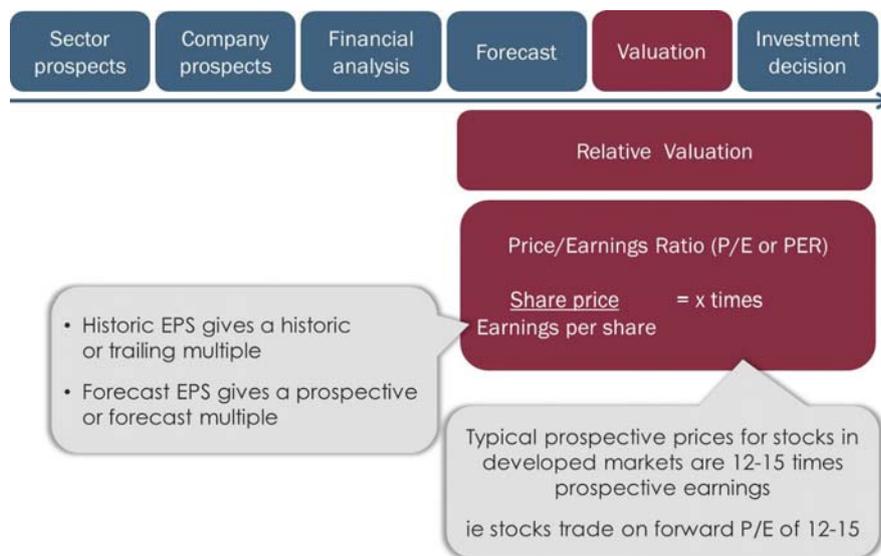
Relative valuation works as follows:

- The context is current market & sector conditions
- The analyst takes a view of a company, the quality of management and of profits, industry growth and the company's growth strategy and the risks inherent in the investment
- He then looks at the share price in relation to indicators of performance and decides whether in relation to similar companies (the peer group), this one looks under or over-valued. He might then decide to buy or sell accordingly.

### 3 The Price Earnings Ratio

The most common ratio or multiple is the Price/Earnings ratio (P/E) or earnings multiple, which compares share price to earnings per share. This ratio shows how many times net income investors are prepared to pay for the shares – ie what multiple of profits the share price represents.

Published P/E ratios generally use historic earnings per share in this ratio (so you'd be looking at a "historic" or "trailing" P/E), whereas investors and analysts more commonly use "prospective" or "forward" P/E's using forecast EPS for the coming year.



As a very rough guide, in markets like the US and the UK, the average historic P/E is between 13 and 15 times. Similarly, the average prospective P/E might be between 12 and 14 in normal market conditions – slightly lower in Europe and slightly higher in the US due to a higher GDP growth rate. This means that typically the share price is 13-15 times last year's earnings per share and 12-14 times forecast earnings per share.

P/E ratios are often used, alongside other valuation metrics, to value companies for their Initial Public Offer (IPO or flotation). On an on-going basis, analysts will tend to look at the P/E ratio and compare it to others in the sector to see whether the company's shares look cheap or expensive.

Of course, you're not limited to earnings multiples (P/E ratios) – you could use a wide range of other ratios as we'll see shortly.

#### 3.1 Calculating the EPS

Before we go on, let's think about what we mean by earnings per share (EPS) – the "e" in P/E ratios. EPS is simply the net profit (after interest and tax) divided by the number of shares.

**EPS Example:**

Example Co Income Statement	\$m
REVENUE	500
- OPERATING COSTS	-400
= OPERATING PROFIT	100
- INTEREST	-30
= PROFIT BEFORE TAX	70
-TAX	-20
= NET PROFIT	50

Number of shares = 100m

Net profit includes one-time costs of \$50m

 Earnings per share (EPS) is calculated here  
= net profit/number of shares

 Reported EPS =  $\$50\text{m}/100\text{m} = \$0.50$ 

 "Adjusted" EPS =  $\$100\text{m}/100\text{m} = \$1$ 

In our example here, this would be net income of \$50m divided by 100 shares – \$0.50 per share. This is the reported earnings per share – ie the EPS that the company is required to report under generally accepted accounting rules.

