

*“How Do You Value a Company?”*

December 2, 2003

Graduate Finance Association  
Stern School of Business

# *Agenda*

**1. Overview**

**2. Public / Trading Comparables**

**3. Acquisition Comparables**

**4. Discounted Cash Flow (Firm, Equity)**

**5. Other Techniques (LBO, Private company,  
Liquidation value, Option value)**

## *The most common types:*

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### *Trading Comps*

- Value based on public multiples (relative value)
- Implied value in public securities markets (IPO analysis)
- Focused on forward looking EBITDA, EPS or Cash Flow

### *Acquisition Comps*

- Value based on multiples paid for comparable companies/assets in M&A transactions
- Implied value in public and private market
- Focused on multiples of historical EBITDA, EPS or Cash Flow

### *DCF*

- PV of cash flows
- “Inherent” or intrinsic value
- Best captures the business in transition
- Sensitivity analysis / Synergies analysis

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*DCF*

*Others*

# Some Valuation Concepts:

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## Equity Value

- Value of shareholders' interest
- Other common terms:
  - market value, offer value, market capitalization

## Enterprise Value (EV)

- Includes all forms of capital:
  - equity, debt, preferred stock, minority interest
- Other common terms:
  - aggregate value, firm value, total capitalization, adjusted market value, transaction value

$$\text{EV} = \text{Equity market value} + \text{Net Debt} + \text{Pref.} + \text{Minority Interest}$$

What are my assets worth?  $\leftrightarrow$  How did I finance them?

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## ***Some Valuation Concepts (cont'd):***

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**EBIT = Earnings Before Interest and Taxes**

-- Income from operations before the effects of the financing and taxes

- income independent of capital structure

**Why use EBIT?**

-- Operating Income ~ EBIT

- measures of profitability independent of capital structure

- interest expense is a tax shield

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## ***Some Valuation Concepts (cont'd):***

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**EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization**

-- “Quick and dirty” approximation of operating cash flow

- D&A are non-cash expenses

- If D&A are very high, then EBITDA growth must be supported by high capital expenditure (focus on EBIT)

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## ***Some Valuation Concepts (cont'd):***

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### **Multiples**

**-- Provide a measure of relative valuation to an underlying financial item**

**EPS** - On December 8, 2002, ABC Corp. traded at 45x FY03  
(forward EPS multiple)

**EBITDA** (trailing / historical multiple) - On December 8, 2002 XYZ Inc. was sold for 10x LTM

**-- Allow for relative comparisons**

**(ABC Corp. was sold for 16x 2003 EBITDA – is that a good price?)**

**traded between 50-60x next FY's EPS. Today it trades at 35x – any conclusions?)**

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*Let us begin..*

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# What is Public Market Valuation?

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-- Comparisons with *similar*, publicly traded companies

-- Common uses:

## 1. Implied value for:

- public company
- division as an independent, publicly traded company
- private company
- valuation does not reflect control premiums or synergy

## 2. Defense analysis:

- are we a possible takeover candidate?

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## ***How is public comparables analysis done?***

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### **The steps:**

- 1. Determine the peer group (your comps universe)**
- 2. Gather the appropriate financial information**
- 3. Enter the financial information into your spreadsheet**
  - normalize for non-recurring items**
- 4. Calculate relevant historical or forward multiples (P/E; EV/EBITDA)**
- 5. Forecast your company's future financial performance (EBITDA, EPS, Cash Flow, etc.)**
- 6. Apply appropriate multiples to your company's financial stats and derive implied valuation range**

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## ***What is a “comparable” firm?***

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**“Comparable” or “similar” in terms of:**

**-- Operations**

**- products / services; distribution; costs structure; geography; interest exposure; customers, etc.**

**-- Financial Aspects**

**- size (sales, mkt cap); capital structure; margins / profitability; management experience, etc.**

***\* You are probably better off to not exclude the comps that are different but use them to explain different relative valuation***

