



Valuation – Public Comps and Precedent Transactions: Historical Metrics and Multiples for Public Comps

Welcome to our next lesson in this set of tutorials on comparable public companies and precedent transactions. This time we are going to go through the public comps we partially completed, one over here for Jazz Pharmaceuticals, the company that we're actually valuing, and then the other one over here for Salix Pharmaceuticals, your practice exercise. We're going to fill in this top area, which lists their revenue, net income and EBITDA. We're going to need all of these of course to calculate valuation multiples on a historical basis for the companies.

Now, there's a lot of information here and so at first it may look a little bit intimidating, but as you'll see most of this is really just copying and pasting numbers from the financial statements, so it's not really that difficult, and the time and effort you spend on this largely depends on how precise you need to make it.

So it goes back to what we talked about in the last lesson. When you run the numbers for the public comps there are a couple different ways to do it.

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You could automate everything, you could cut some corners but still look in the company's filings and get a lot of these numbers on a historical basis and then make a few adjustments, and then get the forward numbers, the projected numbers, from equity research.

Now, we're going to go a little bit more in depth than that, so we are going to go into the filings, and we're not going to comb through every last note in the financial statements to look for random, non-recurring charges, but we will at least review the financial statements and look for non-recurring charges there.

You could be even more exhaustive than this. As we mentioned before, if you're working on something like a fairness opinion or a client presentation and you need it to be 100% precise, then sure, go ahead and spend hours and hours on each company and read through everything in their statements and filings, but we just don't have time for that here and this is not going to come up in interviews or case studies, so we're not worrying about it.

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So last time around we gathered the market data for the comparables, and we used that to calculate their Equity Value and Enterprise Value down here. What we're going to do this time



is go in and calculate the historical metrics and multiples, and using the same format we're going to go through and example for Jazz, and we are going to have you complete and exercise for Salix pharmaceuticals so you understand it in depth.

Let's take a look at the step by step process for this part of the overall process first. You always start by entering the data for the company's most recent fiscal year because you're always going to need this. It doesn't matter what time of year it is or what the valuation date is, you always, at the bare minimum, need their information for their most recent fiscal year. Now, sometimes this is all you need because this is the only or most recent statement that is actually available.

So if the year has just ended and they don't have a 10-Q or interim filing, then you pretty much stop here. Now, once you have the income statement data on it, you would go down to the cash flow statement and look on the cash flow statement and income statement for non-recurring charges.

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You always take the depreciation and amortization from the cash flow statement, and then you could go beyond that and keep looking for other charges to add back. If you want to be really in depth, you could also look in the company's notes to their financial statements and the MD&A section (Management's Discussion and Analysis) and see if you can find anything there.

Then, once you have the full fiscal year numbers, you have to sit back and think about the valuation date and the company's most recent interim reports. So, if there is a report that is more recent than the annual report or the 10-K you just used, then you need to enter information from that, and what you have to do is complete something called calendarization.

We'll look at this more in an upcoming lesson, but the basic idea is that you need to get the Last Twelve Months of numbers. To do that you take the full fiscal year numbers and then you add the most recent partial period, whether it's three months, six months, or nine months. So you add that to the full fiscal year results, and then you subtract that same time period from the year before.

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That sounds a little bit abstract right now, but we'll look at a couple examples and you'll see a visual of how to do this when we go through this exercise. So once you've decided on whether



or not you need to actually do this, then you can go in and enter the data for the relevant partial periods using the company's 10-Q or their interim report.

Once you do this, this part of the process, everything's the same as the annual numbers, it's just that you're working off the quarterly or half-year or nine-month statements rather than the full year ones. Then finally at the end you can calculate the LTM, the Last Twelve Months metrics for everything. So that's the process.

Once again, I would emphasize that if you have access to something like Capital IQ or FactSet you can automate this whole thing. You can just say, give me the company's LTM, revenue, EBITDA, net income and so on and get all the numbers automatically like that, but I want to show you the real way to do it in case you don't have access to those programs or if you need to do a more detailed calculation.

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So let's go up and start doing this for Jazz, and start with their revenue for their full fiscal year, the FY right here. Once again, I have their annual and interim financial statements. Let's start with the annual statements and go down to the income statement here. So I have highlighted in yellow everything that we're going to make use of. Total Revenues, let's enter the \$872.423 right there. Cost of Sales, it is what's highlighted in yellow right here, the \$102.146.