Companies frequently incur one-off costs, like restructuring costs or they might have unusual items of income, such as profits from selling businesses. Because such one-off items are unlikely to be repeated in future, analysts will usually strip these items out of earnings and use the "underlying", "adjusted" or "non-GAAP" number.

In our example, let's assume that "earnings" includes one-time costs of \$50m after taxes. The adjusted EPS will therefore be higher at \$1 per share.

It is this adjusted EPS that is most commonly used by analysts and investors in valuation. However, if you're looking at published P/E ratios in newspapers or on websites, they are more likely to use the reported EPS.

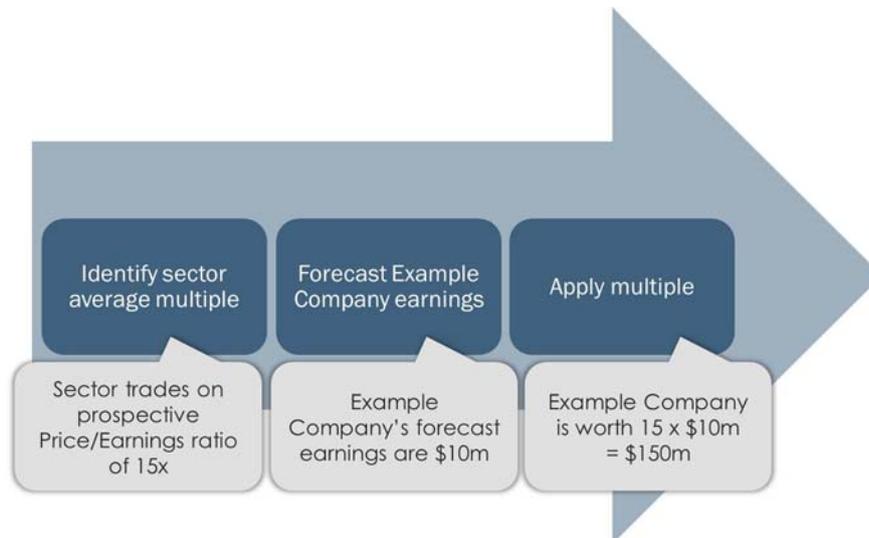
### 3.2 Using P/E Ratios to Value a Company

To value Example Co, we would first identify Example Co's sector or peer group and find the sector average P/E ratio. Let's assume that the sector trades on 15 times next year's earnings (a "prospective" P/E multiple of 15 times).

We then need to forecast Example Co's next year's earnings. Let's assume we think earnings will be \$10m next year.

Finally, assuming that Example Co is typical of its sector, we multiply the earnings by 15 (the sector multiple) to get a valuation of \$150m.

We have done this calculation in total, but it could of course be done on a per share basis – 15 times forecast EPS would give us the share price.



### 3.3 P/E Ratios in Action

Let's see how P/E ratios might alert the market to an under-valued company.

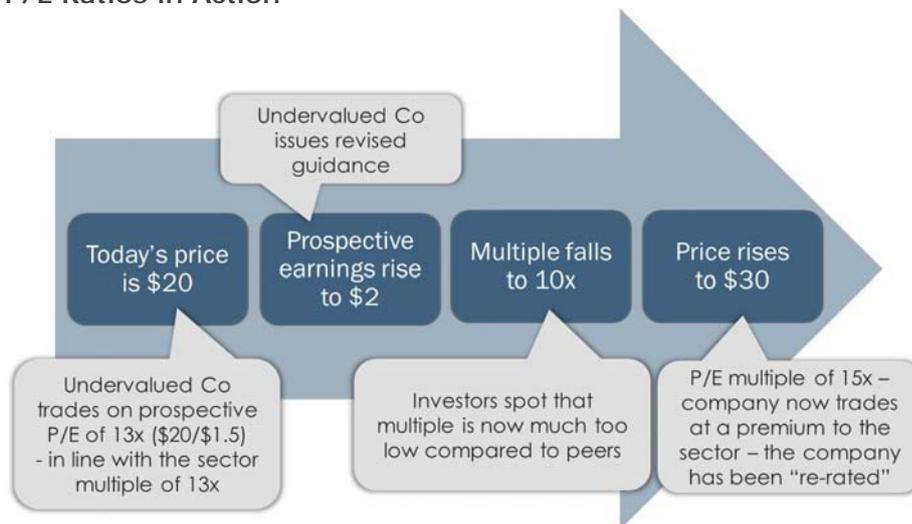
Let's assume that Undervalued Co has higher growth prospects than its peer group. If a company has higher growth potential than its peers, for the same risk, then investors should be prepared to pay more for the shares – ie the company deserves a higher multiple.

