

## **Valuation and Financial Sustainability Analysis:**

The Navigator Company's case

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### **Abstract**

The current project work involves a fair value analysis of The Navigator Company, to advise a stockholder whether to transact the company's stock, or not. For fair value analysis, regarding the consistency and maturity of firm's business, the projections made for the new business sector – Tissue paper – will be of extreme importance.

In this dissertation, to reach the company's stock fair value, it was developed a discounted cash flow model. This financial method was built based on future projections of firm's business key driving forces. The final output is the enterprise value, from which it derives the company market capitalization, in other words, stock fair value.

The case study resolution, brought to big conclusions. The first one is that, company market capitalization is lower than the market stock price. Which means that the company is overvalued by the stock market. The second big conclusion is that the Tissue segment will be a lot profitable, if the assumed combination between market share and demand evolution is verified. To finish it is expected that the Tissue segment has a weight of 13% on the company value.

### **1. Introduction**

Paper Industry produces, annually, 400 million tons of paper, according to SkogsIndustrierna. Industry's biggest companies, on an international level, are International paper (United States of America), Kimberly-Clark Corp. (United States of America) and Stora Enso (Finland)

The Navigator Company is the biggest paper producer in Portugal, and one of the strongest features on paper market worldwide. It's production activity is distributed by four big sites, in Portugal: Cacia (only BEKP pulp), Figueira da Foz, Setúbal and Vila Velha de Ródão (only Tissue paper).

The firm's total revenues, in 2016, were approximately €1.6bn, which corresponds to 1% of Portugal's total GDP.

Navigator raised its revenues in 2016, when comparing with previous years. One of the big reasons for this business growth is the Tissue paper segment investment, which was responsible for 4.3% total revenues in 2016.

This master thesis main goal is to evaluate The Navigator Company, using financial valuation methods like Discounted Cash Flow method, and market multiples. At the end of this present work, it is expected to obtain company's fair value, and to establish a comparison analysis between the results obtained and the actual stock trade value. It will be done, also, a parallel analysis for the Tissue segment, to understand the future impact on firm's cash flows, and to measure its proportion on company enterprise value.

This paper consists of 4 chapters, the first of which relate to this introduction. The following chapters will be of Literature Review (Chapter 2), Case-study (Chapter 3) and Conclusions and future work (Chapter 4).

## 2. Literature Review

An enterprise is a special form of organized activity, which the main goal is to generate added value. The more effective is the resources allocation, the more will be the value generated, and the bigger will be the return rate over the invested capital (Janas, 2003).

The main goal of an equity research is to provide an approximate enterprise value, or market capitalization value, to potential investors (Steiger, 2008). And, to be valid, the valuation should compute an accurate estimation for a business value. Any valuation model should portray the market conditions that affect the company, or the asset, under valuation (Pagourtzi, et al., 2003).

### 2.1. Relative Valuation

Relative valuation methods are used to evaluate assets, based on market comparables. It is called relative valuations, because has as reference other comparable companies (Saliba, 2008).

The main reason for relative valuation popularity, is its simplicity. Unlike the Discounted Cash Flow method, market multiples do not require a detailed prevision of the company's key financial indicators, like sales and costs evolution. Do not require discount rate calculations, either (Yoo, 2006).

For the present work development, the following market multiples will be used:

$$\frac{EV}{EBITDA} = \frac{Enterprise\ Value}{EBITDA}, \quad PER = \frac{Stock\ market\ price}{Earnings} \quad (1), (2)$$

$$PSR = \frac{Stock\ market\ price}{Sales}, \quad PBV = \frac{Stock\ market\ price}{Book\ value} \quad (3), (4)$$

The price to earnings ratio is the best benchmark for investors, because it mirrors how much stockholders are willing to pay, for every monetary unit of company's profit (Bakshi, et al., 2000).

Price to earnings ratio, PER, determines a company's stock market price, through its profits capitalization based on a market multiple computed based a group of comparable companies (Chang, et al., 2000).

However, there is a market multiple that should be used instead of PER. It is called enterprise value to EBITDA ratio, EV/EBITDA. The main advantage is that there is less companies with negative EBITDA, when comparing with profits, so there is less companies excluded from the analysis. The second advantage is that this ration despise the depreciation effect (Damodaran, 2012).

PBV ratio is very useful to determine whether stock is undervalued or overvalued. It establish a comparison between its market price and book value, and it is a reason for interest for investors and stockholders (Damodaran, 2012).

