Is It the Market Approach or the Income Approach?

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Every finance text explains that the most significant measure of comparability between two companies is risk. That is to say that business type (SIC code), sales level, number of employees, profitability, or any other measure that is commonly used pales in effectiveness as a measure of similarity– or comparability.

It is also true that there are two ways to know that the capitalization or discount rate used to value a benefit stream is the "right" one:

1) It reflects the rate of return required to attract capital to a similar business
2) The attributes of the risk rate is consistent with the attributes of the benefit stream (pre-tax vs. after-tax, cash flow vs. income, equity vs. invested capital, etc.)

The first criterion is the tough one. It is based on the theory that the most relevant measure of comparability is the risk associated with the expected benefit stream. It is this criterion that prompts valuation professionals to engage in build-up methods of determining capitalization and discount rates. The build-up methods take the users from the cost of capital of the largest publicly traded companies through to the smallest companies in an industry. The expert then is left to add additional risk premium to reflect additional risk associated with the subject company. Once that work has been done, the final work is to adjust the result to match the attributes of the benefit stream at which time the conclusion is that the "right" answer has been obtained. The risk-adjusted rate is then applied appropriately to the benefit steam and the value is the result.

The process described in the previous paragraph is the focus of activity by the valuation expert when the income approach is being used to value a company. Curiously, this is usually not done when using the market approach. Or, if both the market approach and the income approach are used, there is no attempt to reconcile the market multiple and the discount or capitalization rate used under the income approach. This neglect is to the detriment of the valuation professional and the user of their value conclusion.

The market approach is, in short, the search for a multiple that can be applied to the subject company to render a value. Implicit in the multiple is a capitalization rate; the inverse of the multiple is a capitalization rate. That capitalization rate (multiple) is subject to the same two criteria, described above, of determining the "right" rate. Theoretically, the market approach is attractive because the valuation expert has "found" the similar company(s), thereby making the first criteria academic. Not so fast! An analysis of the capitalization rate should be done to see if the "right" rate is being used. Such an analysis can produce either powerful affirmation of the value conclusion or evidence that the multiple is incorrect for the subject company.

For example, let's take a P/E (price of stock to after-tax earnings) multiple. A P/E multiple of 10 times is the same thing as saying that the capitalization rate for net earnings is 10 percent (1 ÷ 10). Is this the right rate? The practitioner first must consider what kind of a benefit stream the P/E represents. In most cases, it is an after-tax earnings to equity benefit stream. Therefore, to determine whether 10 percent is the right rate, the practitioner should prepare a cost of equity and growth analysis of the subject company. The result of that analysis will either help confirm the conclusions – or help refute the use of the multiple and the resulting opinion of value. It is an effective confirmation. It is also a persuasive refutation and the valuation expert is well advised to be prepared for opposing experts to do the analysis if the work is being done in the context of litigation.

The common perception that using the market approach avoids the necessity of analyzing the cost of capital for the subject company is a dangerous myth. The market approach, in fact, relies on the same theoretical foundations as the income approach, and the work should be done accordingly. ꩜

Note: Most cost of equity models are cash-flow based and this could require adjustment.

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If both the market approach and the income approach are used, there is often no attempt to reconcile the market multiple and the discount or capitalization rate used under the income approach. This neglect is to the detriment of the valuation professional and the user of their value conclusion.