



Which Method Is The Best Valuation Method?

Different valuation tools are used for valuation of companies at different levels of business.

(a) Start-Ups

Startups are driven by far too many factors to be captured by simplistic valuation models. Their sensitivity to economic factors, sector specific and company specific factors must be captured as far as possible to reasonably value them. These factors can only be captured with the DCF method.

(b) High Growth Companies

High growth companies have drastically changing market shares and hence it is very difficult to compare them with a benchmark, making comparable valuation difficult and leaving one to go with the DCF approach.

(c) Matured Companies

Matured companies have fairly predictable financials and hence DCF will result in a fairly reliable valuation. However, the Dividend Discount Model will also work reliably, as matured companies have nominal expansion needs and hence a high dividend payout ratio along with predictability of growth rates.

(d) Cyclical Companies

Cyclical companies by virtue, have a very high degree of uncertainty. Secondly, such companies are always on the radar for news & management comment both of which are immediately reflected in Comparables. On the other hand, DCF may have to wait for a quarter or more to reflect a change.

(e) Distressed Companies

Distressed company valuation, is particularly tricky as the challenge lies in finding fair value and not the lowest value! By distressed, we mean loss making companies or those that are restructuring their businesses by selling off 'toxic assets' and toning down capital structure. Traditional valuation approaches fail miserably as a result of the uncertainty involved and this is where Liquidation Value & Replacement cost method come to the rescue. Liquidation value measures return from selling off or liquidating the assets while replacement cost measures the opportunity cost of setting up a business.

(f) IPO Valuation

Although, for such situations it is best to use DCF as it determines the intrinsic value, not many will want to use it as it is likely to understate value as against Comparable valuation. Simply because, the idea behind an IPO is to raise maximum possible capital for a minimum dilution in equity! Hence most IPOs come out in bull markets where valuations are already stretched and comparable valuation will result in higher values as compared to DCF, as a result of circularity involved in such the approach. Consequently, you may notice that IPOs are 'demand driven' rather than intrinsic value; as a result many average companies get extraordinary valuations.