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## ***Difficulty in finding “pure comps”***

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### **-- Subjective nature and process**

- how do you assess differences in the operations and financial aspects?**
- do you assess intangible differences such as brand equity, reputation or management expertise?**

### **-- What is the appropriate number of comps?**

### **-- Selection may be more art than science**

- use judgment**

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## ***What if there are no publicly traded comps?***

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- Comparables may be:**
  - private**
  - divisions of larger companies**
- Company may be the “first of its kind”**
- Use educated guesswork and creativity**
- Place more emphasis on other valuation methodologies**

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## ***Why normalize? Where is the information?***

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### **-- Why?**

of - items not expected to be part of the normal course of business in the future should be adjusted for

losses on - **examples:** restructuring charges, gains/ sale of assets, legal settlements, asset impairments

earnings - the goal is to evaluate the ongoing business, and cash flows

### **-- Where is it?**

- separate line on IS (other income/expense, COGS, SG&A)

- add back in the CF

- MD&A section

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## ***What are the relevant multiples?***

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### **-- Multiples will vary by industry:**

- Retail: EPS, PEG
- Industrials: EBITDA, EPS
- Internet: Revenues, Subscribers, Page views
- Banks/Financial institutions: EPS, Book Value
- REITS: Funds from operations, Net asset value

### **-- Use forward multiples if possible**

- Projected EBITDA, EPS
- Use research

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# How do public comps look like in Excel?

Merrill Lynch

12/5/02 12:00 PM

Public Comps Valuation Analysis

Page 1

| Market Data   |         |     |              |                | Valuation Multiples |           |                   |           |               |           |             |           |           |           |           |
|---------------|---------|-----|--------------|----------------|---------------------|-----------|-------------------|-----------|---------------|-----------|-------------|-----------|-----------|-----------|-----------|
| Closing Price | 52 Week |     | Market Value | Enterp. Vallue | Price / Earnings    |           | Price / Cash Flow |           | EV / Revenues |           | EV / EBITDA |           | EV / EBIT |           | P/B       |
| 9-Dec-02      | High    | Low | (Diluted-TS) | (Diluted)      | (Diluted)           | (Diluted) | (Diluted)         | (Diluted) | (Diluted)     | (Diluted) | (Diluted)   | (Diluted) | (Diluted) | (Diluted) | (Diluted) |
|               |         |     |              |                | 2002                | 2002      | 2002              | 2002      | 2002          | 2002      | 2002        | 2002      | 2002      | 2002      | LTM       |

