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**REVIEW OF PABLO FERNANDEZ'S ARTICLE ON MOST COMMON ERRORS IN  
COMPANY VALUATION**

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**ABSTRACT:** *It would seem that the author's intention are to highlight and expatiate/ justify twelve (12) most common errors observed in valuations done by financial analysts, investment banks and financial consultants involved in purchase and sale of companies, mergers and the arbitrage process.*

**KEYWORDS:** review, Pablo Fernandez, common errors, company valuation

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## **INTRODUCTION**

Fernandez focused on twelve (12) common errors in company valuation. This was not intended to be an exhaustive treatment, hence the adjective, *common*. Even then it did not consider all *common errors* as he had previously identified eighty (80) in Fernandez (2004), and twenty-four (24) in Fernandez (2001). Although the author did not proffer solutions in an omnibus manner to overcome these errors, the implications of the errors were highlighted and illustrated mainly. These errors were, as the author maintained, made by financial analysts, investment banks and financial consultants, and "belong to public reports of financial analysts" (Fernandez, 2005).

## **METHOD**

The author used a combination of methods, most of them descriptive in nature, to typify the identified errors. For each error, Fernandez adopted approaches that he found suitable to his objective. In some instances, he adopted case analysis and in others, simple narratives. Generally speaking, secondary data were used and the identified error was simulated arithmetically to show what it could be in the event of other approaches.

Occasionally, Fernandez used some econometric models to assess the companies. This is different from earlier papers by the same author on this subject, wherein he endeavoured to guide the reader through various approaches for company valuation and ultimately assessed the assumptions underlying the approaches. That led to the pooling of twenty-four errors relating to methodology (17) and those relating to data (7). Anearlier paper identified and discussed eighty (80) errors, which Fernandez classified into six.

**Objectives of this Review**

It is aimed to review the article with a view to assessing the genuineness, efficacy and applicability of the description of errors to an analyst or investment bank. Other objectives include: to determine the acceptability of the classified error as such; evaluate the relative effects/(materiality) of the errors on the valuation.

**FINDINGS OF THIS REVIEW**

Twelve (12) errors were highlighted by Fernandez (2005) are:

- i. Wrong Beta used for the Valuation;
- ii. Wrong Calculation of Beta;
- iii. Wrong Calculation of the Value of Tax Shields;
- iv. Wrong Treatment of Country Risk;
- v. Wrong Calculation of Cash Flows;
- vi. Errors when Valuing Seasonal Companies;
- vii. Errors in Calculating Residual Value;
- viii. Errors when using Multiples;
- ix. Time-Value Inconsistencies;
- x. Inclusion of the Value of Real Options without Economic Meaning;
- xi. Different Cash Flow Methods Provide Different Valuations; and,
- xii. The Valuation is A Scientific Fact and not An Opinion.
- xiii.

**Wrong Beta used for the Valuation**

Three bases of beta calculation were identified as erroneous, namely –

- a) *The use of historical beta or the average of betas of similar companies, where the result goes against common sense.* The main issue here is arbitrariness of the computations as depicted in Table 1 and 2. There is however an ambiguity in Fernandez's description of the approach as "contrary to all common sense and prudence." How did Fernandez determine what fits into common sense? To justify the arguments, the author demonstrated that betas change dramatically depending on the period used to estimate the beta. This can be quite impacting as the beta influences the discounting procedures and the estimated value may differ significantly from reality.
- b) *The use of wrong formulae to lever and unlever the betas.* Referring to his earlier paper, the author pointed to six different formulae for levering and unlevering the beta. Here, he claimed that only two of these computational bases are correct and the other four incorrect. This is rather too categorical because there is nowhere in this paper that the parameters for the judgment so expressed was explained. The models expressed may have shown some differences, especially with respect to the treatment of tax and tax savings or in relation to  $\beta_d$ . This is not enough to categorize them as incorrect as they may be applicable in some circumstances.
- c) *Where valuing an acquisition, use beta of the acquiring company.* This certainly does not make sense because the riskiness of the target company is more relevant than that of the bidder. The author's argument is clear and valid in this regard.

**Wrong Calculation on WACC**

The author observed that WACC used in valuations tend to differ from that derived when tax savings and value of debts is carefully computed. The effective tax rate is superior, in this

computation, to statutory tax rate and this should be used in valuations. Furthermore, Fernandez noted that book values of debt and equity could be misleading and thus recommended that appropriate values to use should be those deriving from valuation. This position was illustrated in Tables 4,5,6 and 7.

### **Wrong Calculation of the Value of Tax Shields**

From a list of six models that calculates the value of tax shields, Fernandez assessed two as correct and the other four as wrong. Again this categorical assertion calls for closer reassessment of his position because the models in themselves had only minor differences except that for the two he regarded as correct, there was delineation as to increasing debt or no. It is suggested that empirical tests of the models should be further done to determine the validity of Fernandez's position.

### **Wrong Treatment of Country Risk**

Fernandez observed that country risk is wrongly treated in any or combination of three ways. First, by treating country specific risk as unsystematic, hence non-conceptual, an error has been committed. This is actually so because global risk do not arise in isolation, they are a reflection of risks of various countries and thus should be treated in a similar way. Secondly, it is wrong to assume that the beta calculated for companies reflect all the disasters/changes that may occur in that economy. Thirdly, he posited that it is wrong to assume that the *bêta* computed from historical data captures the country risk.

