Comparable Transactions Method

Idea In Short

Comparable transactions method is one of the most conventional methods used in mergers and acquisitions (M&A) as well as startup valuation to determine a company's value. This approach looks for similar or comparable past transactions in which the company targeted for acquisition has either a similar business model and is of similar size. To derive the value of a business, compare a similar multiple of the business's earnings with transaction multiples.

Usually, the comparable transactions method is used to value a company for a merger as well as acquisition. Together with their bankers, those interested in acquiring a company look at comparable transactions that happened in the market. They seek the most recent comparable transactions from valued companies that have a similar business model. The comparable transactions method is very popular among professional investors, such as public market investors, investment bankers, hedge fund analysts or private equity professionals. This is because this valuation method is:

- Based on actual market prices and transactions that occurred
- Relatively easy to perform as most of the data required for analysis is available to such investors

Data sources

Professional investors and Venture Capitalists use several sources to get a good list of comparable transactions. Some of those sources are:

- **Public Tender and Merger Proxy Statements:** A document filed when a company conducts an acquisition. They often have to file a public report where they discuss the background of that specific deal. These documents generally include previous deals the acquirer has looked into
- **8-K:** In the USA, a public company should file an 8-K when a significant event happens. Acquisitions, divestment or any major events that impact a business are considered material. Correspondingly, pubic companies file 8-K reports, which include transaction details
- **SDC Database:** Security Data Corporation database is probably the most extensive database which has 30 years of deal information. You can search within the database for industries, companies and time-frames
- **Bloomberg, Capital IQ or Fact set:** These are additional databases that all have historical transactions
- **Research Notes:** If you have access to research reports within an industry, the reports for companies / industries usually include details on previous deals
- **Google Search:** Surprisingly, an excellent method to find information about deals and subsequent multiples is through Google. Usually, when a deal gets announced, the deal value gets announced

Valuation Metric

The specific valuation metric in widespread usage for comparable transaction analysis is the EV-to-EBITDA multiple. EV is enterprise value and EBITDA is earnings before interest, taxes, depreciation, and amortization. In this formula, a 12-month period is used for EBITDA. Multiples from the comparable transaction analysis are applied to the target company's data to decide the implied valuation range. Other multiples include:

- Price to earnings (P/E)
- Enterprise value to Revenue (EV/Revenue)
- Price to book (P/B)

Quality criteria

The accuracy and quality of transaction analysis depend entirely on selecting the most applicable transactions. Such criteria include:

- **Industry:** the target company's overall industry should be as close as possible to the comparable companies or comparable transactions industry
- **Deal size:** Select the most relevant transactions as close in size (in terms of revenue) as possible to the target companies
- **Transaction characteristics:** Understand the company's background and other circumstances to derive meaningful insights: e.g., domestic vs. overseas, negotiated deal vs. complete auction
- **Time:** Time determines the data's relevance; more recent equals more relevant

Merits

- The valuation is based on the actual purchase price and reliable public information that is available
- This method indicates the transaction trends, such as acquisitions for consolidation, foreign purchases, etc. that represents what buyers are looking for and the most frequent buyers
- Comparable transactions method helps assess market demand for different types of assets, such as the transaction frequency, the paid multiplies, etc.

Shortcomings

- A scarcity of information or incomplete information may be misleading
- Business cycles and marketplace conditions, such as competitive environment, liquidity in markets, etc. can skew the valuation
- Some transactions may not always directly comparable
- Deal dynamics may differ among deals. Hence, one cannot generalize the approach or apply it to the current scenario
- The multiples may vary to such an extent that they may limit the usability of this approach

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Summary

The comparable transactions method is a popular approach to value a company. This approach has its limitations since the outcome depends on the completeness and accuracy of the data on companies under scrutiny. Hence, this approach should be used along with other valuation methods to determine a holistic view of the target company.