Pharmaceutical companies typically don't break it out and show gross profit like a manufacturing might, so we have to do a bit of extra work here. We'll take our revenue and subtract our cost of sales right here.

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Now for Operating Expenses you have to be careful. We want to include everything in this section, but we don't want to include Cost of Product sales because we've already counted that, so if we include that again we'd be double counting it. So essentially we are splitting it up and only including these three line items. So we're going to take the total number and then subtract our Cost of Sales number and effectively take that out of Operating Expenses.

Now of course the Operating Income will still be the same, we're just grouping these items slightly differently. So total operating expenses is going to be \$532.111 minus \$102.146. So we have that.



Now, Operating Income. We want to check and make sure it's the same as the \$340.312 figure listed right here, so let's take our gross profit and subtract our operating expenses, and that looks to be the same.

Interest and Other Income or Expense. We want to get all these numbers down here. We're not going to bother adjusting for foreign currency loss or the loss on extinguishment and modification of debt because we are just using the company's net income as reported in this analysis.

[07:03]

So we're not going to try to adjust or add these back. Even for something like EBITDA, if you think about it, we wouldn't be adding back anything here because these do not impact operating income. They're below the operating income line, and so we're not going to be adding them back in this case.

So, for the Interest Expense, \$26.916 minus \$1.697 minus \$3.749. So we have that. Pre-Tax Income. Let's take our Operating Income and then add the Interest Income. It's a negative here because it's interest expense actually. We have that.

Then for Taxes, again, we're not using the company's tax rate, we're just using the taxes as reported. So \$91.638 right here. Other Items, so if there's anything else in between when we calculate taxes and net income we'd factor it in. So in this case something like discontinued operations might show up right here.

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If we had net income attributable to non-controlling interests or equity investments we might factor in something like that. If we had other income that might also be included here because, once again, we are just using net income as reported. So I'm going to say \$0 because we don't have anything like that.

Then Reported Net Income. Our Pre-Tax Income minus our Taxes. We can check and make sure that we have the right number. \$216.312. And they have \$216.312 right here. So we have that.

We have calculated everything on the income statement, and if you're wondering, by the way, why do we bother going through all of that, why can't we just enter, say, Revenue, Operating Income and Net Income? You could actually do that in this case. The reason why I'm listing all



of those items separately is because sometimes you do like to pull them out separately. So you may want to separate out, for example, the company's interest expense from everything else. Or you may want to separate out, in future analysis, the gross profit margin and look at that separately, so that's why we've entered the items separately.

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Again though, if you're in a time crunch, sure, you could just enter the Revenue, Operating Income and Net Income and be done with it like that, if that's really all you're going to use and you don't have time to do anything else.

Now we're going to turn our attention to the cash flow statement. Remember, when you're calculating EBITDA you always want to take the D&A from the cash flow statement because these are going to be all inclusive. If you look at the income statement, in this case, the amortization number happens to match up, but often it does not. They don't even have depreciation listed here. Why? Because it's imbedded within these other line items, whether it's cost of sales or SG&A, or R&D, it's imbedded somewhere else within these other operating expenses. We went through this concept in the previous module. Take a look at that, the lesson on how to calculate EBITDA, if you need more clarification. The bottom line is that you always want to take these from the cash flow statement right here.

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So let's enter these two numbers, Amortization and Depreciation. So Amortization is going to be the \$79.042 number. Depreciation, \$3.048. Sometimes companies will not list these separately. If they do not, that's fine, just list them together and enter 0 for the other one right here.

Now this other item, Acquired In-Process R&D, this is something specific to pharmaceutical companies. For their annual report they don't actually have anything listed for this, so we are not going to enter anything here because it looks like it doesn't appear historically.

Then looking at the rest of this, really the next question to ask and the next step of this process is, are there any non-recurring charges to add back?

Now, there are a few important notes about doing this. With non-recurring charges, generally we're only going to be adding them back to EBITDA. We're not going to adjust revenue, that wouldn't make any sense.



When we adjust and add these back you have to make sure that first off, it is really non-recurring, and that the item actually impacts operating income because if it does not impact operating income, so something like the loss on the extinguishment of debt for example, it doesn't make sense to add it back because it hasn't reduced your operating income in the first place.

