Comparable company analysis:

Importance of comparability

Abstract

In undertaking a valuation of a business it is common to reference other companies which are comparable. Comparable companies can be used as a valuation cross check and / or assist in developing the discount rate.

The identification and selection of comparable companies is based on professional judgement which may vary between accountants. Adopting a reasoned basis for selecting comparable companies will enhance the robustness of the valuation engagement.

Comparable company analysis is a fundamental tool used in almost every valuation

Identifying comparable companies

The process of using metrics of another business of similar size, industry or other characteristics is referred to as a comparable company analysis. The metrics of the comparable company or companies are used to create benchmarks.

The selection of a comparable company is based on a number of attributes and assessing whether the similarities are reasonable enough to include as a benchmark. This selection process is imprecise and requires professional judgment.

Comparability can be considered by profiling both business characteristics and financial characteristics, some of which are shown in the following table:

Business characteristics	Financial characteristics
Industry / Sector	Size: Enterprise value, Revenues, Profits
Products and Services	Profitability
Customers or End market	Growth
Distribution channels	Return on investment
Geography	Gearing or Credit profile

When selecting comparable companies it is important to consider a range of business and financial characteristics

A starting point to find comparable companies is to obtain a list of companies that operate within the relevant industry or sector.

The next step is to consider the following attributes of the companies on the list:

- Size

The size comparison can refer to a market valuation (equity value or enterprise value) as well as other measures such as revenues, EBITDA, EBIT, net profit and may also refer to the number of products, employees or customers.

Companies in the same industry of a similar size are likely to be the most comparable as similarities often extend to volatility, purchasing power, pricing, customers and growth prospects. The appropriate measure may depend on the industry, for example employee numbers may be relevant in the service industry, net profit margin may be relevant in the retail industry and number of customers may be relevant in the telecommunications industry.

A company's size can be assessed with a number of metrics depending on the industry

- Products and services

The importance of a product or service to the overall business outlook or to its overall profitability may assist in determining comparability.

That is, while a competitor may offer a similar product, its focus (or its revenue, profits or resources) in that industry may only be a small part of its overall business. This may suggest the company is inappropriate as a benchmark.

- Customers or End Market

Companies that operate in the same industry may differ on the basis of who they sell to.

For example, a gold exploration company may not be comparable to gold miners or gold producers. This is because while the industry is comparable, the focus they have on the supply chain makes them non-comparable.

• Geography, demography & regulatory environment:

The geographic location of a company and its operations will impact comparability since different regions impact the expected growth rate, opportunities, potential risks and the cost structure of the businesses. Further, the potential size of the market will differ, the regulatory regimes differ, buying patterns differ and cultural influences vary.

Further, it may be unreasonable to compare a nationwide company to a company that operates in only one state, despite having similar employee and revenue numbers.

Australian companies and the markets they operate in can be relatively small when compared internationally and the macro-economic environment may make companies non-comparable due to:

- Market size and competitive landscape
- Expected growth and inflation rates
- Expected interest rates
- Differences in accounting standards
- Domestic regulations and taxes

The geography of a company's operations can affect comparibility due to a number of macro-economic factors

• Profitability

Profitability measures the ability to convert sales into profit by use of ratios or margins with gross profit, EBITDA, EBIT or net profit as a numerator and sales as the denominator.

Depending on the industry it may also be measured on a per unit basis (e.g. customer or tonne).

All else being equal, higher profit margins translate into higher valuations and determining a company's profitability versus its peers is key when benchmarking.

• Gearing

Gearing refers to the level of debt in a company. It can be a useful tool for comparability purposes as it is an indicator of risk. Generally, the higher ratio of debt to assets, the riskier the business. If the gearing levels differ substantially it may be inappropriate to apply a benchmark since the outlook and risk profile differ.

Importance of comparability

Differences of opinion can arise as to the comparability of companies and it would be argued the inclusion of a non-comparable company in a benchmark would distort the analysis undertaken.

Assessing appropriate comparable companies can have material impacts on assessments of value

For example when creating a beta factor benchmark for the iron mining industry in Australia, if comparable companies are sought for a small iron mining business then BHP Billiton Limited, Rio Tinto Limited and Fortescue Metals Group Limited may distort the benchmark due to factors including their profitability, position on the cost curve and size of ore reserves. In assessing comparable companies for a small iron ore producer, these companies would therefore be excluded.

The betas for ASX listed iron ore miners at 30 June 2016 are as follows:

Company	Beta as at June 2016
BHP Billiton	1.73
Rio Tinto	1.00
Fortescue Metals Group Limited	1.34
BC Iron Limited	2.72
Atlas Iron limited	2.56
Pioneer Resources Limited	2.16
Iron Road Limited	1.94
Average: all companies above	1.92
Average: excluding BHP, Rio Tinto & FMG	2.35

The average beta for all companies is 1.92, however once the large companies are excluded the beta is 2.35.

As such it is crtical to undertake an assessment of comparability rather than simply adopting an industry average.

Conclusion

Finding appropriate comparable companies is an exercise of professional judgement that requires the assessment of the company being valued as well as an understanding of the myriad of factors that affect comparability.

Proper analysis of comparable companies will help ensure that the valuation is robust and capable of withstanding criticism.