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The Art of Corporate Share Valuation

Date: May 20, 2011

Vern Krishna

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There are essentially two theoretical elements to determining the “intrinsic” value of corporate shares. First, one must determine the total of all future free cash flows (net of tax) attributable to the shares. Second, one has to consider the reliability or risk of predicting the cash flows. Thus, the intrinsic fair value of shares depends not only upon the accuracy of the total future free cash flows (net of tax) that one expects to receive from the shares, but also some consideration of the volatility of one’s estimates and the accuracy of predictions.

Estimating the free cash flow attributable to shares requires certain assumptions about the life of the corporation. For example, one must assume that the corporation will be in existence for some extended period of time in order to generate the cash flows. Where an enterprise is a going concern, the theoretical rational basis of stock valuation is to discount its future cash flows in perpetuity to their present value. This is the “intrinsic” fair value of the stock as at the particular point in time.

It is difficult, however, to estimate future cash flows into the indefinite future. Hence, we use surrogate estimates to determine intrinsic value. For example, we can use the price to earnings (PE) ratio to multiply the per-share earnings of a corporation to determine the present fair value of shares. For example, we might estimate that a corporation earns net earnings of \$1 per share to have an intrinsic fair value of \$20 per share. This essentially means that we capitalize the present accounting annual earnings per share at five per cent.

Estimating cash flows is a difficult task because one is attempting to forecast into the long-term future. Hence, we use the PE ratio, a crude surrogate number, for determining what, in theory, we would normally do in discounting the long-term free cash flows of a business. In effect, we use the PE ratio as a proxy for future cash flows, a number that is difficult to estimate over an extended period.

The second element, assessing the volatility of cash flow forecasts, is even more difficult. How risky is one’s estimate of future cash flows and what is the appropriate discount factor to apply in light of the estimated risk? Naturally, the more stable the cash flows, the lower the risk of volatility and, therefore, the lower the risk that those flows will not be met. How, for

example, do we estimate the risk of future tax rates?

We can generally predict the pre-tax cash flows of stable companies, such as utilities, with a far greater degree of confidence because their prices and rates are regulated and do not fluctuate in a volatile manner. Similarly, predicting the future cash flow for a stable industrial company, such as General Electric or Coca Cola, is easier than predicting the cash flows of an emerging technology company or new business. Hence, we will use a lower discount rate (or assign a higher multiple) to a company with predictable cash flows and a higher discount rate (or lower multiple) for a company with unpredictable earnings. For example, we might use a five per cent discount rate (or a 20 times multiplier) for a company with highly predictable cash flows and a 10 per cent (or 10 times multiplier) rate for a company with less certain and more risky figure cash flows.

These uncertainties explain why stock market prices are always moving as investors and, more importantly, analysts revise their estimates of earnings based upon real time disclosures of current earnings, future tax rates, and the impact of those earnings upon future cash flows. For example, where a company releases earnings that are lower than market expectations, analysts may revise their forecast of future cash flows depending upon the real reason for the reduced earnings. Thus, it is important not only to interpret reported accounting earnings, but also to gauge their impact on future cash flows. For example, a company that writes off non-productive assets may reduce current earnings, but indicate future savings and enhanced earnings downstream.

Why then would anyone pay more than the “intrinsic” fair market value of a corporate share? There are several reasons. First, the buyer and the seller may have different estimates of the intrinsic fair market value of the share. For example, an acquiring company may believe that the estimated cash flows of the acquired company have been underestimated and attach a higher value to the shares. Second, the buyer may be prepared to pay a higher premium for the shares in order to own all of the shares of the acquired company and acquire control of the corporation. Third, the acquiring company may believe that it can derive certain cost savings and synergies from the acquired company. For example, the acquiring company may be able to integrate its marketing operations with the acquired company and save in future expenses.

To be sure, valuing the intrinsic fair value of shares is subject to uncertainties. Nevertheless, in an efficient capital market that distributes information on a timely basis it is possible to arrive at a reasonable expectation of future cash flows. However, in an inefficient market with minimal or opaque information about corporate earnings, it is much more difficult to predict future cash flows. The uncertainty is compounded where accounting irregularities and earnings are distorted by bogus accounting principles or the application of improper accounting methods. This makes market regulation of accounting an important public policy issue.

Vern Krishna, CM, QC, FRSC is Tax Counsel, Borden Ladner Gervais, LLP, and Professor of Common Law and Executive Director of the Tax Research Centre, University of Ottawa.

vkrishna@blg.com

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