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How to Select Peer Companies

INTRODUCTION:

One of the most commonly used valuation methodologies is the Comparable Companies Analysis (CCA) whereby a target company is values by applying the observed (typically the median) trading multiples of a set of listed peers to the corresponding financial results of a company. While the methodology for a CCA valuation is rather simple to apply, the selection of the right peer group can at times become a serious challenge.

In this White Paper, we will cast some light on how to define the key properties of your peer group, outline potential screening approaches, and point you to some pitfalls valuation professionals encounter when selecting peers for their target companies.

FIRST, UNDERSTAND THE STEPS

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

IDENTIFY PEERS

In order to value any given company, we first look for listed companies that feature similar risk, return, and growth profiles to that of our target company (the "peer group").

CALCULATE MULTIPLES

The relation of the valuations of these listed peers relative to their respective financials (such as Sales, EBITSA, EBIT, or Net Income) should also be applicable to our target company. Therefore, we compute the respective multiples as a starting point for our valuation.

ADJUST MULTIPLES (DISCOUNTS AND PREMIA)

Of course, a target company may not be listed and therefore feature liquidity risk or lack of marketability risk compared to its peers. Thus, any reasonable investor would account for this additional risk and apply discounts (typically ranging from 20-40%) to the observed multiples. Investors could also consider additional factors such as relative size or market positioning.

APPLY MULTIPLES (TO TARGET FINANCIALS)

The discounted multiples is then applied to the target company's historical, current or forecast financials to arrive at the valuation.

It is evident from the first two steps of this process, that the chosen peer group has a huge impact on the outcome of the resultant valuation.

CHOOSE YOUR MULTIPLE

Frequently used trading multiples include enterprise multiples such as (EV/Sales, EV/EBITDA,

or EV/EBIT) and equity multiples (such as P/E or P/B). The former value of the full enterprise, disregarding the financing structure in the first step. The latter provide a direct valuation of the equity of the company, including its financing structure.

Understanding this conceptual difference is highly important when deciding on the peer group selection. By choosing one of the above multiples for our valuation, we implicitly make assumptions about the similarity of the target company with its peers "down" the P&L and cashflow waterfall.

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BY CHOOSING THE MULTIPLE, YOU MAKE ASSUMPTIONS, BUT WHAT DOES THAT MEAN?

When you use an EV/Sales multiple to value a company, you implicitly assume that the operational performance of the target is similar to its peers i.e., that it generates the same Cashflow or EBITDA margins down to Free Cash Flows. When you use EV/EBITDA multiple, you explicitly consider the operational performance (by using a different EBITDA than that of your peers), but you still implicitly assume the depreciation and CAPEX profiles of the target is similar to its peers. When using the P/E multiple, you can be much more lenient with your peer selection, as you "only" need to ensure the risk and growth profile are comparable, while the entire operational and financial performance are already reflected in the aggregate Earnings figure. *Thus, be careful when selecting your peer group for different valuation multiples.*