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Now, sometimes, it is very difficult to tell whether you should add back an item because you cannot tell whether or not it is really impacting operating income, and you also cannot really tell whether or not it is non-recurring. So as a result, we prefer to be very selective with what we add back.

To illustrate why, here's a chart of Alcoa, a company in another industry, and their so-called restructuring charges. Now, if you look at this and you're not being very careful, you could look at this and say, okay, restructuring, that seems like a non-recurring one-time item. Companies are not always restructuring, but in this case, look at how much restructuring occurs each quarter in this chart.

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We would argue that, in this case, restructuring is actually a recurring charge, especially if you look at the most recent three quarters here. It would be very difficult to look at this and say, okay, well normally it's a non-recurring item so it's also a non-recurring item here because for this company it is actually more of a recurring item. So you have to be very careful with what you add back here, and if you're not sure, we prefer not to add it back.

Now, sometimes, people will also adjust net income for these types of charges. They'll try to create a pro-forma net income where they add back various non-recurring charges, sometimes they'll add back amortization, sometimes they'll add back depreciation. All of this gets extremely confusing and it is not particularly useful for this analysis, so we prefer to leave it out.

We've gotten a ton of questions, especially in the more advanced courses, on how you calculate this, what you add back, what tax rate do you use when you add back these charges, and the short answer is that a lot of it is very arbitrary, and so not only is it confusing to teach but it's confusing for you to actually go through this process.

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So we prefer to keep these add backs limited to EBITDA and to leave net income as reported on the income statement, and we actually label it Reported Net Income to show that we're not adjusting it for anything here. So that's our general approach.

Now, looking at this statement, we would say here that there are no non-recurring charges to add back. Why? Well, with this Loss and Disposal of Property Equipment, the issue here is that this is probably going to be below the operating income line. There's no way to tell. Share-Based Compensation, this is actually a recurring charge. It happens every single year. And then these others. A lot of these others, again, will probably appear below the operating income line. Deferred Income Taxes, for example, makes no sense to add back because this is part of the company's tax expense on its income statement.

Provision for Losses on Accounts Receivable, this is a recurring item. Loss on Extinguishment or Modification of Debt, we saw before it appears along with interest expense below the operating income line, so it doesn't make sense to add back.

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Other Non-Cash Transactions, well these are non-cash but it doesn't mean they're non-recurring. We're only add back non-recurring expenses here.

These other two items, Acquisition Accounting, Inventory, Fair Value Step-Up and Change in Fair Value of Contingent Consideration, these you could make an argument for adding back because acquisitions presumably do not happen all the time, and these step-ups afterward and then also the change in the fair value of the earn-outs that they owe to other companies they've acquired. These also are not necessarily going to recur from year to year, and with both of these they could very well impact operating income, and they actually do here. If you go through and read the notes you'll see that they do impact operating income, but we're not going to add these back because, in this case, the company has been so acquisitive over the years that we would argue that the acquisitions they make are almost more of a recurring item.

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Furthermore, the Change in Fair Value of Contingent Consideration we would argue is more of a recurring item for a biotech or pharmaceutical company. Why? Because they're always acquiring these other products. There's always making these small acquisitions, or larger ones, and so they always owe some amount of payment to other people. So it's not like this item is



just there in only one year and never again. If you look back historically, it's actually been very, very common on their statements.

You could argue either way. Some people would look at this and add these back, but we're not going to take that approach here. So that's really all we have to say about this.

The last thing to do here, we're going to enter \$0 for the non-recurring charges, and then for EBITDA we're just going to take our Operating Income and then add our Amortization, Acquired In-Process R&D, Depreciation and Non-Recurring Charges, and we get to our EBITDA for the Last Twelve Months. So we have that.

The next thing to think about is, what do we need to do in terms of calendarization?

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So in this case we know that they have a quarterly report which ended on March 31st, 2014. Our valuation date is May 9th, 2014, so we know that there is something more recent here, and so we need to get the Last Twelve Months. What we need to do in this case is we need to get the April 1st, 2013 to March 31st, 2014 numbers. To do that I'm going to show you in PowerPoint visually how to think about this.