Undervalued Co's share price is \$20 and prospective EPS are \$1.50, so the company trades on prospective P/E of 13x. This is in line with the sector multiple of 13x. So, if we believe the superior growth prospects, this analysis suggests that the company might be under-valued.

Let's imagine that Undervalued Co now issues guidance which leads analysts to revise their forecasts of next year's earnings from \$1.50 to \$2 per share. At the current share price of \$20, this means that the P/E multiple falls to 10 times, way below the sector average of 13x. This should prompt investors to buy the shares and the price should rise to at least \$26 and possibly as much as \$30.

The shares have been "re-rated" and at \$30, the company is now trading at a premium to the sector, on a P/E of 15.

### P/E Ratios in Action



A re-rating will often require a catalyst such as:

- An upgrade to earnings guidance
- Results that comfortably beat market expectations
- The market the company operates in performs more strongly than anticipated
- The company continues to gain market share
- A disposal or a deal which transforms the company
- The company's cash flow profile is far more attractive than originally thought
- A new CEO or management team
- Takeover and consolidation activity among similar companies
- Improved industry pricing as a result of consolidation.

### 3.4 P/E Relatives

Once you have established a company's P/E there is a slightly more sophisticated equation that helps to tell whether its shares are cheap or expensive.

A P/E relative compares the P/E of the company to the P/E of the sector or the market as a whole.

**Example:**

	Company A	Sector	Company B
Earnings per share	\$1		\$1
Share price	\$10		\$20
P/E ratio	10 x	15 x	20 x
P/E Relative	10/15 = 67%		20/15 = 133%

Company A is said to be trading at a discount to the sector of 33%, whilst company B trades at a premium of 33%. An analyst would then go on to ask whether the discount for A and the premium for B are justified or whether the shares deserve a re-rating or a de-rating.

Clearly companies that have a P/E Relative above 100% are those that are perceived to have better growth prospects and better quality earnings than the sector average. The extent of the premium will depend on how long the earnings growth is expected to continue at a high rate and the visibility (quality) of that growth.

**Example:**

A company is growing at 20% over the next 5 years while the sector is expected to grow at 8%.

Using a rough rule of thumb, this represents 12% (20% - 8%) more growth each year for 5 years – in total, 60% more growth (12% x 5), which would justify a premium of 60% or a P/E relative of 160%.

A slightly more sophisticated calculation requires a calculator but theoretically gives a slightly more accurate answer:

$$(1.20/1.08)^5 = 69\%$$

The reason this calculation is more accurate is that it takes into account the effect of compounding.

### 3.5 PEG Ratios

The PEG ratio is a measure of value that combines a company's P/E and its rate of earnings growth (hence the name PEG, a combination of P/E and G for growth). The PEG ratio is calculated by dividing the P/E by the growth rate. For example, a stock on a P/E of 20x growing at 10% would be on a PEG ratio of 2x.

The P/E is in theory what investors are prepared to pay for growth and so it should be correlated with growth.

A lower PEG value indicates that investors are paying a low price for future earnings growth. Conversely, a high PEG value tells us that you are paying a relatively high price for future growth.

This method of valuation is most commonly used for valuing companies that have good growth prospects with good earnings quality. The PEG ratio approach to valuing shares has been publicized by the investment guru Jim Slater. He suggests that shares are attractive when the PEG ratio is somewhere between 0.6 and 0.8. It is often associated with an investment style called "growth at a reasonable price" ("GARP").

The main problem with PEG ratios is that they have a very short time-frame and used in isolation, will often mean that good, long term, sustainable growth may be ignored as it gives rise to too high a PEG ratio.

## 4 Dividend Yield

Another relative valuation ratio with an equity focus is the dividend yield. The yield measures the cash return to shareholders, based on buying the shares at the current price.

### Example:

Assuming a share price of \$10 and a dividend per share of \$0.50, the yield is 5%. Against a stock market average yield of around 3%, such a stock may be attractive to an investor looking for income. If the yield looks sustainable and/or the dividend is likely to grow, then the higher than average yield would be an argument for buying the shares at the current price.