PSR ratio as the advantage of not being negative, and for that reason they are available even for companies that are struggling to survive. However, using this ratio, it is possible to attribute a strong market value to a growing company, even if its cost structure is also high (Damodaran,2012).

## 2.2. Discounted Cash Flow method

A DCF approach estimates a company value through the sum of the discounted operacional cash flows. To discount the cash flows, it is necessary a discount rate, that reflects the investment/project/business risk (Gajek,et al., 2017).

This method considers the present value rule, according to which every asset value is computed based on the cash flows it can generate (Damodaran, 2012):

$$Value = \sum_{t=1}^n \frac{CF_t}{(1+r)^t} \quad (5)$$

Where: n = asset life period; CF<sub>t</sub> = Cash flow generated on t; r = discount rate.

To the present value of the company's cash flows, it is necessary to add the Terminal Value, which is a value is the present value at a future point in time of all future cash flows when we expect stable growth rate forever (Gajek, et al., 2017):

$$NPV = \sum_{t=1}^{\infty} \frac{CF_t}{(1+wacc)^t} + \frac{TV}{(1+wacc)^t} \quad (6)$$

Where: NPV = Net Present Value; TV = Terminal Value; wacc = weighted average cost of capital.

The Cash Flow used is the free cash flow to the firm, which derives from the operational result (EBIT) net of taxes. After that it is added back the depreciations and amortizations, and it is obtained the Operating Cash Flow. After that, it is included the investment cash flow, composed by the CAPEX and Working capital investments (Naplan, et al., 1995).

The discount rate used, should reflect the risk associated to the investment/business. It also reflects the mix of expected returns by shareholders and debtholders. To discount any cash flow, it is important to check if the discount rate is consistently measured (Koller, et al., 2010).

$$wacc = \frac{E}{D + E} * K_e + \frac{D}{D + E} * K_d * (1 - i) \quad (7)$$

Where: E = Equity; D = Debt;  $K_d$  = Cost of Debt;  $K_e$  = Cost of Equity; I = Tax rate.

Normally, the cost of debt reflects the effective interest rate paid, and the cost of equity reflects the return expected by the investors, and is a measure of capital opportunity cost (Groth, et al., 1997).

$$K_e = r_f + \beta(r_m - r_f)$$

Where:  $r_f$  = risk free rate;  $r_m$  = market rate of return;  $\beta$  = Levered Beta.

The beta coefficient is a measure of the volatility of a security or a portfolio in comparison to the market. In other words, reflects how much a company's stock will vary whenever the market oscillates (Cummins, et al., 2003).

$$\beta_L = \beta_U * \frac{E + D * (1 - i)}{E} \quad (9)$$

Where:  $\beta_L$  = Beta levered;  $\beta_U$  = Beta unlevered.

Beta should be levered to the financial structure, in order to give a better measure of the company risk when facing market oscillations (Dunn, 2001).

### 2.3. Rentability indicators

Before making any investment, it is necessary to take into account some indicators that help to measure the expected profitability. Among these indicators, the most common is the Net Present Value, previously mentioned, however, and in order to determine the consistency of this indicator, others are used, as the Internal Rate of Return, the Profitability Index or the Payback period (Brealy, et al., 2011).

Internal rate of return is computed using the following formula:

$$VAL = \sum_{t=1}^{\infty} \frac{CF_t}{(1 + IRR)^t} = 0 \quad (10)$$

To compute the Profitability Index, it is used:

$$IR = \frac{VAL(6)}{\sum_{t=1}^{\infty} \frac{Inv.}{(1 + r)^t}} \quad (11)$$

The reference values of the indicators are: (i) VAL greater than zero means that the investment is profitable, the higher the value, the more profitable the investment; (ii) The IRR should be higher than the discount rate, the higher the profitability, the higher the IRR; (iii) The IR should be higher than 1, because in this case it means that the NPV is higher than the Current Value of the investment (Camilo, et al., 2017).

#### **2.4. Sensitivity and Robustness analysis**

Sensitivity analysis is the study of how the uncertainty in the output of any model can be imputed to each uncertainty in the input of the same. Consequently, this analysis should be considered by the evaluator as a prerequisite for the construction of any type of model (Saltelli, 2002).

In the other hand, when a model is developed, whatever the type, the result obtained is always subject to errors, whether systematic or random, so it will be necessary, in the end, to test the performance of the model (Zhang, Yang, et al., 2017).

To test the robustness of the results obtained, another method of calculating company value will be used. In this case, the relative valuation method will be used, or in other words multi-valuation.

