Startupval

Peer Company Selection

Strategies for Effective Peer Group Selection and Accurate Valuation

A guide to valuation

Visit
startupval.com

ABOUT STARTUPVAL

Startupval is an innovative portal designed to streamline the valuation process for companies, firms, and businesses, with a particular focus on startups. Users can bring their financial data to Startupval, and through a few simple steps, the portal converts this information into comprehensive and accurate valuation reports, while leveraging established financial models such as **Discounted Cash Flow (DCF)** and **Trading Multiples**, providing valuable insights for businesses, venture capitalists (VCs), and accelerators to make well-informed decisions about market value.

Startupval's core is backed by a self-owned database, which aggregates data from over **20,000 companies** spanning more than a decade of financial information across **150+ industries**. The database pulls from reputable sources like **Yahoo Finance, Professor Aswath Damodaran's datasets, and Trading Economics.** This vast repository allows Startupval to perform thorough comparable company analyses, giving users the advantage of peer company data to enhance the accuracy and relevance of their valuations. Whether you're a startup or an established business, Startupval makes sophisticated valuation report accessible and easy to navigate.

INTRODUCTION

One of the most widely utilized valuation methods is Comparable Companies Analysis (CCA). This approach values a target company by applying the observed trading multiples (usually the median) of a set of comparable listed peers to the target company's financial results. Although the methodology for CCA is relatively straightforward, selecting the appropriate peer group can be quite challenging.

In the banking industry, one of the foundational skills is performing a comparable company analysis (comp analysis). This process involves evaluating similar companies to estimate a firm's stock price or overall value. The steps to create a comp analysis are quite straightforward. The resulting report offers a rough estimate of the company's valuation based on the performance and metrics of its peers.

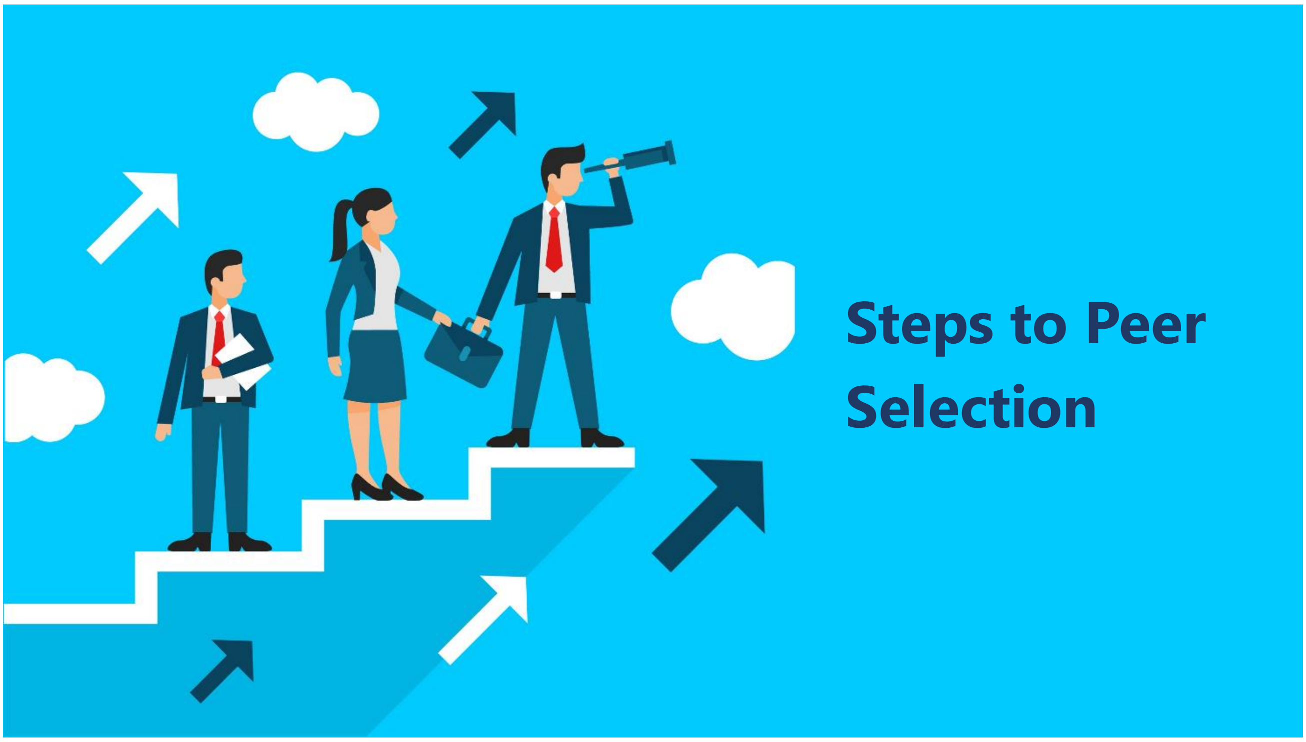
Comparable company analysis involves forming a peer group of companies that are similar in size, industry, or geographic location. This allows investors to make relative comparisons between a company and its competitors. Such comparisons can be crucial in estimating a company's enterprise value (EV) and in calculating various financial ratios to benchmark the company against its peers.

