

INAUGURAL LECTURE BY PROF SOON NEL

The following is a brief overview of the inaugural lecture of Professor Soon Nel, Professor of Management Accounting and Finance and Deputy Director: Research of the School of Accountancy, on 10 May 2018:

In his lecture entitled *The quick, rough and dirty side of the market-based approach to valuations: caveat emptor vs. caveat venditor*, Prof Nel highlighted the inherent dangers embedded in the use of multiples as a valuation approach when valuing a company or an equity stake held in a company. He specifically addressed pitfalls pertaining to peer group selection, conventional multiples, composite constructs and intra-modelling inconsistencies.

“South African valuation practitioners should employ a combination of economic fundamentals for peer group selection purposes. The evidence suggests that analysts should take cognisance of the substantial gains in valuation precision (as much as 42%) that could be secured by adopting a peer group selection strategy based on a combination of profitability and risk or profitability and growth, the latter in particular.

“The findings also indicate that earnings-based multiples offer the most accurate price estimates among conventional multiples, with headline earnings-based equity multiples outperforming all the other multiples tested. When comparing the valuation precision of the five most accurate conventional multiples from each of the five different types of multiples used in practice, the market price/headline earnings multiple produced the most accurate price estimates, while the market value of invested capital/revenue multiple produced the least accurate price estimates. The results revealed that a suboptimal choice of multiple carried a substantial potential opportunity cost, ranging from 37% to 50%.”

According to Prof Nel, multiples are used extensively in practice, which is why analysts' reports are typically inundated with various different types of multiples, each potentially carrying incremental information content – especially if they originate from different financial statements. The intuitive reasoning behind the inclusion of various different types of multiples in the same report seems to present an argument for compiling a composite construct from these conventional multiples. The optimisation of these composite constructs is achieved by applying various algorithms with the objective of minimising, *inter alia*, the sum of the absolute valuation errors and the median valuation errors. The evidence suggests that equity-based composite constructs may offer gains in valuation precision of between 20% and 45% over conventional multiples used in practice.

Prof Nel heeded a warning to those valuation practitioners who ignore the rule of intra-modelling consistency when applying the multiples valuation approach, which typically culminates in them using flawed multiples constructs. The risk embedded in the use of these flawed constructs is that valuation practitioners may severely under- or overprice a company or an equity stake held in a company. Valuation theory dictates that the magnitude of these price deviations will depend on the nature of the capital structure of the companies involved.