High yields tend to be found in mature industries where companies are generating more cash than they can profitably invest. Low yields tend to be found in growth companies, where the majority of profits are being reinvested for growth.

### Dividend Yield

$$\frac{\text{Dividend per share}}{\text{Share price}} \times 100 = x\%$$

- Show cash return to shareholders
- High yields tend to be found in mature industries
- Low yields tend to be found in growth companies
- Tax issues – in most markets dividends are taxed

The long term average yield in developed markets is approx 3%.

### Interpreting Yield

- A high yield may mean the shares will find it difficult to increase in capital value. Therefore you may be sacrificing capital growth for income.
- High yield stocks are likely to be paying out to shareholders a large proportion of their profits. This means that there is relatively little left to be re-invested in the business, which in turn, may mean that the management is not maintaining the quality of the assets/its competitive position.
- A high yield and high pay-out ratio (proportion of profits paid by way of dividend as opposed to reinvested) often reflect the fact that there are few opportunities open to management for profitable investment.
- A very high yield often means that the market is anticipating a dividend cut or poor set of results and has already factored this into the share price.
- A low yield (or indeed no yield) is fine so long as the profits are being reinvested profitably and the investor base does not require an income stream.
- A consistent dividend policy together with dividend growth (often referred to as a progressive dividend policy) signals management confidence. It is the future direction of dividends not their historic level that is important.
- Remember that “total return” is what drives investors - ie income and capital growth - so both need to be considered when interpreting the yield.

## 5 EV Multiples

The Price/Earnings ratio compares the price of a company's share to its earnings per share – or alternatively, the price of the equity with the company's net profit (profit attributable to the shareholders, after interest and tax). There are three particular problems with this:

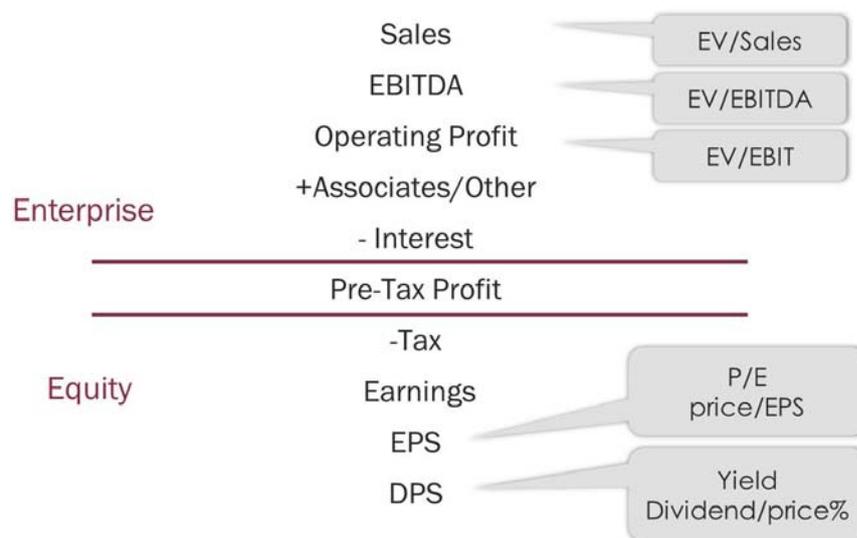
- Firstly, net profit is the profit after all income and expenses and is difficult to adjust to look at the core business (which will be necessary to compare realistically to a company's peer group).
- Secondly, because equity is a residual concept, comparisons between companies with different levels of debt will not be valid.
- Thirdly, we may wish to compare valuations across a sector on the basis of sales or operating profit. We cannot do this by comparing price (equity) to sales or operating profit if a company has any debt, as those sales/profits will have been generated by the funding from lenders as well as from shareholders.

Enterprise value on the other hand, is leverage independent (ie it takes into account the equity AND the debt). EV therefore enables analysts to consider multiples of sales, EBITDA, operating free cash flow or operating profit (EBIT).

We can value companies with different depreciation and amortization policies, or companies which are not yet making enough profit to cover depreciation, using EV/EBITDA (incidentally, an average EV/EBITDA ratio would be around 7 times).