## Teleservices Companies

|                               |         |         |        |             |             |              |              |              |              |             |             |              |              |              |              |              |
|-------------------------------|---------|---------|--------|-------------|-------------|--------------|--------------|--------------|--------------|-------------|-------------|--------------|--------------|--------------|--------------|--------------|
| Convergys Corp (CVG)          | \$10.00 | \$12.00 | \$8.00 | \$1,552,349 | \$1,281,449 | 9.4x         | 8.7x         | 5.0x         | 4.7x         | 0.6x        | 0.6x        | 3.0x         | 2.7x         | 4.6x         | 4.1x         | 1.5x         |
| Minacs Worldwide Inc. (MXW)   | \$10.00 | \$12.00 | \$8.00 | \$1,257,783 | \$1,273,145 | nmf          | nmf          | 286.2x       | 303.4x       | 15.4x       | 14.4x       | 258.3x       | 232.0x       | nmf          | nmf          | 74.7x        |
| Sitel (SWW)                   | \$10.00 | \$12.00 | \$8.00 | \$830,086   | \$935,220   | 46.8x        | 38.5x        | 11.9x        | 12.1x        | 1.2x        | 1.2x        | 10.5x        | 10.6x        | 22.0x        | 20.5x        | 4.4x         |
| Teletech Holdings (TTEC)      | \$10.00 | \$12.00 | \$8.00 | \$645,820   | \$582,069   | 20.0x        | 17.2x        | 9.9x         | 8.4x         | 0.9x        | 0.8x        | 6.4x         | 5.3x         | 10.4x        | 8.4x         | 2.1x         |
| West Teleservices Corp (WTSC) | \$10.00 | \$12.00 | \$8.00 | \$645,034   | \$621,920   | 11.8x        | 10.8x        | 7.0x         | 6.4x         | 1.0x        | 0.9x        | 4.7x         | 4.4x         | 6.7x         | 6.4x         | 1.6x         |
| APAC Customer Services (APAC) | \$10.00 | \$12.00 | \$8.00 | \$498,916   | \$583,097   | 40.8x        | 32.3x        | 10.9x        | 11.5x        | 1.3x        | 1.2x        | 8.7x         | 8.8x         | 17.4x        | 15.8x        | 7.2x         |
| Sykes Enterprises (SYKE)      | \$10.00 | \$12.00 | \$8.00 | \$414,406   | \$328,072   | 16.5x        | 16.0x        | 6.6x         | 6.5x         | 0.5x        | 0.5x        | 3.9x         | 3.7x         | 7.1x         | 6.7x         | 1.7x         |
| Telespectrum (TLSP)           | \$10.00 | \$12.00 | \$8.00 | \$357,935   | \$494,854   | nmf          | nmf          | 17.3x        | 11.9x        | 1.5x        | 1.6x        | 18.5x        | 16.1x        | 73.6x        | nmf          | 2.3x         |
| ICT Group (ICTG)              | \$10.00 | \$12.00 | \$8.00 | \$129,134   | \$142,298   | 24.5x        | 18.1x        | 9.3x         | 8.1x         | 0.9x        | 0.7x        | 7.9x         | 6.8x         | 15.1x        | 11.4x        | 2.4x         |
| RMH Teleservices (RMHT)       | \$10.00 | \$12.00 | \$8.00 | \$89,391    | \$86,397    | 33.3x        | 25.2x        | 19.5x        | 16.7x        | 0.7x        | 0.6x        | 12.9x        | 9.8x         | 17.9x        | 12.3x        | 3.0x         |
| <b>Mean</b>                   |         |         |        |             |             | <b>25.4x</b> | <b>20.8x</b> | <b>38.3x</b> | <b>39.0x</b> | <b>2.4x</b> | <b>2.3x</b> | <b>33.5x</b> | <b>30.0x</b> | <b>19.4x</b> | <b>10.7x</b> | <b>10.1x</b> |
| <b>Mean - adjusted</b>        |         |         |        |             |             | <b>21.2x</b> | <b>17.4x</b> | <b>10.8x</b> | <b>9.6x</b>  | <b>1.0x</b> | <b>0.9x</b> | <b>8.5x</b>  | <b>7.6x</b>  | <b>12.6x</b> | <b>10.2x</b> | <b>2.9x</b>  |
| <b>Median</b>                 |         |         |        |             |             | <b>22.2x</b> | <b>17.6x</b> | <b>10.4x</b> | <b>10.0x</b> | <b>1.0x</b> | <b>0.9x</b> | <b>8.3x</b>  | <b>7.8x</b>  | <b>15.1x</b> | <b>9.9x</b>  | <b>2.3x</b>  |
| <b>Median - adjusted</b>      |         |         |        |             |             | <b>20.0x</b> | <b>17.2x</b> | <b>9.9x</b>  | <b>8.4x</b>  | <b>0.9x</b> | <b>0.8x</b> | <b>7.9x</b>  | <b>6.8x</b>  | <b>12.7x</b> | <b>9.9x</b>  | <b>2.3x</b>  |

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M&A Comps

DCF

Others



**Next,**

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# What is Acquisition Comparables Valuation?

