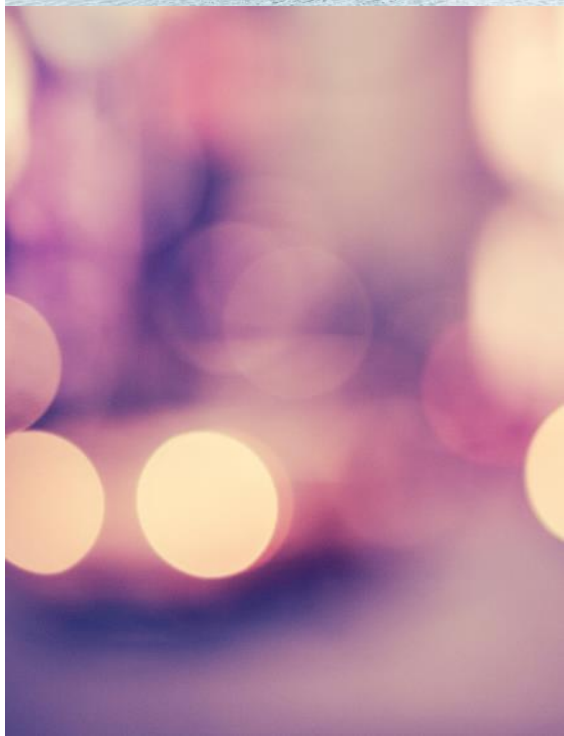


Choose the Right Valuation Method

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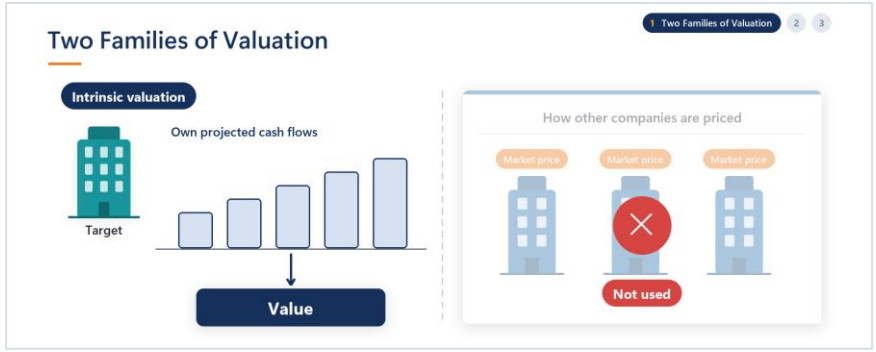




4. Choose the Right Valuation Method

🔢 Two Families of Valuation

- Valuation methods fall into two broad families: absolute and relative valuation.
- Both answer how much a company is worth, from different starting points.
- Intrinsic valuation derives value entirely from the target's own projected cash flows.
- It ignores how other companies are priced in the market.
- One question: what cash will the business generate, and what is it worth today?



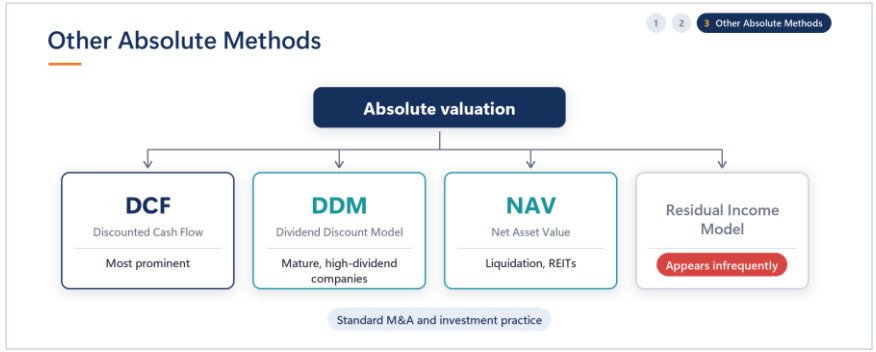
📉 Discounted Cash Flow

- The DCF model is the most prominent intrinsic valuation tool in practice.
- Project the target's future operating cash flows, then discount them back to today.
- EV = Present Value of FCFF.
- Enterprise value equals the present value of free cash flow to the firm.



🧩 Other Absolute Methods

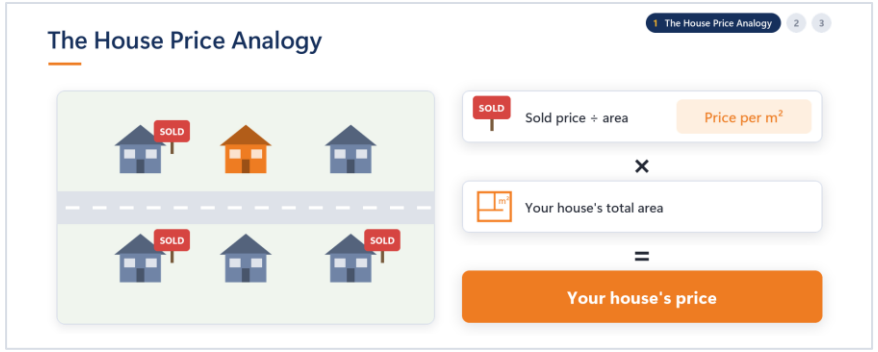
- The DDM follows the same logic but discounts expected future dividends: Equity Value = PV of Expected Dividends.
- DDM is used mainly for mature, high-dividend companies: utility firms and large commercial banks.
- NAV values current market value of existing assets minus liabilities.
- NAV assumes no active operations: it suits liquidations and asset-heavy funds like REITs.
- Other methods such as the Residual Income Model appear infrequently in M&A or investment practice.