We could even value a company with no profits at all, using EV to sales. The EV/Sales ratio is typically used to value early stage technology companies and history shows that it is often unreliable!

### Alternative Ratios for Valuing the Income Statement



The picture here shows that EV ratios can be used to value sales, EBITDA and operating profit (all of which are before interest and tax and therefore leverage-independent). P/E ratios and dividend yield both focus on shareholders and so are equity concepts.

## 5.1 EV/Sales Ratio

EV/sales values the “top line” of the income statement. The trend in sales is an indication of both the company’s growth and its competitive performance. Furthermore, sales (or revenue) is a function of price and volume and will drive everything else further down the income statement – making it a logical performance number to value.

The EV/sales ratio shows how much investors are paying for \$1 of sales. As a rule of thumb, a company with operating margins of around 10%, generating sales growth of around 5% would trade on around 100% or 1x sales.

EV/Sales will be influenced by

- Growth in sales
- Quality or visibility of sales
- Operating profit margins
- Confidence in those margins being sustained.

## 5.2 EV/EBIT and EV/EBITDA

EV/EBIT shows how much investors are prepared to pay per \$1 of operating profit. EBITDA is derived from adding back depreciation and amortization (both of which are non-cash costs) to the operating profit. So EV/EBITDA shows how much investors are paying per \$1 of EBITDA – or “cash” profit.

As with a low P/E ratio, a low EV/EBITDA could reflect a combination of:

- Uncertainty over a company’s prospects for profits
- A highly cyclical sector or a company serving volatile markets
- A sector with over-capacity and weak pricing power
- A sector or company with consistently low returns (operating profit margins and/or return on capital) and not adding economic value
- A mature sector, with little prospects of growth or a company which is ex-growth
- Poor management or management with no convincing strategy for growth
- Poor cash generation
- An undervalued company.

Of course, the multiple is also affected by the capital intensity of the business – the more capital you need the lower the multiple will be.

As with all ratios driven by growth and quality, analysts will also be concerned as to whether this growth is actually generating value for investors (ie returns exceeding the cost of capital). This is particularly relevant where growth is driven by an aggressive capital expenditure or acquisition policy.

## 6 Asset Valuations

Another way to measure the value of a company is to see how the share price relates to the book value of the company's assets (net of liabilities). This is known as price/NAV or the price/book (P/B) ratio.

We've focussed on valuing profits. However, in some sectors, value is created in the asset base, rather than by annual profits. A good example would be real estate companies or investment companies. So long as the assets are fairly valued in the balance sheet, the net asset value per share should be a reasonable indication of value.

P/B can also be used for valuing cyclical stocks at a low point in the cycle (when they may have no earnings). Many other sectors (particularly service companies) have few assets or assets which are valued at historic cost, so "price to book" type considerations will be irrelevant.

### Price/Book Ratio (Price/NAV)

$$\frac{\text{Share Price}}{\text{Net assets per share}} = x \text{ times}$$

- Net assets is another equity concept (net assets = equity)
- Useful for sectors where assets are important (when correctly valued)
- Banks, life insurance, real estate

The price to book ratio compares the share price to the NAV per share. If the share price is lower than NAV per share (ie the ratio is less than 1 times), the company is said to be "trading at a discount" to NAV. If the ratio is more than 1 times, the company is trading at a premium to the value of its asset base.

Companies might trade at a discount to NAV because:

- The assets may not be easily sold (ie they are illiquid)
- The assets may be difficult to value
- The assets may be overvalued
- There may be concerns that the assets are falling in value
- The company may be generating a very poor rate of return on the assets with little prospect of that changing (an example here might be a poorly run hotel or department store)
- Selling the assets might create a tax liability.