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## -- Comparisons with *similar transactions*

- actual vs. hypothetical valuation
- “grounds you in reality”

## -- Price reflects control premiums and synergies

## -- Key factors to consider:

- Timing and surrounding events (industry trends)
- Nature (friendly, contested, hostile)
- Consideration paid (cash, stock, combination of both)

## -- Bottom line: Very similar analysis as public comps (use of multiples), but a different perspective

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## How is acquisition comparables analysis done?

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### The steps:

1. Determine the appropriate deal list
2. Gather the appropriate financial information
3. Enter the financial information into your spreadsheet
  - calculate Transaction Value (TV) and Offer Value (OV)
  - normalize for non-recurring items
4. Calculate relevant multiples (TV/Sales, TV/EBITDA, OV/Net Income, OV/Book Value; Offer Price per Share/EPS)
5. Analyze the results
6. Derive implied valuation range

*Transaction Value = Total Firm Value (incl. debt); Offer Value = Total Equity Value; Offer Price = Offer Value per Share*

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## ***Narrowing down the transactions list***

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### **-- Goal:**

**- to find transactions where the companies involved have similar business and financial characteristics to the company you are advising**

### **-- Factors to consider:**

- operations, line of business**
- size**
- financial aspects (growth, margins, etc)**
- consideration paid**
- timing (last 3 – 5 years)**
- the then market conditions**

### **-- What is the right number of deals?**

### **-- Know the basic story behind each deal; note revisions**

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## ***Premiums paid analysis***

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**-- Premium (%) = (Offer Price / Target Price) – 1**

**-- It is common to use various time frames to control for leaks:**

**- Premium to:**

**- 1 day prior**

**- 1 week prior**

**- 1 month prior**

**- other points: 52 week high and low; last month average**

**-- The idea is to use “unaffected share price” – i.e. prior to announcement of possible sale or before the “evaluating strategic alternatives” press release**

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# Calculating the Offer Value

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-- Offer Value is similar to Equity Value

- also called “Total Equity Purchase Price”

**Offer Value =**

(Total Shares Outstanding\* x Purchase Price per Share) – Option Proceeds



**\*Total Shares Outstanding =**

Basis Shares + In-the-money-options + Shares from in-the-money convertible securities)

-- Check footnotes for options and convertible securities

-- *Outstanding*, not exercisable options → change of control event

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## ***A word about convertible securities***

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### **Test: What would a rational investor do?**

- **Conversion Price > Purchase Price Per Share**
  - the convertible security is underwater
  - assume securities do not convert into common shares
- **Conversion Price < Purchase Price per Share**
  - the security is “in-the-money”
  - assume securities do convert into common shares

### **Example:**

**No of Shares Underlying the Convert. Sec. =**

**Face Value of the Security / Conversion Price**

Face Value = \$1,000; Conversion Ratio: 40 (Conversion Price \$25); ...Purchase (Offer) Price per Share \$30 → 😊

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# Calculating the Transaction Value

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-- Transaction Value is similar to “Enterprise Value” for acquisition comparables analysis

- also called “Total Consideration”

**Transaction Value =**

**Offer Value + Total Debt\* + Pref. Stock + Minority Interest – Cash & Equiv.**



**\*Total Debt excludes convertible securities that are assumed to convert into common shares (do not double count)**

-- Use most recent balance sheet

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# What are the relevant multiples?

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## -- Multiples will vary by industry

- Transaction Value / EBITDA almost always used
- Similar to public comparables analysis
- Unlike trading multiples, acquisitions multiples will generally be higher as they include control premiums and synergies

## -- Last twelve months (LTM) multiples are most common

## -- Also, use forward multiples if possible

- Could be difficult with private targets
- Obtain research with Sales, EBITDA and EPS estimates just prior to the transaction announcement date

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## DCF - What is it?

