THE COMPARABLES APPROACH

STOCK VALUATION

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The primary purpose of equity/stock valuation is to estimate a company's or its security's value. A key assumption of any fundamental value technique is that the value of the security (in this case an equity or a stock) is driven by the fundamentals of the firm’s underlying business at the end of the day.

There are a number of different methods of valuing a company with one of the primary ways being the comparable (or comparables) approach. Before we explore this valuation method, let's compare it to other valuation methods.

1

Comparables Approach

A company's equity value should have some characteristics of other equities in a similar class. This entails comparing a company's equity to competitors or other firms in the same sector.

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2

Discounted Cash Flow

A company's equity value is determined by the future cash flow projections using net present value. This approach is most useful if the company has strong data to support future operating forecasts.

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3

Precedent Transactions

A company's equity depends on historical prices for completed M&A transactions involving similar companies. This approach is only relevant if similar entities have been recently valued and/or sold.

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4

Asset-Based Valuation

A company's equity value is determined based on the fair market value of net assets owned by the company. This method is most often used for entities with a going concern, as this approach emphasizes outstanding liabilities determining net asset value.

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5

Book-Value Approach

A company's equity value is determined based on its previous acquisition cost. This method is only relevant for companies with minimal growth that might have undergone a recent acquisition.

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Comparables Approach

One of the more popular equity valuation approaches is the comparables approach.

This strategy evaluates similar companies and compares relevant valuation metrics. The comparables approach is often one of the easier valuations to perform as long as the company is valued as public company comparables.

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The comparables valuation can simply be determined by comparing a firm to its key rivals, or at least those rivals that operate similar businesses.

The difference in the value between similar firms becomes an opportunity. The hope is that it means the equity is undervalued and can be bought and held until the value increases.

The opposite could hold true, which could present an opportunity for selling the stock or positioning one's portfolio to profit from a decline in its price.

Types of Comp Models

The comparables' common market multiples include the following: enterprise-value-to-sales (EV/S), the enterprise multiple, price-to-earnings (P/E), price-to-book (P/B), and price-to-free-cash-flow (P/FCF).

To get a better indication of how a firm compares to rivals, analysts can also look at how its margin levels compare. For instance, an activist investor could make the argument that a company with averages below peers is good for a turnaround and should increase in value.

Precedent vs. Comparables Approach

A different valuation approach called the precedent approach looks at market transactions where similar firms, or at least similar divisions, have been bought out. These companies would have been acquired by other rivals, private equity firms, or other classes of large, deep-pocketed investors.

The primary difference between the precedent approach and the comparables approach is the nature of the business being compared. The precedent approach relies on prior sales. Meanwhile, the comparables approach relies on operating information and financial performance. While the precedent approach focuses on similar sales, the comparables approach focuses on similar operations.

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Example of the Comparables Method

The comparables approach is best illustrated through an example. Analysis of the largest, most diversified chemical firms that trade in the U.S. is on the next slide.

The financial information on the next slide is as of May 24, 2022.

Company	Market Cap (in billions)	Enterprise Value (MRQ) (in billions)	P/E Ratio (TTM)	P/R Ratio (TTM)	P/B Ratio (TTM)	Net Margin (TTM)	Free Cash Flow (TTM) (in millions)
Eastman Chemical Company (NYSE: EMN)	$13.31	$19.803	16.95	1.25	2.33	0.076	$844
Dow Chemical (NYSE: DOW)	$48.83	$60.189	7.35	0.86	2.73	0.118	$7,376
DuPont (NYSE: DD)	$33.29	$48.150	21.89	2.11	1.27	0.090	$1,253
Air Products & Chemicals (NYSE: APD)	$52.52	$60.405	24.35	4.65	3.89	0.191	$390
Huntsman Chemical (NYSE: HUN)	$7.44	$9.428	6.56	0.85	1.73	0.132	$740
Average of Selected Multiples	$31.08	$39.595	15.42	1.94	2.39	0.121	$2,121

COMPARABLE COMPANY VALUATION: EASTMAN CHEMICAL (NYSE: EMN)

When performing the comparables approach, it's valuable to not only select similar companies in the same sector but to compare performance against the industry average. Although our sample size is small in this example, let's compare Eastman Chemical Company to other companies in addition to the average of our sample.

1

Market Capitalization

Of the companies selected, Eastman is among the smallest in terms of market cap. This is valuable information when comparing dollar figures like net income, net margin, and free cash flow.

This could mean that Eastman may have less operational efficiencies than Dow Chemical, Dupont, or Air Products & Chemicals.

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2

Enterprise Value

The enterprise value of Eastman is almost 50% higher than its market cap.

The closest comparable is Huntsman, whose enterprise value is roughly 25% higher than its market cap. This indicates that Eastman may have higher debt or lower cash value than the nearest comparable.

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3

Price/Earnings Ratio

Of our sample of 5 companies, Eastman's P/E ratio is fairly similar to the average.

This is important to note when comparing other ratios. Because Eastman is among the higher P/E ratios, the market is pricing in the expectation that there will be further company growth (at least compared to the companies with lower P/E ratios such as Huntsman or Dow Chemical).

4

Price/Revenue Ratio

Unlike the P/E ratio, Eastman is below our sample average for the P/R ratio. This indicates the market expects less revenue growth compared to other firms.

By comparison, this means the market is anticipating expense savings or operational efficiencies due to the difference in expectations regarding P/E and P/R.

5

Price/Book Ratio

Eastman appears to be on target with our sample average.

This indicates the company's stock is not trading at too high of a premium compared to the industry average.

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6

Net Margin

Eastman's net margin is the lowest of the group and below the sample average, indicating that this small company is operating on the smallest margins.

This indicates that while Eastman has some favourable metrics, it is likely still operating with inefficiencies due to its size.

7

Free Cash Flow

The industry average does get skewed by Dow Chemical's large free cash flow (which appears to be a potentially unlikely outlier).

Still, it is encouraging to see Eastman's free cash flow similar to (and even larger than) some bigger companies like DuPont and Air Products. This may that Eastman may have cash on hand to invest in its infrastructure for future growth.

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