In this Guide, we will elucidate the key characteristics of an effective peer group, discuss various screening methods, and highlight common pitfalls that valuation professionals may face when choosing peers for their target companies.

STEPS TO SELECTION

The logic behind the Comparable Companies Analysis (CCA) valuation approach is very intuitive. In an efficient market, similar assets (i.e., companies) should trade at similar prices.

- **Select Peers:** To value a given company, we first identify listed companies that have similar risk, return, and growth profiles to our target company (the "peer group").
- **Determine Multiples:** The valuations of these listed peers relative to their financials (such as Sales, EBITDA, EBIT, or Net Income) should apply to our target company. Therefore, we compute the respective multiples as a starting point for our valuation.
- **Modify Multiples:** If the target company is not listed, it may have liquidity risk or lack marketability compared to its peers. A reasonable investor would account for this additional risk by applying discounts, typically ranging from 20-40% to the observed multiples. Investors might also consider additional factors such as relative size and market positioning.
- **Utilize Multiples:** The discounted multiple is then applied to the target company's historical, current, or forecast financials to arrive at the valuation.



SELECT YOUR MULTIPLE

Common trading multiples include enterprise multiples (like EV/Sales, EV/EBITDA, or EV/EBIT) and equity multiples (such as P/E or P/B). Enterprise multiples evaluate the whole enterprise, ignoring the financing structure at the outset. In contrast, equity multiples directly value the company's equity, including its financing structure.

Understanding this conceptual difference is essential when choosing your peer group. Selecting one of these multiples for valuation inherently assumes that the target company is similar to its peers in terms of profitability and cash flow.

- **Industry Relevance**: Different industries have different benchmarks. For example, EV/EBITDA is often preferred in sectors with high capital expenditures, while P/E is commonly used for companies with stable earnings.
- **Company Lifecycle**: Start-ups or companies with fluctuating earnings might be better evaluated using revenue-based multiples like P/S, rather than earnings-based ones.
- **Capital Structure**: Consider if the multiple adjusts for differences in debt levels. EV-based multiples like EV/EBITDA provide a clearer picture when companies have varying amounts of leverage.

IMPLICATIONS OF SELECTING MULTIPLE

When using an EV/Sales multiple to value a company, you implicitly assume that the target's operational performance is similar to its peers, meaning it generates comparable cash flows or EBITDA margins down to Free Cash Flows. With the EV/EBITDA multiple, you explicitly account for operational performance by considering EBITDA, but you still implicitly assume the target has similar depreciation and CAPEX profiles as its peers.

Choosing these multiples allows for more flexibility in peer selection, as you only need to ensure the risk and growth profiles are comparable. The operational and financial performance are already encapsulated in the aggregate earnings figure.

Selecting the appropriate multiples for financial analysis can have significant implications for how a company's value is perceived and how it compares to its peers. Below are some key implications of selecting multiples, drawing insights from sources like Investopedia:

1. Relevance to Industry and Business Model

- **Industry Standards**: Different industries have standard multiples that best reflect their value. For instance, tech companies often use the Price-to-Earnings (P/E) ratio, while real estate might focus on Price-to-FFO (Funds from Operations).
- **Business Model Suitability**: Choosing multiples that align with the company's business model provides a more accurate and meaningful comparison. For example, EV/EBITDA is often preferred for capital-intensive industries as it accounts for debt and depreciation differences.

2. Reflecting Financial Characteristics

- **Growth and Profitability:** Multiples like P/E are sensitive to a company's growth and profitability expectations. A high P/E might indicate high growth prospects but could also suggest overvaluation.
- **Capital Structure:** EV-based multiples (e.g., EV/EBITDA) take into account debt and cash, providing a clearer picture for companies with varying leverage levels. This is especially important for comparing companies with different capital structures.

3. Market Perception and Investor Sentiment

- **Investor Expectations**: Multiples can reflect market sentiment and investor expectations. For instance, a company with a high EV/Sales multiple might be expected to grow rapidly.
- **Benchmarking:** Using common multiples allows investors to benchmark a company against its peers, helping to identify if it's undervalued or overvalued compared to the market.