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- DCF is often the primary valuation methodology in M&A
- Comparable public company and comparable acquisition analysis are often used as confirming methodologies
- DCF is the PV of 2 main types of free cash flows:
  1. Free cash flows to all capital providers (debt and equity)
  2. Free cash flows to equity capital providers
    - special case: dividend discount model
- DCF measures the “inherent” value of the asset and best captures business in transition
- Fundamental in nature, DCF allows for questioning all of the assumptions and for performing sensitivity analysis
- One can easily estimate equity value from firm value by subtracting the market value of debt today

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# *How is DCF analysis done?*

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## **The steps:**

- 1. Project operating results and free cash flows**
- 2. Estimate the terminal value of the business by 1 of 2 methods:**
  - perpetuity formula**
  - exit multiple**
- 3. Calculate appropriate discount rate**
- 4. Discount the annual cash flows and the terminal value to present**
- 5. Determine range of values**
- 6. Interpret the results and perform sensitivity analysis**

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# Free Cash Flow to the Firm (FCFF) – the cash flow available to all capital providers

|                           |              |                         |                              |
|---------------------------|--------------|-------------------------|------------------------------|
|                           | or           | or                      | or                           |
| Sales                     |              |                         |                              |
| - (COGS + SG&A)           | EBIT (1-T)   | FCFE                    | CFO (NI + Depr - Add. to WC) |
| - Cash Taxes              |              | + Interest (1-T)        | - Cap Ex                     |
| + Depr.                   | + Depr.      | + Principal Debt Repmts | + Interest (1-T)             |
| - Cap Ex                  | - Cap Ex     | - Issue of New Debt     |                              |
| - Add. to WC              | - Add. to WC | + Payment of Pref Dvds. |                              |
| <hr/> <hr/>               | <hr/> <hr/>  | <hr/> <hr/>             | <hr/> <hr/>                  |
| = FCFF                    | = FCFF       | = FCFF                  | = FCFF                       |
| <b>most likely formul</b> |              |                         |                              |

# The terminal value

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-- Estimating the terminal value (the value of all future cash flows after the explicit forecast period of 10 years)

1. Perpetuity growth method (Gordon growth formula):

Terminal value =  $FCF (n+1) / (r-g)$  → assumption

- forecast 10 explicit years of FCF
- grow Year 10 FCF and obtain estimate of FCF in Year 11
- “r”, the discount rate is either  $E_r$  or WACC  
(depending on whether we are discounting FCFE or FCFF)
- “g” is the perpetuity growth rate (the growth forever) and in many models is often equal to GDP growth rate
- discount the Terminal Value to present using the appropriate discount rate

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## ***The terminal value (cont'd)***

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**-- Estimating the terminal value (the value of all future cash flows after the explicit forecast period of 10 years)**

**2. Exit multiple method:**

**Terminal value = Statistic x Multiple → assumption**

- forecast 10 explicit years of FCF, EBITDA, Net Income
- grow Year 10 FCF and obtain estimate of FCF in Year 11
- apply an “exit” multiple
- multiply and estimate Terminal Value
- discount the Terminal Value to the present using  
the appropriate discount rate

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# Free Cash Flow to the Equity (FCFE) – the cash flow available to the common equity holders

or

NI

+ Depr.  
- Cap Ex  
- Add. to WC

- Principal Debt Rpmnts.  
+ Issue of New Debt  
- Payment of Pref Dvds.

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**= FCFE**

**the most likely formula**

CFO

- Cap Ex

- Principal Debt Repmnts.  
+ Issue of New Debt  
- Payment of Pref Dvds.

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**= FCFE**

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**DCF - equity**

Others



## The discount rates

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-- Discount Free Cash Flows to the Equity at the cost of equity:

$$E_r = R_f + \text{levered } \beta \times (R_m - R_f)$$



$$\text{Levered } \beta = \text{Unlev. } \beta \times (1 + (1 - \text{Tax rate}) \times D/E)$$

-- Discount Free Cash Flows to the Firm at the cost of capital:

$$\text{WACC} = \text{After tax cost of Debt} \times D/C + E_r \times E/C$$

↓  
The tax deductibility of interest expense provides a “tax shield”

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## *Moving on..*

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# LBOs

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## -- What is it?

