RELATIVE VALUATION

- Technique used to value businesses, business units and other major investments
  - Assumes similar assets should sell as similar prices
  - The critical assumption is that the “comparable” assets/transactions are truly comparable to the investment being evaluated.
- Should be used to complement DCF analysis

Steps in Relative Valuation

1. Identify similar or comparable investments and recent market prices for each
2. Calculate a “valuation metric” for use in valuing the asset
3. Calculate an initial estimate of value
4. Refine or tailor your initial valuation estimate to the specific characteristics of the investment

The ratios:

- **ROE**
- **Equity Growth or Book Value Growth**
- **Price-to-Book Ratio**
  - Low ratio may indicate low growth
- **Price-Earnings Ratio**
  - Use in assignment
  - Most common
- **Price/EBITDA**
  - Removes some of the non-cash items from earnings, but ignores tax
- **Price/FCFF**
  - Best but requires more assumptions and harder to calculate and apply

Equity valuation using the Price-to-earnings (P/E) Ratio

- Analysts tend to focus their attention on estimating the earnings of the firms they evaluate, and then use the price-to-earnings (P/E) ratio to evaluate the price of the common stock
- P/E ratio is most widely recognized by investors and is most common
- EPS is a major focus by security analysts

$$\left(\frac{\text{Price per Share for a Comparable Firm}}{\text{Earnings per Share for a Comparable Firm}}\right) \times \text{Earnings per Share for the Firm Being Valued}$$

= Estimated Value of the Firm’s Equity