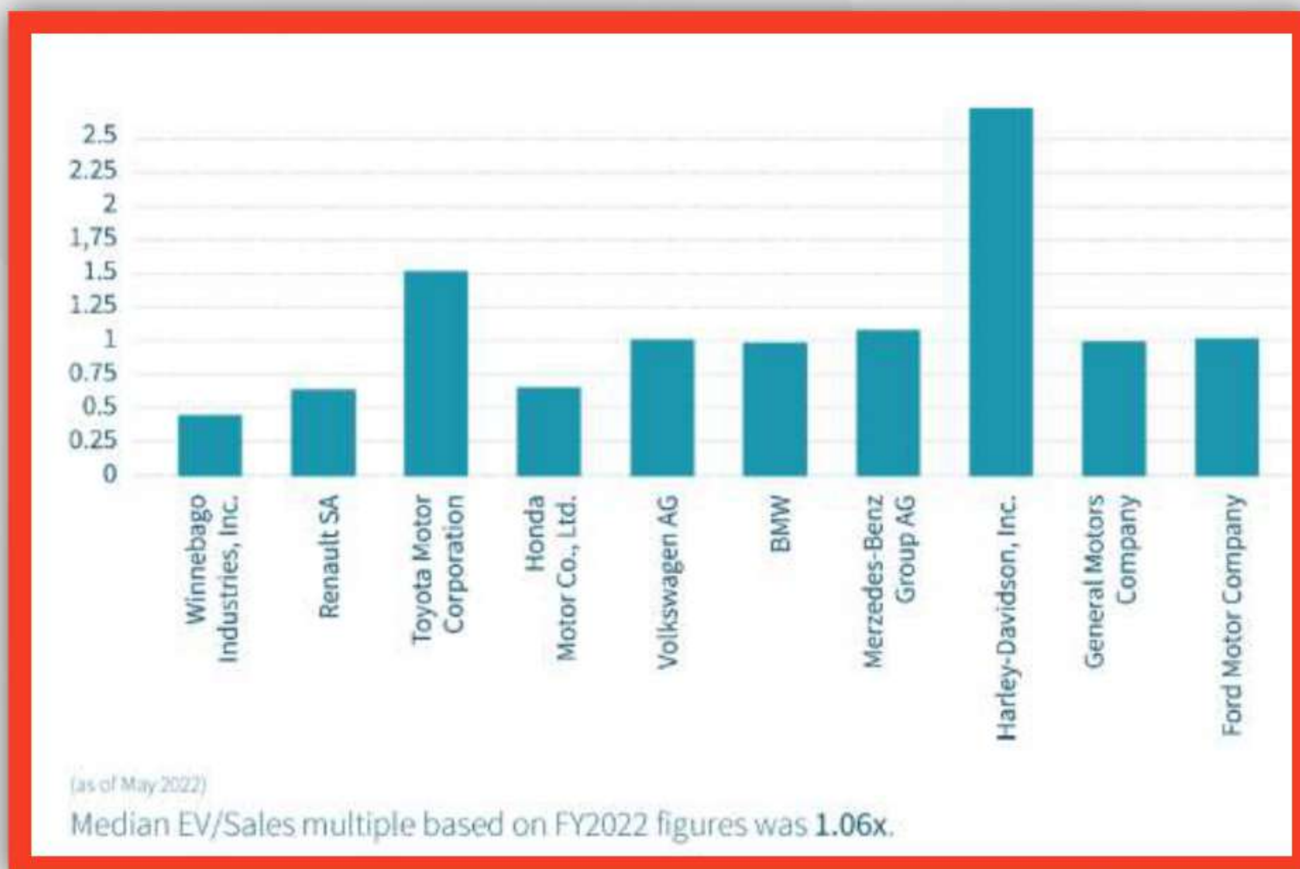
TAKE A PRACTICAL APPROACH

In practice, some of these considerations need to be sacrificed due to a lack of (listed) comparable companies out in the market. Frequently, within an industry and/or ageography, there are only so many comparable companies; you cannot find enough of them to build a reliable set of a handful of peers. Hence, you will have to settle with some uncertainty, a degree of best estimates, or apply out-of-the-box thoughts on business models that feature similar risk, return and growth profiles outside the actual industry you are looking at.

Think of the example of Tesla: Do you compare it to traditional car companies or more specifically to electric vehicle companies?

TRADITIONAL MOTOR VEHICLE MANUFACTURERS – TRADING MULTIPLES (EV/SALES)