- definition
- **DCF** → Free Cash Flow to the Firm
- Calculate the Terminal Value
- Add the PVs of Cash Flows and the PV of the Terminal Value and estimate the firm's Enterprise Value
- Subtract the debt from the Enterprise Value
- The issue to get the equity value in 3, 5 or 7 years
- Calculate equity returns
- Compare with cost of equity (usually 20-30%)

## -- Debt service analysis extremely crucial

## -- State of the high yield market important

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# Private companies

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## -- Why are we valuing the firm?

- to make a minority investment, or
- to buy the whole firm (in a “private sale”, a publicly traded company or at an IPO) and control the cash flows

## -- Valuation challenges

- difficulty in estimating beta, cost of equity and cost of debt
- short history of cash flows

## -- Other issues

- business vs. personal expenses; accounting standards
- selling a private firm to stay private: apply both liquidity discount and control premium
- selling to a publicly traded company: no liquidity discount, just control premium

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# Liquidation Value

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## -- Forced Liquidation (Auction)

- **Definition:** A professional opinion of the estimated most probable price expressed in terms of currency which could typically be realized at a properly advertised and conducted *public auction sale*, held under forced sale conditions and under present day economic trends, as of the effective date of the appraisal report.

- **Issues:** Taken into consideration are physical location, difficulty of removal, physical condition, adaptability, specialization, marketability, overall appearance and psychological appeal. Further, the ability of the asset group to draw sufficient prospective buyers to insure competitive offers is considered.

## -- Orderly Liquidation Value

- **Definition:** A professional opinion of the estimated most probable price expressed in terms of currency which the subject equipment could typically realize at a *privately negotiated sale*, properly advertised and professionally managed, by a seller obligated to sell over an extended period of time, usually within six to twelve months, as of the effective date of the appraisal.

**Issues:** Further, the ability of the asset group to draw sufficient prospective buyers to insure competitive offers is considered. All assets are to be sold on a piecemeal basis 'as is' with purchasers responsible for removal of assets at their own risk and expense.

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# Company shares as Option value

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## -- What is it?

- Equity in a firm is a residual claim:
- When a distressed firm is liquidated the equity investors have the chance to get whatever is left over in the firm after all debts and outstanding financial claims have been paid off.

## -- Why similar an option?

- Equity investors in publicly traded firms cannot lose more than their investment in the firm.
- Equity in a near-bankruptcy firm can be considered as an option to liquidate → equity is a call option on the assets of the firm and the price of one share is considered the option premium.

