Corporate valuation

Finance

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The companies that grow, in terms of revenues, at the rates higher than 15% annually can be defined as high-growth companies (Koller et al., 2005). Traditional valuation methods such as the Gordon growth model, dividend discount model, free cash flow to equity, residual income model and the likes are more suitable for the ongoing established companies with stable growth and having a long history of dividend distribution for the last several years or decades. It is quite likely that many high-growth companies in new technology fields may not have a long dividend history or many of them may not have even begun declaring dividends either due to funds needed for the growth of business or for some other reasons.

Wall Street relies considerably on P/E multiples (market price/earnings per share) for valuation of the companies and that can also be applied to even high-growth companies. But P/E varies significantly across the companies and across the industries. Within the same industry group, companies are found to have different P/E multiples as it takes into account growth prospects, competitive environment, revenue growth rate and so on. This adds up to the complexities in the valuation of the stocks that include high-growth stocks too.

Benjamin Graham is known as the father of value investing in the world of investment.

What he formulated in 1962 has been simplified by Martin et al. (2011) in his recent book entirely devoted to describing the valuation nuances of the stocks that include high-growth stocks. The issue that puzzles all analysts is the P/E multiple applied to high-growth companies in the stock market. Graham has tried to simplify the matter by incorporating only a single

variable in the formula namely growth in earnings.

Graham's formula is simple and suggests P/E multiple that any company can command if its growth in earnings in percentage terms is known or can be forecast with accuracy.

Accordingly,

P/E multiple = 8. 5+ (earnings growth×2)

If earnings growth is 5% (assumed)

Then P/E multiple = 8. 5 + (5×2)

= 18. 5

Knowing current annual earnings per share one can estimate its likely market price.

Usually, high-growth companies register significantly higher earnings growth (above 10% or so).

Exploring P/E multiples for a company with 12% earnings growth, it can be given as

= 8. 5 + (2×12)

= 32. 5

Thus, market price of the company per share will be 32. 5 times its last earnings per share.

Growth in earnings leads to an increased cash-flow for the company. When the company is in a high-growth trajectory from earnings point of view, it is obvious that its cash-flow will also grow almost with the same rate and that will be reflected in the higher P/E multiples. Graham's formula takes into account impact of all these factors in a single variable.

From the formula, it is amply clear that knowing correct earnings growth rate for any company is extremely important to arrive at P/E multiples for its

valuation. This also means that just last four quarters' earnings growth is not sufficient to arrive at correct P/E multiples. According to Martin, one must know the firm's normalised earnings per share of yesteryears and should be able to forecast the same for at least next 7 years. This also implies that past growth rates and estimated future growth rates can be aggregated to arrive at the correct P/E multiples. Analysts' perceptions greatly vary in the market when the question comes to estimating future earnings growth. One can even normalize analysts' perceptions while arriving at future growth rates.

References

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