4. Potential for Misleading Valuations

- **Earnings Manipulations**: Multiples like P/E or P/B can be misleading if a company's earnings or book value are subject to manipulation or accounting anomalies.
- **Volatility and Cyclicality:** In volatile or cyclical industries, multiples based on short-term earnings (like P/E) may not provide a stable basis for valuation.

5. Adjusting for Non-Recurring Items

- **Exclusions and Adjustments**: Some multiples, such as EV/EBITDA, are less affected by non-recurring items like one-time gains or losses. This can provide a more normalized view of ongoing performance.
- **Comparability:** Selecting multiples that adjust for non-operating factors can enhance comparability across companies with different non-recurring or exceptional items.

6. Focus on Different Aspects of Performance

- **Operational vs. Market Focus:** Multiples like EV/EBITDA focus on operational performance, while P/E and Price/Sales (P/S) reflect market perspectives on value.
- **Cash Flow Multiples:** For companies where cash flow is more indicative of value than earnings, multiples like Price-to-Cash-Flow are more appropriate.

7. Influence on Investment Decisions

- **Valuation Insights**: Properly selected multiples can guide investment decisions by highlighting whether a stock is trading at a premium or discount compared to its peers.
- **Strategic Implications:** Multiples influence how companies are perceived in mergers and acquisitions (M&A) scenarios, affecting negotiations and valuations.

A PRACTICAL APPROACH

In practice, certain considerations must be compromised due to the limited availability of comparable companies in the market. Often, within a specific industry or geographic region, there are only a few comparable companies, making it difficult to assemble a reliable peer group. Consequently, some uncertainty and a degree of estimation are inevitable. It may also be necessary to think creatively and consider business models from different industries that exhibit similar risk, return, and growth profiles to those within your targeted industry.

Traditional methods for selecting peer groups, which typically rely on general industry classification systems like the Standard Industry Classification (SIC) or Global Industry Classification System (GICS), often fail to identify suitable peer groups for valuation purposes. A 2015 study

compared the valuation performance of multiples in emerging markets, using peer groups based on either industry classification or valuation fundamentals (such as EBITDA margins or Return on Equity). The study found evidence suggesting that multiples with peer groups based on valuation fundamentals outperform those with peer groups based solely on industry classification.

Here are several factors to consider when defining your optimal peer group:

1. Industry Classification Similarity

This is the most commonly used and crucial approach. Companies within the same industry often operate in similar competitive environments and are subject to comparable regulatory, legal, and market dynamics. Consequently, their risk, return, and growth profiles tend to be alike.

Industry classification systems are frameworks used to categorize companies into specific sectors and industries based on their primary business activities. These systems are crucial for investors, analysts, and researchers to make accurate comparisons and conduct sector-specific analyses.

For large companies in mature industries, identifying comparable peers is relatively straightforward. These companies, by their nature, are often substantial and well-diversified in terms of their product and service offerings. However, the challenge increases when the target company operates in a niche or emerging industry. Finding directly comparable peers in such cases may require broader thinking and creativity. Below, we provide some suggestions to help expand the traditional definition of "industry."

Analyst Coverage Overlap

Analysts typically specialize in a single industry. Therefore, if analysts include companies in their reports that fall outside the narrow initial industry definition, it can be inferred that these companies have similar or complementary business models and industries.

Analyst Coverage Overlap is a concept referring to the degree to which different financial analysts provide coverage on the same set of companies. Understanding this overlap is crucial for investors, companies, and analysts themselves. It impacts stock analysis, market sentiment, and investment decisions. Here’s a detailed look into what it entails, why it’s important, and how it’s applied in financial analysis.

Comparable Company Descriptions and Sources

Companies often mention their competitors in their publications. This can be particularly insightful for diversified companies, leading to valuable information on potential peers.

News Coverage Co-occurrence

When companies are mentioned in the same news articles, they often share similar characteristics and could be considered peers.

Market Dynamics Exposure

Similar market reactions to news affecting the target company, often reflected in similar betas, can indicate comparable exposure to market dynamics.

Open-Access Online Sources

Freely accessible online sources, such as MSN Money or finanzen.net, can provide clues to identify potentially comparable companies.

Subscription-Based Platforms

Subscription-based platforms, such as Startupval, generate automated peer lists by considering various factors, including some mentioned above.

2. Same or Similar Country or Region

The initial approach is typically to look for peers within the same country as the target company. The reasoning is straightforward: companies in the same country are subject to identical regulatory and tax regimes. This can become challenging in smaller countries or those with a limited number of listed companies in a specific sector. Consequently, it is widely accepted that the geographic focus should be expanded to include other countries. This expansion can be done systematically as follows:

- Neighbouring countries, provided they share similar economic traits
- Regions, especially those with developed trade agreements, such as the EU
- Countries that are geographically distant but share similar characteristics, such as other developed countries
- Countries where the target company operates, aside from its main markets.