So here's what their results look like right now. We have their full year 2013 numbers, and then we have the first quarter of 2014. So, how do we get to just this region, just April, 2013 to March of 2014? We start by adding the full fiscal year, because we want to get these three months in here. That's really the purpose of doing this. We want to get those three months and so we need to take the entire fiscal year first, January to December of 2013. Then we add the next three months, so the first three months of 2014. We add that. That's what I just highlighted in PowerPoint.

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Then we go back and subtract this three month period in 2013. By doing that we get to these 12 months in between, from April to March. Now, you might look at this and say, okay, well, that seems kind of complicated, why can't you just add up each quarter individually or why can't you just look at the company's statements and get this 12 month period? Why do you have to add and subtract different periods?

The answer is that companies normally do not disclose this in their filings. They don't disclose all the individual quarters, and especially for Q4, they often do not disclose this



separately. They often just list the entire full year together. Also, it would actually be more work if we tried to add up the individual quarters because then we'd have to look at multiple sets of filings instead of just the annual report and the interim report.

So there are a number of reasons but it's partially a matter of what they disclose, and then the fastest way to do this. So that's the idea.

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If you had a six month period, if you wanted the period from July to June, for example, you would do the same thing, except it would be six months instead of three months. If you wanted, say, October to September, same thing, except it's nine months rather than three months now.

So that's how it works. What we're going to do here is take the three month period Q1 of 2014 and then the three month period of Q1 of 2013, and the process is really the same, it's just that now we are working with the quarterly statements instead. So let's look at Jazz Pharmaceutical's interim statements right here. So once again I have everything that's relevant highlighted, let's enter the new partial \$246.919 right here, and then \$196.237 for the old partial. Cost of Sales, \$30.924 and \$27.220.

Gross Profit, we can copy over our formula for this. Operating Expenses, we have to do the same thing. We have to take our Total Operating Expenses and then subtract Cost of Product Sales because we counted that separately.

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So, \$313.578 minus the \$30.924, and then \$128.050 minus \$27.220. Operating Income, let's copy this across. Then Interest and Other Income or Expense. So here, I'm actually going to highlight this, we need to take the -\$10.076 plus \$0.123, and then for the old partial, -\$7.399 plus \$0.271 right there. Pre-tax income, let's copy these across, and add this up.

[19:56]

Then Taxes. So, once again, I'm going to highlight this row down here. So we have \$17.027 and then \$17.634. Then Other Items. So now we actually have something because we have the net loss attributable to non-controlling interests. We do need to factor this in. We only have it in one of these partial periods so let's just enter the -\$0.989 right there, and then \$0 for the old



partial. For reported Net Income we can copy our formula once again, and we can check and make sure that these line up. So \$43.4 and -\$93.6.

You can see it doesn't actually line up here and there are two issues. One is that we should actually be using a positive sign for Other Items right here, and then the other issue is that we haven't factored in other items to begin with. So let me just add Other Items right here. So now \$43.4, -\$92.7, and these actually line up now. We have that.

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Let's go to our cash flow statement and think also if we need to add back any non-recurring charges on the income statement. It looks like the answer is no. Typically, you get the non-recurring charges on the cash flow statement anyway, but it looks like here we don't really have much of anything to add back, so let's go down.

So once again, let's go to our Amortization, our Depreciation and our In-Process R&D. Amortization, \$31.182, acquired in-process R&D, \$127, depreciation, \$1.309. Then for the old partial, let's take \$19.555, and then Depreciation is \$0.575, and then Acquired In-Process R&D is \$4, right there, because we have \$4,000, meaning \$4 million, really. For the rest of these items we're not going to add back anything for the same rationale that we went through before. They're either recurring or they appear below the operating income line, so we're not going to be adding back any of these.

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So enter \$0 for the Non-Recurring charges and then for EBITDA we can copy this across. So that takes us almost to the end, now. We've entered all the data for the interim periods, and now really the last step is to calculate the LTM metrics for everything. So we're going to take our fiscal year numbers, add the most recent interim period, and then subtract that period from the year before, and we're going to calculate that for all the metrics here.

Let's start with the fiscal year for revenue, then let's add the new partial period and subtract that old partial period, and we can just copy this formula down, and then do the same thing for EBITDA right here.

So we have their LTM EBITDA of \$422.9 million right here. And so that's really all there is to this exercise. You can see that it gets a little tedious, especially to look for the non-recurring charges, but it is good to know how to do this the real way in case you do not have a way to automate it at your fingertips. Again, there are many ways to simplify and make this easier.



