Comparable Company Analysis: What It Is, Why It Matters, and How to Do It Efficiently

Would You Like a Stock Screener with Your Non-Recurring Charges?

We've referenced valuation multiples, comparable companies, "Public Comps," etc. in many tutorials, but have not defined exactly what they mean.

So, we'll explain what they are, why they matter, and how to complete the analysis quickly and cheaply here.

Plan for This Tutorial

1) **Meaning:** What does "Comparable Company Analysis" mean, and why do we use it when valuing companies?

2) **Process:** What are the set of steps required to use this analysis?

3) **Quick/Cheap:** How can you complete a Comparable Company Analysis *without* much time/effort or expensive services?

4) **Real Life:** Why does this process take so long in real life, and what makes it more complex than the examples shown here?

Defining Comparable Company Analysis

- **Idea:** You calculate a company's "Implied Value" – what it *should be worth* – based on what other, similar companies are worth

- **Example:** Company A has an Enterprise Value of $1,000, with an EBITDA of $100 and, therefore, an EV / EBITDA of 10x

- **But:** Other, similar companies in the market have EV / EBITDA multiples between 11x and 13x

- **So:** Company A should also trade at an EV / EBITDA of 11x to 13x, and its Enterprise Value should be between $1,100 and $1,300

Defining Comparable Company Analysis

- **Unlike** in a DCF, which is mostly based on *your views* of Company A and its long-term prospects, Comparable Company Analysis ("CCA") is based on *the market's views of this industry/sector*

- **So:** It's a "relative valuation methodology" – useful if the market is right about the other companies, and not so useful when it's wrong

- **Result:** We tend to think of CCA as a supplemental methodology rather than "real valuation" – yes, the DCF has issues as well, but *if you set it up properly and make plausible assumptions*, it works

CCA – The Set of Steps to Follow

- To value a company with CCA, follow these steps:

1) **Select** an appropriate set of comparable public companies.

2) **Determine** the metrics and multiples you want to use.

3) **Calculate** the metrics and multiples for all the companies.

4) **Apply** the median or 25th/75th percentile multiples from the set to your company to estimate its Implied Equity Value and Enterprise Value.

Step 1: Selecting the Comps

- **Criteria:** Geography, industry, and financial "size"

- **Target:** Ideally, you want 5-10 companies in the set; ~50 is too many to be useful, and a 1-2 company set has too little data

- **Example for STLD Here:** Geography – U.S. Only; Industry – Steel Manufacturers; Size – Projected Revenue Between $1 and $20 Billion

- **Why This Matters:** You want the companies in this set to have similar **Discount Rates**, i.e. similar risk and potential returns

Step 1: Selecting the Comps

- **Company Value** =

$$\frac{\text{Cash Flow}}{(\text{Discount Rate} - \text{Cash Flow Growth Rate})}$$

Where the Cash Flow Growth Rate Must Be **<** Discount Rate

- **So:** If the companies in the set have similar Discount Rates and similar Cash Flows, then differences in the Cash Flow Growth Rates *should* explain differences in the multiples

- **So:** "If one company has a higher expected growth rate, it *should* trade at higher multiples." (**Note** the emphasis on "*should*")

Step 2: Determining the Metrics/Multiples

- **Guidelines:** Usually you want 1 sales-based metric and 2 profitability-based metrics, and their corresponding multiples

- **Examples:** Revenue, EV / Revenue, and Revenue Growth; EBITDA, EV / EBITDA, and EBITDA Growth; and Net Income, P / E, and Net Income Growth

- **Time Periods:** Mix of historical and projected ones; historical uses real data, but can be distorted by acquisitions/divestitures

- **Here:** We focus on Revenue and EBITDA and also look at EBITDA margins to assess how similar these companies are

Step 3: Calculating the Metrics/Multiples

- **Start:** Calculate each company's Equity Value and Enterprise Value based on its current share price, shares outstanding, and Balance Sheet

- **Then:** Get historical figures for Revenue, Net Income, EBITDA, etc. from the company's annual or quarterly reports, or online sources

- **Then:** Get projected figures from equity research reports, or find estimates in free online sources

- **Finally:** Calculate the growth rates, margins, and multiples – this is simple arithmetic

Step 4: Applying the Metrics/Multiples

- **Start:** Calculate the minimum, 25th percentile, median, 75th percentile, and maximum for each version of each multiple

- **Then:** Multiply the "Applicable Company Figures" by each multiple to calculate the Implied Equity Value or Enterprise Value

- **Then:** Back into Implied Equity Value, if necessary, and divide by the share count to calculate the Implied Share Price

- **GOAL:** "Steel Dynamics might be worth between $15.00 and $20.00 per share according to revenue multiples, or between $17.00 and $23.00 per share according to EBITDA multiples."

Completing a CCA Quickly and Cheaply

- **Fastest Solution:** Finviz, Zacks, or Motley Fool to find companies and basic financial information

- **Ideal:** Search by the name of the company you're valuing on these sites and then click through to "Industry" section to find peers

- **Screening/Sorting:** A bit annoying because you cannot sort by Revenue on Finviz (????)... but Market Cap works decently

- **Projected Numbers:** Click through to "Financial Highlights" or "Statements" to find these

Completing a CCA **Quickly and Cheaply**

- **PROBLEM:** These projections rarely have EBITDA, EBIT, etc. – typically just Revenue and EPS

- **Solution:** Approximate and assume that EBITDA grows about as quickly as EPS in the future periods

- **PROBLEM:** No easy way to download all the data in one spot or pull all the numbers into Excel quickly and simply

- **Solution:** Don't put ~25 companies in your set – this is partially why you limit it to 5-10 (maybe also look at browser plugins?)

Added Complexities

- **Manual Search:** You often have to search through each company's filings manually and look for the financials, fine print, etc.

- **Non-Recurring Charges:** It can be tricky to determine whether something like "Restructuring" should be added back when calculating EBITDA – is it really non-recurring?

- **Calendarizing the Figures:** What if one company's fiscal year ends on June 30th and another's ends on September 30th?

- **Solution:** Take the Jul 1st to Jun 30th numbers, add the Jul 1st to Sep 30th numbers, and subtract the previous year's Jul 1st to Sep 30th numbers

Recap and Summary

- **Comparable Company Analysis:** Companies A – G are like us, and they have EV / EBITDA multiples of 10x – 13x, so we should as well

- **Selection:** You want these companies to have similar Cash Flows and Discount Rates, so you screen by industry, geography, and size

- **Process:** Select companies, determine metrics/multiples, calculate them, and apply them to your company to get its Implied Value

- **Quick/Cheap:** Use Finviz or Zacks to find comps by searching for the company; pull basic information from there and make estimates

- **Real Life:** Manual search, non-recurring charges, and calendarization