### **Wrong Calculation of Cash Flow**

The author highlighted six errors commonly committed with cash flows. First, there is a disjoint between equity cash flow ( ECF) and free cash flow (FCF), increase in debt, interest payments and effective tax rate such that ECF does not reflect equity cash flow (dividend + share repurchase). Secondly, considering the increase in cash position and improvement in financial investment as equity cash flow is wrong in that the company will not distribute the entire funds in foreseeable future. "It should be recognized that the company increases its value by distributing the excess cash to the shareholders or by using it to reduce its debt rather than keeping it". Thirdly, Fernandez emphasized that equity cash flows are not equal to dividends and other payments to shareholders, thus the computed value of equity cash flow is not correct, unless it can be assured that the amounts not paid out are reinvested at a return equal to required rate of return to equity ( $K_e$ ). Fourthly, there is failure to project the balance sheet such that increase in assets does not match the assumed increase of debt plus assumed increase of the book value of equity. Furthermore, an exaggeration of the company's fundamentals that is disconnected from reality. Finally, the decision to exclude cash flows from future investment understates the potentials of a target company.

### **Errors When Valuing Seasonal Companies.**

Fernandez observed that they wrong treatment is often given to seasonal working capital requirements by using annual data without due adjustments. This tends to depart from time values. It is not clear however what Fernandez intends to communicate here because values like 45%, 38%, -17.9% and 8.5% are 'naked' in their description.

**Errors in Calculation of the Residual value**

The author alleges that inconsistent cash flow is used to calculate the value of perpetuity. In his illustration, residual value computed by discounting expected free cash flows at the WACC rate and calculating the residual value by assuming a residual growth rate. He emphasized that it is inconsistent to use the FCF to calculate residual value. He attempted to reflect the correction in the valuation showing substantial reduction of the residual value. One wonder if this will always be the outcome.

**Errors When Using Multiples**

Fernandez discusses the effects of three types of errors involving multiples, namely;

- a) Use of average multiples extracted from transactions executed in a very long period of time and/or the average of transactions multiples by time frame and scope.
- b) Use of multiple from an extraordinary transaction. This can be misleading because extraordinary events may not be repetitive.
- c) Use of ad-hoc valuation multiples that hits the common sense. Extensive rigorous calculations of company values based on the market performance of economies where the company's branches operate, especially, benchmarking against some remarkable companies on leading stock exchanges can be quite misleading as the conditions of each country vary so is the effect of such macro economy on share values. Fernandez derided the valuation arising from such bases by alluding to the illustration of valuation for Terra shares as analogous with twice the age of a woman on the street where the company operates and marks of arbitrariness, even though rigorously arrived at. The true share value of the company, Terra, in the illustration was a far cry from the estimations of this type of valuations. Thus, it is not only unrealistic but quite misleading.

**Time Value Inconsistencies**

The writer challenges the assumption that equity value can be taken to be consistent by demonstrating that equity values will be affected dividends and thus capable of growing from year to year. He concluded that the relationship between the enterprise value of different years and dividends is given by the equation  $E_i + D_i = (E_{t+1} + D_{t+1}) (1 - WACC) - FCF$

This position is in consonance with similar works done by Gordon and others to prove that growth is an essential consideration in determining cost of capital and hence values.

**Inclusion of the Value of Real Options without Any Economic Meaning**

When valuing companies, it is customary to consider the NPV of significant and notable ongoing contracts or businesses and integrate them into them into the profit evaluations of the company. Sometimes, the outcome could be negative until some options stated in the deal are included in the computations. Ferdinand posited that whatever such inclusion would be, should be done in such a way as to answer some pertinent questions, otherwise it should not be included. These questions are in respect of who owns the options and who has control over the fulfilment of the options. This may not be absolutely correct as it is possible to isolate the contracts whose options are not owned or in control of the company while treating others as part of the company's business. This way the company's values will be fair and reasonable.

### **Different Cash Flow Methods Provide Different Valuations.**

The emphasis here is the argument that different cash flow methods provide different valuations cannot be sustained because the commonly used discounting methods will all give similar outcomes, especially if the relativities are considered, that is the IRR, PI or BCR. But this position held by Ferdinand may not hold when valuation involves intangibles and non-traded values of social significance or futuristic values. These considerations may influence investors' perception and valuation of companies. Thus, although the methods may produce similar effects on decision makers, the cash flow may differ.

### **The Valuation is A Scientific Fact and not An Opinion.**

The position of the author in respect of whether the valuation is a scientific fact or opinion is quite clear and deserves to be accepted. Much of what goes into company values transcends the fundamentals and is influenced by perceptions of the investors of the risk complexion of the company in its context.

### **CONCLUSION**

It is hereby concluded that several errors are committed in the course of company valuation that would have affected decisions of investors or predators in takeover bids. These identified errors need to be avoided or adjusted for in the determination of consideration to pay for company's shares. Some of the errors can be explained in terms of prevailing parameters but nonetheless may not be of universal and enduring application, hence the critique. It is doubtful however if these errors and the recommendations made in its stead will be acceptable to analysts, investors, other market players and consultants.

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