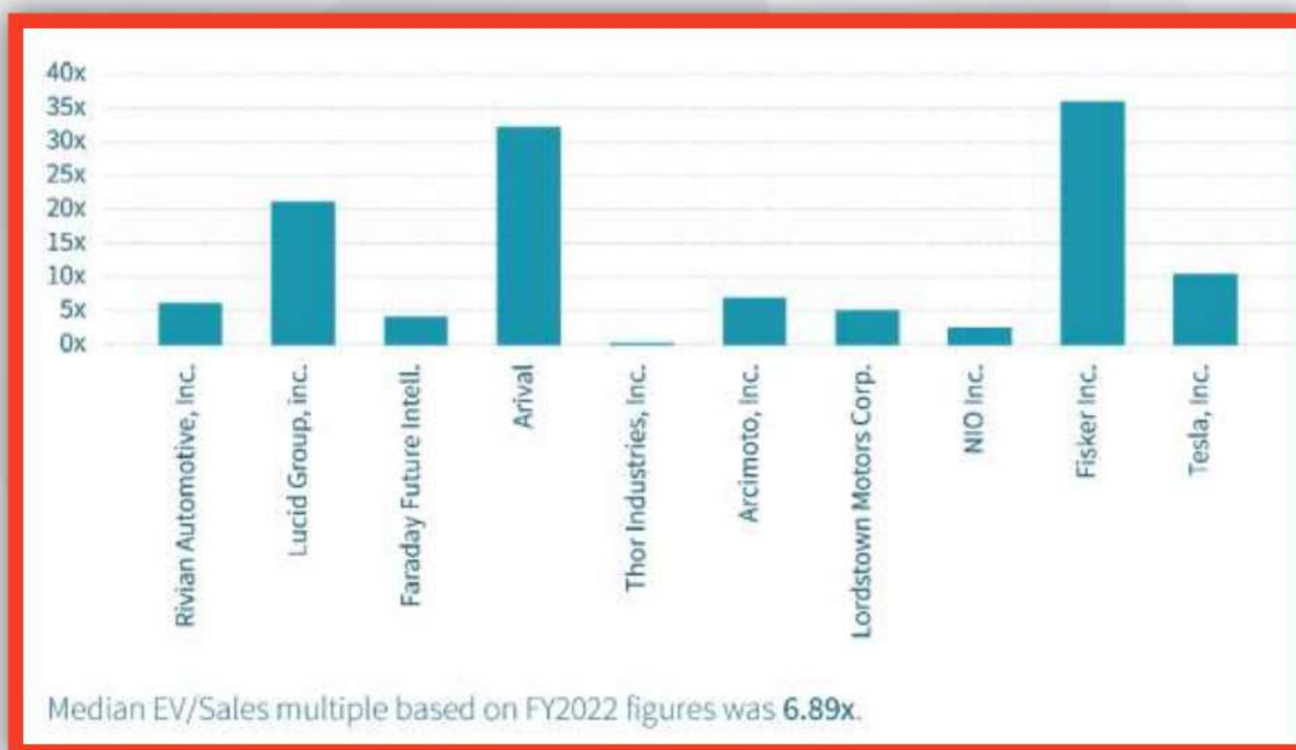
Comparing the above to the median EV/-Sales multiple of Electric Vehicle Manufacturers, in the chart below, of 6.89x clearly illustrates the importance of the peer group selection and the impact it could have on the final valuation result.



ELECTRIC VEHICLE MANUFACTURERS – TRADING MULTIPLES (EV/SALES)

Traditional peer groups selection methods – such as only looking at the general industry classification based on internationally recognized classification systems such as the Standard Industry Classification (SIC) or Global Industry Classification System (GICS) – often fall short of the goal of finding a suitable peer group for valuation purposes. A 2015 study that compares the valuation perfor mance of multiples in emerging markets whose peer groups are based on either industry classification or valuation fundamentals (such as EBITDA margins or Return on Equity) found evidence that suggests that multiples whose peer groups are based on valuation fundamentals outperform multiples whose peer groups are based solely on industry classification.

Below we suggest several factors you should consider when defining your optimal peer group:



Median EV/Sales multiple based on FY2022 figures was **6.89x**.

SAME OR SIMILAR INDUSTRY CLASSIFICATION

This is the most commonly used approach and then most important one. Companies in similar industries typically operate within a similar competitive envi ronment with similar regulatory, legal and market dynamics. As such, the risk, return, and growth profiles should be comparable for companies within the given industry. For relatively large companies in mature industries, the above is a rather simple exercise Almost by definition, companies included in a listed peer group, are typically relatively large and reasonably well diversified in terms

of their product and service offerings. The difficulty arises when the target company operates in a niche or nascent industry. This may make it harder to find directly comparable peers and may require a bit of "thinking outside the box". Below we offer some ideas to assist in expanding the narrow definition of "industry".

OVERLAP IN ANALYST COVERAGE

Analysts often cover only the one industry, this if analysts include companies in their analysis that fall outside of the narrow initial definition of the industry, it can be assumed that those companies have similar/complementary business models and industries.

COMPARABLE COMPANY DESCRIPTIONS, WIKIPEDIA PAGES, WEBSITES, SUSTAINABILITY REPORTS

Companies often refer to some of their own competitors in their own publications. Especially for diversified companies, this could lead to some valuable insights.

OVERLAP/ CO-OCCURRENCE IN NEWS COVERAGE

If companies are mentioned in the same news article, they often have similar traits and could be considered peers.

COMPARABLE EXPOSURE TO MARKET DYNAMICS

This could be reflected in how the market reacts to news impacting the target company and its usually reflected in the companies having similar betas.

OPEN-ACCESS ONLINE SOURCES

Some freely accessible online sources such as MSN money or finanzen.net provide some clues to potentially comparable companies.

SUBSCRIPTION-BASED ONLINE SOURCES

Subscription-based online platforms such as Valutico generate automated Peer lists by taking into consideration various factors including some of those mentioned above.

