

210 Common mistakes to avoid when valuing a company

Can you imagine assigning a negative value to the shares of a company whose expected cash flows are positive? This is just one of the 210 mistakes in company valuations that Pablo Fernández compiles in a paper.



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A 2007 audit concluded that the shares of an aeronautical company had a negative value, despite the fact that expected cash flows to shareholders were always positive. As counter intuitive as it seems, the conclusion becomes understandable when we break down and consider the many mistakes made in the valuation process.

Valuing companies is as important as it is dangerous. A miscalculation or faulty method can prove quite costly in negotiations and investing. Moreover, there is no single, foolproof method, and absurd results are often obtained, such as those cited by IESE's [Pablo Fernández](#) in his document cataloging [210 mistakes in company valuations](#).

His intention is not to mock (most names and identifying details are removed), but to explain, point by point, the most common errors and the serious limitations of certain widely used methods for company valuations.

Memorable mistakes

The author organizes the common mistakes into seven groups — covering errors in discount rates and risk measures, cash flow calculations, and terminal value calculations first. He then turns to inconsistencies and conceptual errors, interpreting valuations, interpreting accounting, and organizational missteps.

Discount rates and risk: Frequent mistakes in discount rates and risk occupy the first section. For example, Fernandez notes that calculating "risk" for a public company's stock price with historical data on volatility (i.e., beta) is a bottomless well of confusion.

Cash flows: In the second section, the author asserts that it is wrong to consider the increase of liquid assets as cash flow for shareholders, among other things.

Terminal value: Here Fernández shines a light on the use of inconsistent cash flows to calculate perpetuity and the inappropriate use of arithmetic averages (in lieu of *geometric* averages) to estimate growth.

Inconsistencies and conceptual errors: As an example for this section, the author recalls a company that registered a large volume of oil sales in Russia, where it intended to build a plant. According to an investment bank, the net present value of future investments should be considered zero, thus mistakenly disregarding the cash flows deriving from future investments.

Interpreting valuation: Fernández reminds readers that valuations are contingent upon a series of expectations (re: the company's future, the industry's, the country's and the global economy's) and also upon estimations of the company's risk.

A prime example here is confusing "value" with price. Value always depends upon expectations, and thus a company's value will vary from one buyer to another. Meanwhile,

the price is whatever ends up being paid following a negotiation or depending on the dynamics of the market.

Interpreting accounting: In terms of errors in this section, Fernández includes the tendency to confuse net profits and cash flows. He also cites the mistaken belief that a company's equity or capital somehow determine its stocks' value.

Organizational missteps: Finally, the document delineates organizational problems, including making valuations without reviewing the forecasts of the client and assigning an economics professor to the task who doesn't have real-world business experience.

Most of these 210 mistakes stem from making hasty decisions, over-simplifying or being too fond of formulas. Many professional analysts either fail to question the logic behind a particular method or they gloss over the estimates that support a given theory.

In this sense, the document serves as a healthy warning to professionals from any sector looking at valuations, reminding them to add the proverbial grain of salt.

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