## -- Black Scholes option valuation formula

## -- Enron article (read it - it is good)

Overview

Public Comps

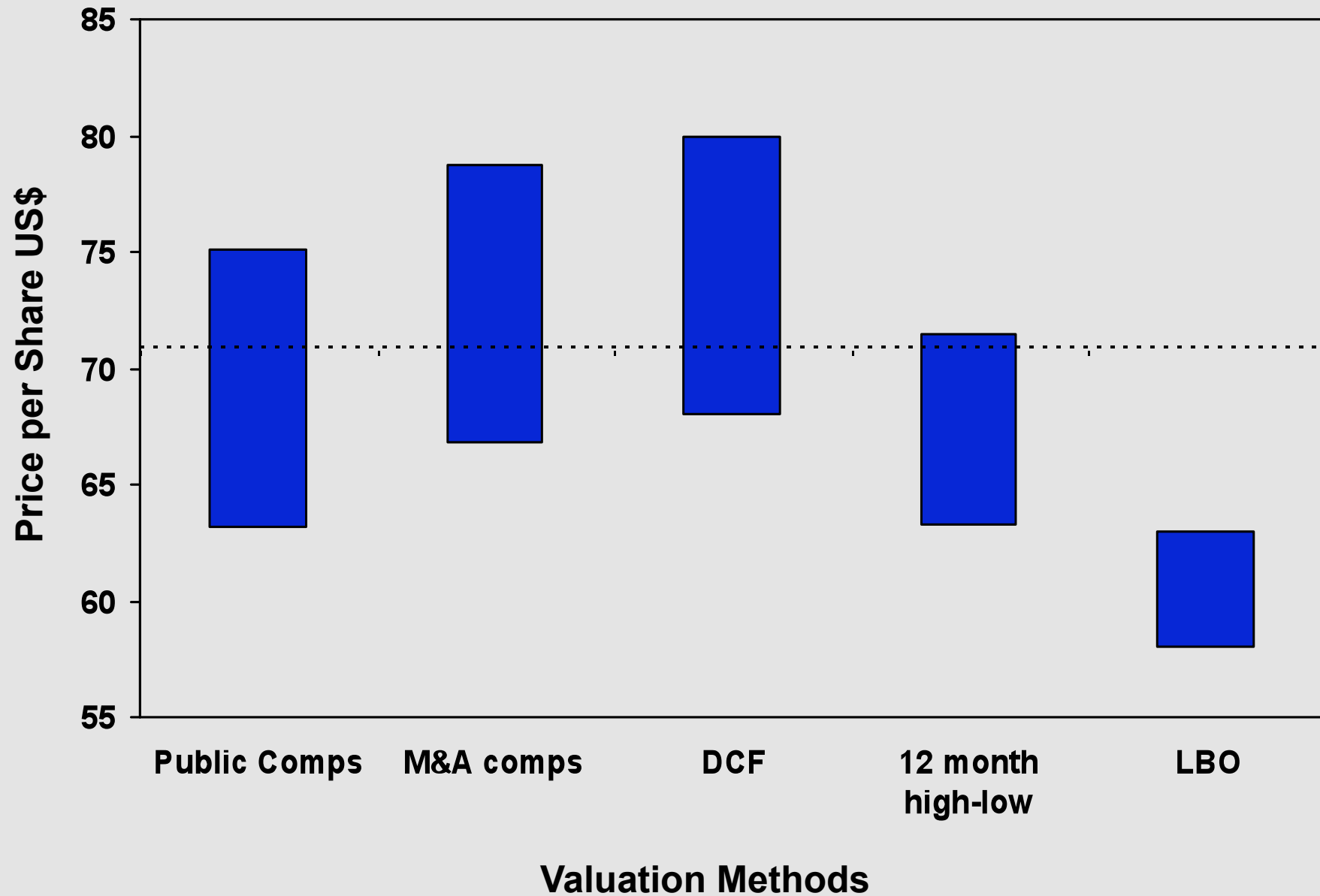
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## *How do the main valuation methods compare?*

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# ***Sarbanes-Oxley Act of 2002***

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## **-- What is it?**

**- A 66-page document created to enforce better disclosures and corporate governance**

## **-- Purpose?**

**- “...to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes...”**

**- “...this act may be cited as the Sarbanes-Oxley Act of 2002...”**

**- Contents: company oversight boards, auditor independence, corporate responsibility, enhanced financial disclosures, corporate and criminal fraud accountability, white collar crime penalty enhancements, etc.**



## ***What do I need to remember to answer the valuation question?***

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### **-- 2 main types of Relative Valuation based on multiples (Trading multiples or Acquisition multiples)**

- estimates the value of an asset by looking at the pricing of 'comparable' assets relative to a common variable like earnings, cash flows, book value or sales

### **-- 2 main types of DCF Valuation (FCFF, FCFE,.. also DDM)**

- relates the value of an asset to the present value of expected future cash flows on that asset

### **-- Be aware of 3 more cases: Private company issues, LBO Valuation and Liquidation Value**

### **-- Contingent claim valuation (equity as a call option)**

- uses option pricing models to measure the value of assets that share option characteristics

*Final slide*

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**Enjoy the holiday  
season and  
good luck on the  
interviews!**