4. Choose the Right Valuation Method (Part 2)

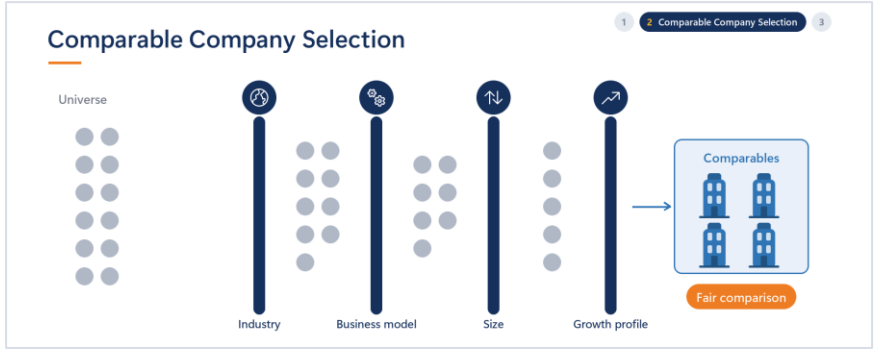
🏠 The House Price Analogy

- Relative valuation works like estimating the price of a house.
- Look at nearby houses that recently sold and calculate the price per square meter.
- Multiply that rate by your house's total area to estimate its price.
- Then adjust for differences, such as a renovated kitchen or a smaller yard.
- Comparable companies are the nearby houses; revenue or earnings is the square footage.



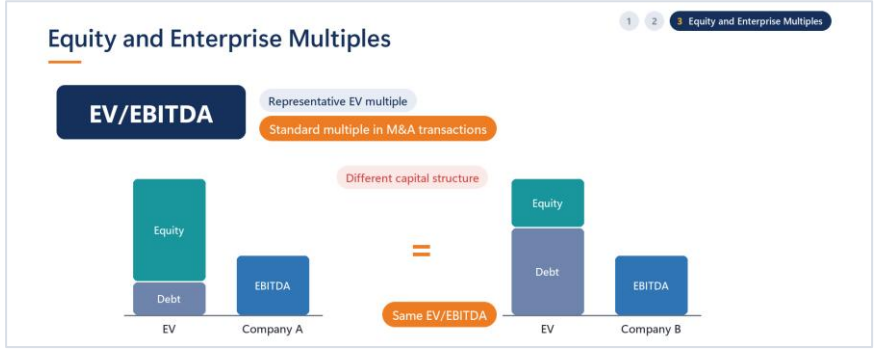
🔍 Comparable Company Selection

- Selecting the right comparables is the most important and often the most difficult step.
- Comparing a high-growth software company to a slow-growth manufacturer gives misleading results.
- Analysts screen by industry, business model, size, and growth profile for a fair comparison.



📊 Equity and Enterprise Multiples

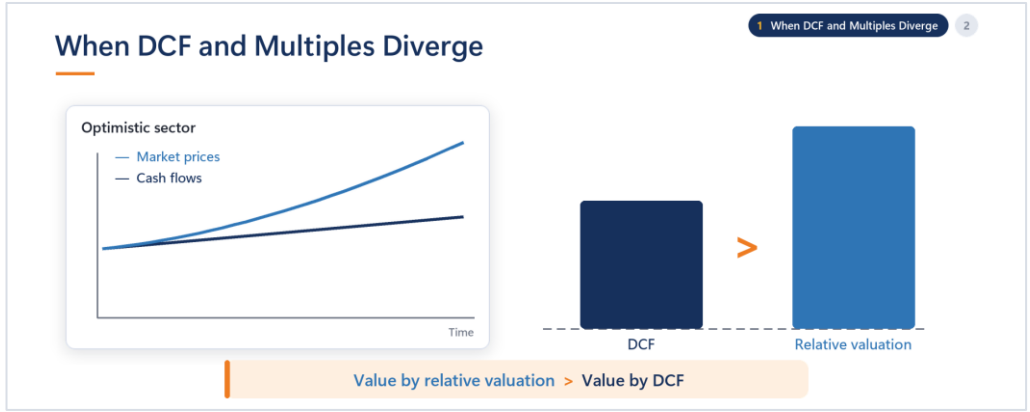
- Multiple = Market Value / Fundamental Metric; relative valuation uses two types.
- Equity value as numerator gives the shareholder's view; P/E is the most widely used equity multiple.
- P/S (Price-to-Sales) and P/B (Price-to-Book) apply when earnings are low or negative.
- EV as numerator gives all capital providers' view; EV/EBITDA is the standard M&A multiple, unaffected by capital structure.
- EV/Sales is used when EBITDA is unavailable or not meaningful, common for early-stage businesses.



4. Choose the Right Valuation Method (Part 3)

⚖️ When DCF and Multiples Diverge

- DCF and relative valuation often produce different numbers, and the gap is informative.
- When investors are highly optimistic, market prices rise faster than underlying cash flows.
- Then relative valuation gives a higher estimate: value by relative valuation > value by DCF.
- When a sector is out of favor, market prices fall: value by relative valuation < value by DCF.
- Experienced analysts run both methods and triangulate the outputs rather than relying on one figure.



🏛️ Corporate Buyers vs. Private Equity

- The choice of method may shift depending on who is doing the buying.
- A corporate buyer holds and grows the company long term; cash flow and synergies make DCF the more appropriate tool.
- A private equity firm buys, improves, and sells the company, usually within 3-7 years.
- The exit price is what the market pays then, so EV/EBITDA multiples sit at the center of the PE case.
- Both buyer types use both methods but weight them by investment horizon and return objectives.

