Valuing growth companies: A comprehensive approach

Krystel Dookhith Burrun of Perigeum Capital Ltd emphasises that valuation of growth companies poses specific challenges for investors and analysts alike, and uses the space to explore key methodologies used for it, the importance of strategic foresight, and common pitfalls to avoid during the process.

Valuing growth companies presents a unique challenge for investors and analysts. Unlike mature firms with stable cash flows and predictable earnings, growth companies often operate in dynamic environments, characterised by rapid expansion, high reinvestment rates, innovation, and uncertainty. Their value lies not in current performance but in their future potential.

It is essential to employ a nuanced approach that captures both the potential and the risks associated with these companies.

This article will explore key methodologies used in the valuation of growth companies, the importance of strategic foresight, and common pitfalls to avoid.

Understanding growth companies

Growth companies are businesses that are expected to grow significantly faster than the overall market or their industry peers. These companies often reinvest earnings into the business to fuel further expansion, resulting in little to no profit distribution to shareholders. Investors are attracted to growth companies because of the potential for capital appreciation. Their appeal lies in the promise for exponential growth, driven by disruptive products, expanding markets, competitive advantage, being the first mover in an untapped market or innovative business models.

However, this potential also brings volatility. Growth companies are more susceptible to market fluctuations, technological changes, and competitive pressures, leading to uncertainty surrounding their future cash flows. Therefore, valuing these companies requires a tailored comprehensive approach that accounts for both the opportunities and risks inherent in their business models.

Below is an overview of the application of two commonly used valuation techniques in the context of growth companies:

1. Discounted Cash Flow (DCF) Analysis:
The DCF model remains one of the most widely used valuation techniques, even for growth companies. However, it requires careful consideration of the inputs. For growth companies, the focus should be on estimating future cash flows, reflecting the

expected growth trajectory. However, those forecasts can be difficult to estimate for a company that is still in its growth phase. Small changes in assumptions about revenue growth, margins, terminal value or discount rates can lead to significant variations in the valuation outcome.

The inherent risks associated with the future cash flows of growth companies may be integrated in the valuation model by using scenario analysis to arrive at a probability-weighted performance. Scenario analysis is a valuable tool, allowing analysts to explore different growth scenarios and their impact on valuation. This approach helps in understanding the range of potential outcomes and the associated risks. Another possible way to cater for risks in a DCF valuation is by adjusting the discount rate upwards with a higher equity risk premium or beta to account for the company's volatility.

2. Relative Valuation:
Relative valuation methods, such as price-to-earnings (P/E), price-to-sales (P/S), and EV/EBITDA multiples, can be useful, but they need to be applied with caution. Comparisons should be made with other high-growth companies within the same industry or sector to provide a meaningful context. It is important to identify peer companies that are in similar stages of growth and have comparable business models.

Obviously, the challenge lies in finding truly comparable companies, as growth companies often have unique business models or operate in emerging markets where direct comparisons are limited.

Common pitfalls to avoid

1. Over-reliance on Short-term Metrics:
Focusing too much on short-term financial metrics can lead to an inaccurate valuation. Growth companies often sacrifice short-term profitability for long-term gains, so it's crucial to adopt a long- term perspective.

2. Lower focus on the CAPEX and cost structure
In building forecasts for growth companies, a lot of focus is put on the revenue line. It is important to ensure that the costs and required capital expenditure are both proportionate to the growth strategy of the company. Furthermore, in the long term, it may be reasonable to expect that performance KPIs will stabilise to industry norms, unless the company operates in a disruptive market or is able to retain an edge over its competitors.

3. Ignoring Market Sentiments:
While intrinsic valuation is important, it's also essential to consider market sentiments and investor expectations. Growth companies are often subject to hype cycles, which can inflate valuations. Understanding the market's expectations can help in assessing whether a company's current valuation is sustainable.

> The value of high-growth companies lies not in current performance but future potential

4. Underestimating Risk:
Growth companies inherently carry higher risk, whether due to market conditions, execution challenges, or technological disruption. It is important not to underestimate these risks and to incorporate them into the valuation model.

Adopting a comprehensive approach

Valuing growth companies requires a blend of analytical rigour, strategic insight, and an understanding of market dynamics. While traditional valuation methods like DCF and relative valuation are still relevant, they must be adapted to account for the unique characteristics of growth companies.

Strategic foresight is key. Analysts must consider the company's competitive position, scalability, and the sustainability of its growth. Factors such as market size, competitive advantage, management quality, and innovation potential play a critical role in determining whether the company can sustain its growth trajectory.

By adopting a comprehensive approach and avoiding common pitfalls, investors can better navigate the complexities of valuing high-growth firms and make informed investment decisions.

**By Krystel Dookhith Burrun,
Director - Corporate Finance,
Perigeum Capital Ltd**