Valuation of companies

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I hope you enjoy reading these columns as much as I enjoy writing them. As you will have noticed, a lot of the material discusses the importance of good governance. This month, the topic is valuation methods for companies.

Through the modern era, financial statements have been used as the basis for valuations. Published financial statements disclose the historical financial performance of a company.

Based on this information, analysts build models, using spreadsheets, to estimate future performance. Well-established algorithms, explained in most introductory finance classes, are available as pre-defined equations in spreadsheets to convert the estimates into a valuation.

Financial services professionals make recommendations about buying or selling stocks based on a comparison of the estimated value of a company to its current share price on the exchange where it is traded.

Historically, this valuation process has worked well, though there are notable exceptions.

Stock markets have crashed, and traders have been known to make great profits by arbitraging inefficiencies in the market.

Despite these situations, the rise of passive investing (using products designed to track indices) is testimony to the efficiency of markets and the historical importance of this valuation process.

However, and this is a big however, the increasing divergence of the market capitalization of major public companies from the assets on their balance sheets indicates that balance sheets are less predictive of company valuations.

Further, the high valuation placed on businesses that continue to lose money, such as Amazon for most of its existence and Uber for its entire existence, indicates that profit and loss statements are also less predictive of valuation.

There is enough evidence to draw the conclusion that valuation needs to be reconsidered.

As we look at updating the valuation process for companies, we should look at disruption. The companies with some of the highest valuations relative to financial performance are in businesses where technology has enabled completely new products and services.

These new offerings tend to change the economics of markets. Online businesses have eroded the traditional advertising model of newspapers.

Businesses in the sharing economy have eroded the model for dedicated ownership of assets in areas such as overnight accommodations and vehicular transportation.

Today, companies like Facebook, Amazon, Apple, Netflix and Google are successful and appear invincible.

Appearances can be deceiving. To get a perspective, we can look back at the history for other companies that were perceived to be invincible.

In the early 1970s, General Motors and IBM were sources of innovation, high valuations and perceived invincibility.

In the 1980s, Digital Equipment and WANG, along with a host of minicomputer companies, were poised to push IBM to the side.

In the 1990s, Microsoft and AOL were invincible. Some of these companies survived, but are nowhere near as dominant as before and are obviously less invincible, while some no longer exist.

Digital Equipment was acquired by Compaq. Compaq was acquired by HP.

The indigestion created in HP by the Compaq acquisition cost some CEOs their jobs. HP has now split into two companies. One of those two companies is now an acquisition target.

Clearly, the potential to be a disrupter through technology is part of the better sense of valuation. I submit that disruption is not enough.

Apple, IBM and Microsoft have reinvented themselves multiple times. Apple and Microsoft achieved US$1 trillion market capitalizations. Many companies did not.

A better method for valuation should include the leading indicators of companies being able to reinvent their businesses. In subsequent columns, we will explore potential improvements to valuation methods.