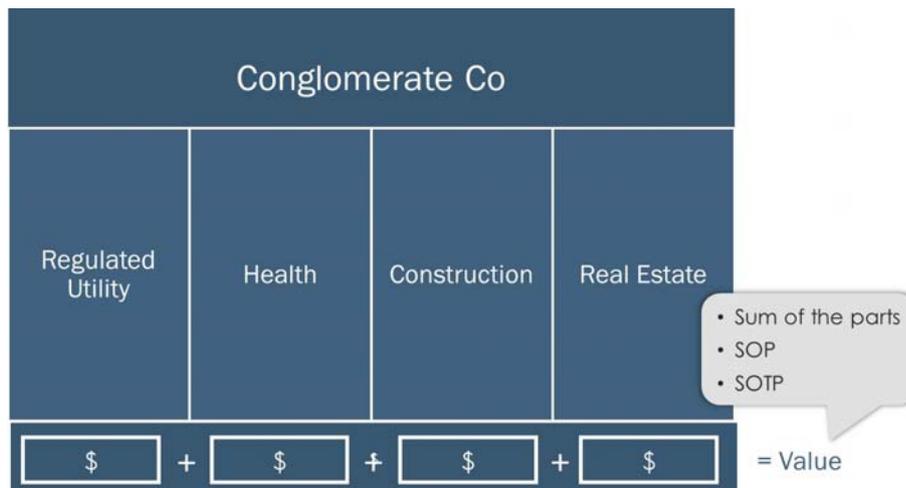
Of course it is also possible for companies to trade above their asset value. This would be expressed as trading at a premium to NAV. This could be because investors are expecting an improved valuation of the assets shortly or it could reflect the fact that the assets are generating excellent returns.

Takeover speculation will often force a reassessment of asset values. The assets may be valued at a discount to the stock market but might be worth a lot more to a competitor or another industrial company. Value investors often buy companies on a discount to net asset value to benefit from this - believing that there is very little downside given the low valuation of assets in the first place.

## 7 Sum of the Parts Valuation

For a company with very different businesses, it may be more appropriate to try and value each of the businesses separately and then add the individual valuations together to find the value of the group.

The advantage of this method is that the analyst can apply different valuation techniques or different multiples for different parts of the business, depending on what is appropriate for effective comparison with other listed peers.



In the example above, you might use DCF to value the utility because the profits and cash flows are likely to be very predictable.

Healthcare companies tend to be relatively fast-growing and would probably be valued using a relatively high P/E. Because of the cyclical nature of the business, construction is quite difficult to value. A relatively low P/E ratio could be used, or perhaps an average through the cycle P/E.

The real estate sector derives its value from assets, so price/book would usually be appropriate. However, this would only work well if the value of the properties in the balance sheet is reasonably representative of fair value

## 8 Drivers of Multiples

Multiples are driven by a combination of:

- Quality of earnings
- Growth of earnings
- Risk.

### 8.1 Quality

“Quality” refers to how predictable or “visible” the company’s earnings are and the concept can, in addition, be applied to the management team. A company operating in a growing market and where contracts might run over several years, or a company with lots of repeat business, would be said to have good quality earnings. While such a company may not be growing as rapidly as some others, investors may pay a higher multiple because of the security of the earnings stream.

Quality profits come from the core business, rather than from one-offs, such as profits from selling assets or gains from litigation. Understanding the composition of profits is what drives analysts to ask lots of questions at results aimed at getting to the underlying performance of the business. When companies disclose “underlying” profits, it makes it easier for analysts to forecast future profits without all the “noise” from short term decisions that may have helped the results but not the business. However, there is often debate between management and analysts about what should be left in and what should be stripped out.

Where a company’s sales are very volatile – this may be due to rapid changes in demand or very volatile pricing for its products – clearly predicting the company’s earnings is quite a hazardous exercise. In this situation the earnings are far from predictable and would be deemed “low quality”. This does not necessarily mean the company is low quality – the business may manage these difficult circumstances extremely well. The markets it operates in, however, makes forecasting a risky business and analysts will price this in.

### 8.2 Growth

Growth must be generated by good performance in the underlying business (strong volumes and prices and a close attention to cost control) if it is to command a high valuation. Growth, which is unsustainable, is clearly less valuable. And growth must never be at the expense of returns (remember that companies must make a return on capital which exceeds the cost of that capital).

### 8.3 Risk

Investors expect a higher return from more risky investments. So if risk is perceived to be high, the share price may be correspondingly low. Some examples of factors that increase risk include:

- A sector which is susceptible to changing economics (ie cyclical)
- High leverage (gearing)
- High operational leverage (high fixed costs)
- A company involved in risky acquisitions
- Susceptibility to raw material price increases
- Potentially high risk of litigation (eg pharmaceuticals)
- Operations in countries with high political risk.

