The right role for multiples in valuation

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Multiples can play a useful role in valuation. However, if not correctly used, they can lead to wrong conclusions. For example, multiplying the industry average P/E by the company's earnings will not lead to a fair valuation. Average P/E is conceptually incorrect as companies in the same industry may have different growth rates, returns on invested capital and capital structures. And even comparing companies with identical prospects, we must remember that earnings (the E in P/E) include both operating and non-operating items.

When using multiples for valuation, the questions which need to be addressed are:

- What companies are comparable?
- What kind of multiple should we use and in what context?
- If different multiples lead to different conclusions, which is the right multiple to use?

The following guidelines can be useful when using multiples for valuation:

- We must look at peers with similar prospects for ROIC and growth. For this, it is important to get a granular understanding of the financial and operating profiles of each of the companies, what products they sell, how they generate revenues and profits and how they grow.
- Wherever possible, we must use forward looking multiples, i.e. multiples based on forecasts rather than historical profits. They tend to be more accurate predictors of value. Where forecasts are not reliable, we must use the last 4 quarters of profits and adjust for onetime events.
- We should prefer enterprise value multiples rather than P/E which has two major flaws: It is affected by leverage and also by many non-operating items like restructuring charges and write offs. Enterprise value to EBITA is less susceptible to changes in capital structure. Enterprise value includes both debt and equity. EBITA is the profit available to investors. So, a change in capital structure will have no systematic effect. Only when such a change lowers the cost of capital, will it lead to a higher multiple.
- Enterprise value to EBITA must be suitably adjusted for non-operating items. For example, excess cash should be deducted. The value of leased assets must be added to the market value and the implied interest expenses must be added to EBITA. The present value of all

employee stock option grants currently outstanding and pension liabilities must be added to the value.

Price to sales multiples have limited use. They assume that comparable companies have similar growth rates, operating margins and returns on incremental investments.

PEG (P/E divided by EPS growth rate) multiples have the advantage that growth rates can vary across companies. So, a comparison is possible between companies in different stages of the life cycle. But there is no standard time frame for measuring growth. Also, a linear relationship between multiples and growth is assumed. Often companies with low growth rates are undervalued by industry PEG ratios.

For new companies with small sales and negative profits, nonfinancial multiples can be of help. These multiples compare the enterprise value with a non-operating statistic such as website hits, unique visitors and the number of subscribers. But we should be able to translate these non-operating statistics into profits and cash flows. Otherwise, a multiple based on financial metrics will be more useful.