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For example, you could just enter Operating Income and Net Income and Revenue, and then adjust Operating Income to get to EBITDA like we did here. That would save you some time and cut back on the data entry. So there are many options but I just wanted to show you what you might see in a real calculation for this type of thing in real life at a bank.

So now that we've been through that I what I want you to do is go over to Salix Pharmaceuticals and then complete this exercise on your own for them. So take a look at their 10-K and 10-Q reports and go through and enter everything the same way we just did, and then calculate the LTM figures at the end. So follow that same exact process. I have not created separate extracts for their statements but you can find them in the filings. Get practice doing that yourself and then enter everything here. So pause the video right now. Once you're done un-pause the video and then we will walk through it together.

[23:57]

Okay, good. So let's open up Salix's financial statements and let's jump to where they actually have their financial statements listed in the 10-K. We don't need anything on the balance sheet. Let's go to the income statement. They have largely the same set up as Jazz Pharmaceuticals did where they do not list cost of goods sold and gross profits separately.

So let's just go in and start entering their figures. For revenue we have \$933.838. Cost of Sales, we have \$179.392. Gross Profit, we can just take Revenue and subtract Cost of Sales. Operating Expenses, we have to do the same thing here, take Total Cost and Expenses and then subtract out Cost of Products Sold. So \$662.125 minus \$179.392. We have that.

Then for Operating Income we can take Gross Profit minus Operating Expenses. Interest and Other Income. So here they have it listed separately, the expense portion and the income portion, so let's say -\$61.651 plus \$2.003.

[25:10]

And then pre-tax income, let's take our Operating Income and then add Interest, Income or Expense right here. Taxes, we have -\$69.031. You have to be really careful with the signs because this is a negative but for Jazz it was actually listed as a positive on their statements and they just subtracted it out, so just be careful and be aware of this type of issue. So \$69.031.



Do we have other items here? It looks like the answer is no. They just go straight from pre-tax income to net income. So let's enter \$0 for other items, and then take our pre-tax income, subtract our taxes and add other items right here. They have \$143.04. We could just check this quickly, and it looks like the same thing.

[26:01]

Now let's go to the cash flow statement and see what we should be adding back on there. So we have a couple things listed. We have Depreciation and Amortization, Intangible Impairment Charge, Amortization of Debt Discount, and Loss on Extinguishment of Debt. So again, with a lot of these items you have to be really careful about what's actually non-recurring. We would say out of these the impairment charge is a non-recurring item.

The Loss on Extinguishment of debt also is non-recurring. Stock Based Compensation, no. Deferred Income Tax is recurring and also below the Operating Income line.

The gain on the adjustment of the put option also is a non-recurring item, but the question with a lot of these is, where do they show up?

Now we know that the impairment charge would actually show up and affect operating income because look, they actually list the impairment charges right here in the Total Costs and Expenses section, so it's actually going to affect Operating Income down here. So we would definitely be adding this back if we actually had something in this period.

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For the Others it is not quite as clear what to do and we probably have to look through the statements and look up a description of them and where they're listed to see what the treatment should be.

Something like the Amortization of the Debt Discount also gets very complicated because a portion of this is typically recognized within interest expense, and sometimes its embedded within other items, so if you think about it, again, we shouldn't be adding this back if it only impacts the interest expense because that is below operating income anyway and so it's not going to reduce our operating income, therefore it makes no sense to add it back to EBITDA.

Now, how can you tell where exactly it shows up? Well, if you do a search for Amortization of Debt Discount you can see that they have a full breakout and they give right here, it looks like it's pretty much all in the interest expense category right here.



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So we would say in this case, upon further investigation, we **shouldn't** be adding back this type of item because even though it is amortization, it is not amortization that affects operating income and is shown below that on the income statement.

Sort of a tricky concept, but if you want to be a little bit more accurate that is what you can do. You wouldn't be wrong technically if you added this back to calculate EBITDA. It wouldn't be the end of the world, you're not going to change EBITDA by that much if you actually add this back here.

So let's go back in here. For Amortization from the cash flow statement I'm just going to say \$0. We don't have Acquired In-Process R&D. Depreciation, I'm just going to use the \$52.133 number right here because they list Amortization and Depreciation together. And then for Non-Recurring Charges we are going to say nothing in this case for the reasons we just went over. They're either below the line or they're actually recurring.

