

201 mistakes never to make when valuing a company

May 15, 2008

Imagine giving a negative value to the shares of a company with positive cash flow. This type of mistake is more common than you think.

A 2007 audit concluded that shares of a particular aeronautical company had a negative value, despite the fact that stockholders' cash-flow forecasts had always been positive. As unreasonable as it seems, the mistakes made in the process of reaching that conclusion are quite understandable.

Valuing companies is as important as it is dangerous. A miscalculation or faulty method can prove quite costly in a negotiation or in the financial market. Moreover, there is no single, foolproof method, and oftentimes absurd results are obtained, such as those cited by [IESE Prof. Pablo Fernández](#) in his book, [201 errores en valoraciones de empresas](#) (*201 Mistakes in Company Valuations*).

Excluding most of the names and specific references, Fernández seeks to focus on the mistakes themselves and explain, point by point, the serious limitations of certain methods widely used among professionals.

Memorable mistakes

The first part of the book features 13 "memorable" valuations, which add up to no less than 100 mistakes. These include:

Book value. Two experts analyzing a distribution company each take different routes but

arrive at the same conclusion: the company's share value is its book value, which they also have coinciding with its liquidating value. By their estimation, the value of a company with 15 billion in sales and 600 million in profits is its liquidating value. In other words, the company was worth no more than what it would sell for at that moment, regardless of what price it might fetch in the future. Mistake.

Fernández points out that analyzing a company is a bit like valuing a cow. The result will be the higher of two options: that obtained by sacrificing the cow for meat, or by taking care of it in order for it to yield milk. Likewise, one must simply compare the book value and the share price for companies listed on the stock market, given that the two never coincide.

Discount rates. Most analysts acknowledge that people can accept varying expectations about the flows that a company will produce, but not divergences in the perceived risk. The appreciation of the cash-flow risk (discount rates) should be the same for everyone: the Capital Asset Pricing Model (CAPM).

Beta calculation. Calculating the risk factor of a company's stock against historical data is a bottomless well of mistakes. Fernández points out that the regulators themselves acknowledge the limitations of the CAPM model, which cannot explain the return on an asset, and that it is only used as a reference method because no one has come up with a better idea.

Cash flow. For a company, it is the outgoing money in the form of cash; for shareholders, it is the cash that goes to them. A common mistake is to consider the increase of liquid assets as cash flow for shareholders.

Conceptual inconsistencies. A leading oil company in Ukraine registered a large volume of sales in Russia, where it intended to build a plant. For that very reason, an arbitration tribunal analyzed the company's stock. A professor, acting as an expert, said that future investments would have no value in the present; if the value of the project were considered in the sale of the company, the owners would achieve a return on it without running a single risk. Therefore, the planned future investment was worthless. The head of the tribunal asked the professor: "Do you actually teach that to your students?" The mistake, explains Fernández, was not considering the cash flows deriving from future investments.

Organizational, statutory and interpretational mistakes. Mistaking value for price is a prime example. Value always depends on expectations, and thus a company's worth will vary from one buyer to the next. Price is the amount of money paid following a negotiation or the

market dynamics. A buyer could pay less than the amount they were willing to invest.

How to value a company

There are six major methods of valuing a company. Fernández supports those that consider the company as a cash-flow generator and thus an entity that can be valued as a financial asset.

The two key factors are the expected future cash flows, and the required return on the shares. Investors will pay 100 million euros for a company if they are convinced that down the line they will recoup their investment and earn more than they would have with no-risk alternatives, such as state bonds. After that, there are different methods for applying this general principle, such as those based on free cash flow (FCF) and weighted average cost of capital (WACC).

The book concludes with two chapters devoted to the method of valuation using multiples and brand valuation. Fernández explains that analyses based on multiples - such as Price to Earnings Ratio (PER) or Enterprise Value/Earnings Before Interest, Tax, Depreciation and Amortization (EV/EBITDA) - provide highly disparate, questionable results. But they are useful as a complement for comparing companies with similar cash-flow valuation results.

Brands, meanwhile, are one of the more complicated propositions, given that the valuations will always be somewhat dubious. Here, says the author, is where analysts must rely on common sense above anything else. Some experts have lost sight of this, as shown by the example of a professor who reached the conclusion that a brand's value was three times its stock market capitalization.

Nevertheless, Fernández feels that the most common brand-valuation methods are interesting, though not so much for the final result as for the process itself. In other words, it's not particularly significant to conclude that the Real Madrid brand is worth 155 million euros but, in order to arrive at that figure, it was necessary to identify the driving forces behind the brand's value. The identification of those enhancers could turn into an effective tool for managing a company.

In short, the book stresses that valuing stocks requires, above all, professional expertise, wisdom, experience and certain technical knowledge. Most mistakes are the result of hasty decisions, simplifications or a fondness for formulas.

Many times, analysts either do not question the logic behind a method, or they disregard

hypotheses that support a given theory. This happens even in companies of great prestige. In that sense, the book serves as a salutary warning as well as a tool for professionals in this sector.

www.iese.edu/insight