## 9 High and Low Multiples

On the face of it a low multiple is going to be more attractive than a high multiple as it could suggest that the shares are cheap in relation to profits. However, this may not always be the case. There are a number of situations that commonly produce low multiples but may not mean the shares are cheap. Similarly, high multiples don't always mean that a share is over-valued. The multiple could be justified by the characteristics shown in the table below:

<b>Low Multiples</b>	<b>High Multiples</b>
Uncertainty over a company's prospects	A company with an excellent growth record and prospects for growth
A highly cyclical sector or a company serving volatile markets	Predictable/stable revenues and high confidence in the company's forecasts
A company facing over-capacity, with weak pricing power	A company with strong pricing power
A company with consistently low returns, not adding economic value	A company that produce excellent returns and add value
A mature company with little prospects of growth	A company in a high growth sector
A company which is ex-growth or a management team with no convincing strategy for growth	An excellent growth strategy.
Poor management	Excellent management
Poor cash generation	Strong cash generation
A weak balance sheet	A strong balance sheet
Low barriers to entry	High barriers to entry
Low market share	Strong market share

## 10 Driving a Re-Rating

While there may well be a very good case for a re-rating, it is often the case that without a catalyst, the shares continue to languish at low valuations. Sustained analyst and investor relations efforts should help to avoid this, ensuring that the market has a thorough understanding of the dynamics of the business and both sector and company prospects.

When management does not do this and fails to actively deliver a “catalyst” the shares may remain cheap. This is often referred to as a “value-trap”. This is potentially dangerous. Hedge funds or activist fund managers may spot the valuation anomaly and force the company in to changes (eg a break-up of the business) that will produce a re-rating. This can be a very profitable move for some investors but can cause anxiety for management.

Conversely, shares that disappoint expectations can undergo a severe de-rating. If the growth expectations that justify the high rating are not fulfilled, then the share price and the multiple will fall dramatically. As well as the growth being disappointing, the downgrade is likely to flag up risks and issues that were previously thought to be unimportant.

A de-rating might result from factors that cause the earnings to disappoint and lead the growth assumptions to be questioned such as:

- A new entrant has taken market share
- Extra competition from a new product or service
- Pricing disappoints
- Demand proves to be susceptible to economic slowdowns when it was previously thought to be recession proof
- Costs go out of control
- A poor acquisition or strategic decision.

These factors not only reflect disappointing growth, investors will also see them as highlighting the risks involved in the business. To the extent that the downgrade reinforces the concerns of investors, the higher risks will inevitably translate into a lower multiple.

The last factor is more a case of management disappointing rather than the growth of the business falling below expectations. Nonetheless, it can be an important trigger for reassessing the company’s rating. After all in most surveys management emerges as the crucial factor driving investors.

## 11 Summary

Relative valuation is very commonly used to justify share prices. A low multiple in relation to similar companies indicates that the shares may be good value at the current price, whilst a high multiple alerts investors to the possibility that it might be time to sell.

Which multiple to use depends on the sector and this can change. For example, prior to the financial crisis of 2008-10, banks, being high dividend payers, were often valued using dividend yield. However, many banks reduced their dividends or stopped paying altogether during the crisis, so Price/Book has become the norm since.

Many sectors are valued using P/E ratios. However, when leverage (gearing) varies significantly across the sector, EV ratios may be more appropriate.

Sectors with no net profits clearly cannot be valued using P/E ratios, so analysts will go up the income statement until they find a profit which can be valued. For example, the company may be EBITDA positive, in which case EV/EBITDA is a possibility. Failing that, analysts may use EV/Sales.

Because valuation is so subjective, most analysts will use a range of valuation methods – combining DCF (absolute) valuation and a number of multiples. This helps to ensure that the valuation is realistic – ie it has been sense-checked in a number of different ways.

## Need More Help?

If you would like FinanceTalking to help you with financial training and/or communication ideas in this area please contact us on:

 +44 1572 717000

 [info@financetalking.com](mailto:info@financetalking.com)

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FinanceTalking Ltd  
Cophill Farm  
Launde Road, Loddington  
Leicestershire LE7 9XB

[www.financetalking.com](http://www.financetalking.com)  
[info@financetalking.com](mailto:info@financetalking.com)  
+44 (0)1572 717000