Valuations of Terra

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Terra was floated on the stock exchange in November 1999. The placement price was 13 euros per share. In February 2000 each share was worth 139.75 euros. In less than four months the company provided its shareholders with the creation of 34,000 million euros of worth (a return on investment of 975%). But on 3rd August 2000 the price per share was 40 euros, 29% of February's record high. Terra's shares have seen an average annual volatility of over 100%. Using its cash flow forecasts, one American firm valued Terra's shares just before the IPO (at the end of October 1999). They estimated Terra's beta coefficient as being 2.5% and the market premium as being 3.5%. Since the long-dated Treasury bonds were at 5.15%, they estimated a return on investment demanded of the shares of 13.9%. And so they reached the price of 16.3 euros per share. Using this valuation, they recommended going ahead with the IPO. In March 2000, when the price of Terra's shares was 117.15 euros, a French bank issued a report in which it valued each share at 86 euros.

This valuation was based on the ratio [market value/sales] of comparable companies: Freeserve, Tiscali, Freenet.de and Infosources. The French bank also provided a reverse valuation, as described by my colleague Javier Estrada in his article. This was a cash flow discount valuation.

Estimating a beta coefficient of 2.5%, a market premium of 3.5% and a risk-free ratio of 6%, they reached a return on investment demanded of the shares of 14.75% and a weighted cost of resources of 14.6%. The bank argued that in order to justify the price of 117.15 euros per share, it would have to expect cash flow growth of 14% as of 2010. Since it believed growth of 14% to be too high, the French bank concluded that Terra was overvalued at its price of 117.15 euros.

On the 8th September, with the price at 52 euros, the consensus among the analysts was to purchase. However, there were more than 10 million loaned shares. The spectacular drop in Terra's share price is not unique. The following chart shows evolution of 13 B2B companies. The capitalisation of the 13 companies moved from 30,082 million dollars in March to 9,908 million on 3rd August. It is interesting to observe that the price variations over last year have been enormous. In 11 of the 13 companies, the minimum price has been at 10% of the maximum price or less. Using these details, we can conclude that the valuation of Internet companies is, at best, questionable. Some analysts and directors maintain that the Internet companies cannot be valued using the traditional method of discounting expected cash flow.

This is false and the conceptually incorrect, and is the best way to create speculation bubbles. It is true that the discount of cash flow should in some cases be complemented with the valuation of real options (possible new businesses which can provide additional cash flow to the company in the future). But not all Internet companies have valuable
real options. A real option only contributes value to a company when this company has the possibility to exercise the said option in exclusivity at a future date. On the other hand, the real options found in Internet companies cannot be described as easily as the real options which make up the exploitation of a mine or the exploitation of an oil deposit.

Any good valuation of an Internet company should judge how sensible the business plans are (with emphasis on the analysis of the expectations for sales and margin growth) and ought to recognise and quantify the value (should it exist) of the real options found in the company. Can we conclude that all Internet companies are living in a bubble? The answer is no (although it is obvious that several of the aforementioned companies have been part of a speculation bubble). There are many Internet companies and projects with sensible business plans and reasonable expectations for sales and margin growth. There are also many Internet companies and projects with no expectations for growth or increased margins. The word Internet does not have the Midas touch, although at times it may seem otherwise.