SAME OR SIMILAR COUNTRY OR REGION

The starting position is normally to look for peers in the same country as the target company. The rationale is simple companies in the same country are exposed to identical regulatory and tax regimes. This can become challenging in smaller countries or in countries with a limited set of listed companies in a specific sector. It is therefore widely accepted that the geographic focus should be expanded to include other countries. The geographic focus can be expanded systematically as follows:

- Neighbouring countries (provided that they share similar economic traits)
- Regions (especially regions with developed trade agreements such as the EU)
- Countries that are geographically far apart but which shares similar traits, for example most developed countries have developed economies and efficient stock markets, thus compar

ing a listed company in the USA to one in, say, the United Kingdom, could still make sense.

- Countries the target company operates in (other than the main markets)

COMPARABLE SIZE

One of the biggest mistakes practitioners sometimes make is to target peer group companies that are similar in size to the target company being valued. While in theory this would produce optimal results, the reality is that most private companies being valued are significantly smaller (in terms of sales, number of employees, profit, etc.) than most listed companies. The result is that micro-cap (<$50m market cap) listed peers are sought as they are the closest in size. Several challenges arise with this approach.

- Micro caps typically trade much less frequently than mid-or large caps causing distorted valuations and inefficient pricing of the shares in the market;
- Micro caps often be closely held, having only a small percentage of shares as free float which can also distort share prices;
- Micro caps frequently have more volatile earnings, thus resulting in periods with negative earnings and this not usable multiples;
- And Micro caps seldom have analysts that cover them, thus are frequently no analyst forecasts to base forward multiples on.

While the goal could be to target a peer group that is similar in size to the target company, quality data (in terms of multiples and beta) is more important and should thus be prioritized. It is, however, important to ensure that the companies contained within the peer group are relatively similar in size. Once the peer group has been finalized, the appropriate discount to be applied to the observed multiples can be determined based on various differences between the peer group and the target company, one of which being relative size (more on discounts below). It is therefore wholly possible to have a peer group of multi-billon dollar companies for the valuation of -$10m in target company, as the application of an appropriate discount makes them comparable.

COMPARABLE OPERATING METRICS

As alluded to earlier, there has been some empirical evidence suggesting that using peers with comparable operating metrics is more valuable than simply focusing on industry classification. A balanced approach would be to expand the peer group to include a wider selection of adjacent industries and geographies and then to target companies with comparable operating metrics, particularly Revenue Growth, EBITDA margins, Return to Equity, and Total Assets.

One pitfall to mention in this respect is a “success bias” that applies to any multi

ples other than EV/Sales or EV/Capacity multiples: Typically, only companies with positive multiples are included in the set of peers. Say, looking at EBITDA multiples, any companies with negative EBITDA would be excluded from the peer group, as the relation of positive valuation and negative EBITDA would create apparently meaningless (negative) multiples. However, negative EBITDAs of individual companies within an industry might not only be specific to these individual companies, but may well be symptomatic within the industry. The practice of excluding these non-performing companies from a peer group might very well cause an upwards bias in the remaining peer group. In any case, the occurrence of a larger number of negative earnings figures within the peer group might be an indication for systematic issues within the industry and should be treated with care when compiling a peer group for valuation.

EXAMPLE: BENCHMARKING IN PRACTICE

In Valutico, the peer selection process is enhanced by providing a visualisation of some of the variables to be considered and compared. For example, there is a visualisation of the sales growth CAGR, because it can allow you to identify outliers in the selected peer group. Even without this data visualisation, comparing operating metrics in some way is highly recommended.

A NOTE ON DISCOUNTS/PREMIUMS

As mentioned abovce, one would almost always apply some kind of discount to the observed trading multiples to make it comparable to the target company. Most practitioners refer to the discount being applied as the Discount for Lack of Marketability (DLOM). Despite the specific name, this discount is typically used as an all-encompassing term which captures the discount related to not only marketability but any other relevant aspects such as size, growth rates, etc.

While most practitioners apply a discount between 20-40% some research papers have found that discounts of up to 70% vould be applied in some sectors of the economy. Typically, the earlier-stage and smaller the target company is relative to its peer group, the larger the discount will be and vice versa.

We hope this guidance has provided some useful insight. If you have any questions about this information, please contact CEO and Founder, Paul Resch at p.resch@valutico.com. If you would like to learn more about the Valutico platform, contact Siddhant Sangal at s.sangal@valutico.com.