[28:57]

Then for EBITDA we can just take our Operating Income, add Amortization, Acquired In-Process R&D, Depreciation and Non-Recurring Charges and we get to our EBITDA for the period. So we have that.

Step two is that we need to go to their 10-Q interim reports and get all of the numbers from here. So let's scroll down and get to their income statement. Let's start by entering the revenue at the top and go back here. So we have \$384.374 and then we have \$202.601. Cost of Products Sold, so we have \$115.566, and then \$33.072. Let's copy across the formula for Gross Profit.

[29:57]

Operating Expenses. So we have \$422.463 minus the \$115.566. And then over here we have \$153.327 minus \$33.072. Operating Income, let's copy this across. \$49.3, -\$38.1, and it looks like our numbers match up to theirs. Then for the rest of this, so Interest Expense, we have -\$42.460 plus the Other Income down here, and then -\$15.330 plus \$0.015.

[30:52]



The Income Tax Benefit or Expense, so for the first one it is actually a benefit for the 2014 period. So I'm going to enter $-\$36.368$ instead. For the Other Period it is actually an expense so I'm going to enter $\$11.518$. Pre-Tax Income, we can copy across these formulas. Other Items, do we have anything here? It looks like the answer is no. We just go straight from pre-tax income, take out taxes, and then get to net income like that.

So we can copy across our formula once again. Let's check our net income numbers to make sure they're correct. $\$22.441$, what they have, $-\$43.872$, also what they have. So we have that.

Let's go down to the cash flow statement. And once again, the Amortization of Debt Discount, I really highlighted it here to draw your attention to it and to tell you that sometimes you need to look into this in more detail and see where it's actually included, but since it's included within the interest expense we would not be adding it back here.

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We do have this Loss or Gain and Stock Based Compensation but we're not adding back either of those because they're either below the operating income line for the loss or gain or for stock based compensation. They are not real, non-recurring expenses. So really, we just have this one item here to add back. And so I'm going to enter this $\$57.066$ back in our Excel file over here. Then $\$12.929$ for the old partial period. Enter 0's for the rest of these.

Then the EBITDA formula we can just copy this across as-is. So we have our EBITDA for each of these periods.

Then really the last thing we have to do here is just to calculate the LTM numbers. So let's take our full fiscal year numbers, add the new partial and subtract the old partial right here, and then copy these down.

[32:58]

Then let's get the same thing for the EBITDA over here. So we have that. So we have an LTM EBITDA of $\$280.6$ here, so $\$281$ million. So that takes us to the end of this lesson. Another longer lesson, I know, but I wanted to go through this in some level of detail and show you how to find these types of items, how to make judgment calls, and also how to look through the rest of their notes to their statements and see whether or not something should really be added back.



To recap what we did, we went through in the beginning how there are a couple different approaches to running the numbers for public comps. We are using a moderate level of detail here, but not an exceedingly high amount of detail. To calculate the historical metrics you always want to start with the company's most recent fiscal year, enter at least Revenue, Operating Income and Net Income. We chose to enter Other Items here just in case we need them in the future.

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Then you want to turn your attention to the cash flow statement, enter Depreciation and Amortization from there and then look for Other Non-Recurring charges. Sometimes you'll have to do some detective work like we did with the amortization of the debt discount to see if something should really be added back or not. In general, though, you want to be very selective with what you add back because often these items are below the operating income line or are not really non-recurring.

We didn't even both to adjust net income for any of this. We're just using the reported net income to simplify this treatment. Then, you need to think about whether or not you need partial periods, so three-month, six-month or nine-month periods. In this case we do because the valuation date is in May and so the Q1 results are already available. Once we decided on that we entered the relevant partial periods from the 10-Q here for both companies, and then we calculated the LTM metrics at the end by taking the fiscal year, adding the most recent partial period and subtracting that same period from the year before.

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So that's it for this lesson. We're now almost done with these comparable companies. Coming up next in our last lesson on public comps we're going to look at how you get forward projections from equity research, consensus estimates and other sources, and also how you can do a bit of a check of your numbers at the end and make sure that nothing you have is wildly off from what other people are saying about this set of companies.