Benefits of Same or Similar Country/Region Selection

Enhanced Comparability
Ensures that companies being compared operate under similar economic, regulatory, and market conditions.

Accurate Benchmarking
Facilitates more accurate benchmarking against local or regional peers, providing insights into relative performance and valuation.

Risk Management
Helps manage risks associated with foreign exchange fluctuations, political instability, and regulatory changes specific to the chosen country or region.

3. Comparable Size

A common mistake practitioners make is targeting peer group companies that are similar in size to the target company being valued. While this approach theoretically yields optimal results, in practice, most private companies being valued are significantly smaller (in terms of sales, number of employees, profit, etc.) than most listed companies. As a result, micro-cap (<$550m market cap) listed peers are often sought, as they are the closest in size. However, this approach presents several challenges:

- Micro caps typically trade much less frequently than mid- or large caps, causing distorted valuations and inefficient pricing of shares.
- Micro caps are often closely held, with only a small percentage of shares as free float, which can distort share prices.
- Micro caps frequently have more volatile earnings, leading to periods with negative earnings, making them unsuitable for certain multiples.
- Micro caps seldom have analyst coverage, resulting in a lack of analyst forecasts to base forward multiples.

While the goal might be to target a peer group similar in size to the target company, prioritizing quality data (in terms of multiples and betas) is more important. It is crucial to ensure that the companies within the peer group are relatively similar in size. Once the peer group is finalized, the appropriate discount can be applied to the observed multiples based on various differences between the peer group and the target company, including relative size (more on discounts below).

Therefore, it is entirely possible to use a peer group of multi-billion-dollar companies for valuing a $10m target company, as the application of an appropriate discount makes them comparable.

4. Significance of Comparable Size in Financial Analysis

- **Accuracy in Comparison:**
  Ensures that companies being compared are similar in scale and operational scope, providing more accurate insights into performance and valuation.
- **Risk Management:**
  Companies of comparable size often face similar risks related to market competition, economic conditions, and industry-specific challenges.
- **Investment Decisions:**
  Helps investors assess relative investment opportunities by comparing companies with similar financial metrics, growth potential, and market positioning.

5. Analogous Operational Indicators

Analogous operational indicators refer to metrics or measures used to assess and compare operational performance across companies or industries that operate under similar conditions or face comparable challenges. These indicators provide a basis for understanding how effectively companies manage their operations and can be crucial for performance evaluation, benchmarking, and strategic decision-making.

As mentioned earlier, there is empirical evidence suggesting that using peers with comparable operational metrics is more beneficial than solely focusing on industry classification. A well-rounded approach involves expanding the peer group to encompass a broader selection of adjacent industries and geographies, then targeting companies with similar operational metrics, particularly in terms of Revenue Growth, EBITDA Margins, Return on Equity, and Total Assets.

One particular challenge to note in this regard is the "success bias" that applies to multiples other than EV/Sales or EV/capacity multiples. Typically, only companies with positive multiples are included in the set of peers. For instance, when examining EBITDA multiples, any companies with negative EBITDA would be excluded from the peer group, as the relationship between positive valuation and negative EBITDA would yield seemingly meaningless (negative) multiples.

However, negative EBITDAs of individual companies within an industry might not only be specific to those individual companies but could also be symptomatic of general trends within the industry. Excluding these non-performing companies from a peer group might introduce an upward bias in the remaining peer group.

AN OVERVIEW OF DISCOUNTS AND PREMIUMS

Discounts refer to reductions applied to the value of an asset or security for various reasons, typically reflecting risks or uncertainties associated with the asset.

Premiums are additions or increases applied to the value of an asset or security above its intrinsic or calculated value. They typically indicate a perceived additional value due to specific attributes or advantages.

As previously mentioned, it's common practice to apply a discount to the observed trading multiples to align them with the target company. This discount is often referred to as the Discount for Lack of Marketability (DLOM). Despite its specific name, this discount is typically used as a comprehensive term encompassing not only marketability but also other relevant aspects such as size, growth rates, and more.

While practitioners commonly apply discounts ranging from 20% to 40%, research papers have suggested that discounts of up to 70% could be appropriate in certain sectors of the economy. Generally, the earlier stage and smaller the target company relative to its peer group, the larger the discount will be, and vice versa.

Contact Us.

Let's embark on this transformative journey together.

Contact us today to schedule a demo and witness the difference firsthand.

Mail us at: **crm@startupval.com**