How Do Sell-Side Analysts Obtain P/E Multiples to Value Firms?

Abstract

Prior literature suggests that earnings multiple-based valuation methods play a dominant role in practical equity valuation. This study examines how sell-side analysts perform relative valuations using price-earnings multiples. We focus on how analysts select the price-earnings multiples for the firms they follow. By mimicking analysts’ relative valuation processes, we show that analysts tend to assign earnings multiple premiums (discounts) to those firms expected to have growth premiums (higher risk levels) relative to comparable firms. We also provide evidence that analysts use firms’ historical earnings multiples as benchmarks, and assign firms that are expected to have more (less) attractive fundamentals than they have had in the past premium (discounted) earnings multiples relative to the average historical earnings multiples at which they traded.