#### **2.5. Business Diversification**

Diversification happens when a company expands to produce / sell products in markets that have no relation to the markets in which it is initially inserted. The lack of interaction between markets leads to the justification for diversification being the savings caused by shared productive factors and the impact of diversity on organizational efficiency. The ideal level of diversity is the one that balances the economies of scope (the total average cost of production is reduced, with the increase of the number of different products produced) with the diseconomies of organizational scale (Rumelt, 1982).

### **3. Case Study**

This chapter will be divided into two groups. It will begin with an analysis of the industry and the market of paper (UWF and Tissue), to understand which are the key factors in these two segments. Then, the assumptions made in the construction of the financial model will be explained, with a higher incidence in the projection of sales and related costs.

#### **3.1. Market Overview**

Through the studies conducted by Hawkins Wright (2017) and Banco BBVA (2017), it can be concluded that, currently, consumption of UWF paper has been higher in emerging economies, that is, in developing countries. Conversely, in developed countries, the opposite movement occurs, with the increasing development of digitalization, the growth of consumption of this type of paper is stagnating.

According to the study carried out by AXIA in 2017, in these countries, it was found that the main UWF paper producers diversified their production spectrum, extending it to packaging, as a way to combat the slowdown in consumption of UWF paper.

According to the same study, in 2016 the negative trend in paper prices was slightly reversed because of the peak in demand in Europe, Middle East and Africa. In addition, the costs of transporting goods from Asia, as well as the exponential increase in demand in the region, have turned the attention of the main Asian producers to domestic consumption. Given that the increase in production capacity, mainly from Asia, should be aimed at satisfying domestic consumption needs, combined with the stabilization of demand on the European continent, it is expected that the prices practiced by the company will remain constant, governed by the index prices.

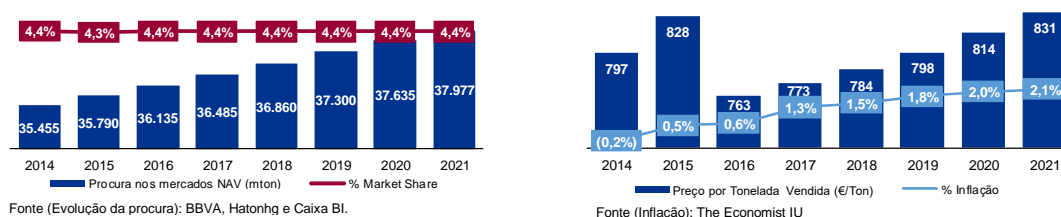


Image 1 - Demand vs. Navigator market share and Price/ton sold (by Navigator) vs. inflation. Historic and projected.

Regarding Tissue paper, the Tissue market is driven by purely socioeconomic factors such as the level of global hygiene, per capita disposable income and level of urbanization<sup>1</sup>. According to data provided by the company's market analysis department, demand in the Western markets is expected to continue to rise as a result of global quality trends, lifestyle changes and essentially geographic changes such as population growth.

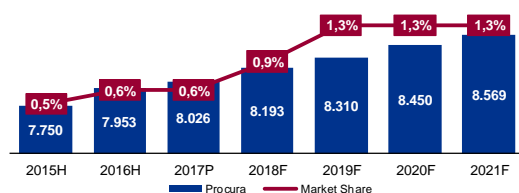


Image 2 - Tissue demand vs. Navigator market share. Historic and projected.

In what concerns pulp market, the pulp index declined significantly between 2015 and 2016, both in Europe and the United States of America, due to the slowdown in the Chinese economy, the main destination of pulp exports<sup>2,3</sup>. China is the main driver of the BEKP pulp market, so any change in the country's own economy can have a major impact on the pulp price index. Although this index has risen steeply between the end of 2016 and the beginning of 2017, as a result of the strong demand in the Asian market, and especially in China, the increases in capacity, operated by the various market players, will make the offer equal or even exceed demand, and in that sense the price index tends to stabilize.

<sup>1</sup> <http://www.equityinsider.org/2017/07/19/tissue-paper-market/>

<sup>2</sup> <https://www.bloomberg.com/news/articles/2017-08-14/china-s-economy-slips-some-as-factory-output-investment-slow>

<sup>3</sup> <https://www.nytimes.com/2016/10/19/business/international/china-economy-slows-impact.html>

### 3.2. Assumptions

According to the Navigator's Annual Report of 2016, the company sells its product to a group of 123 different countries, most of them sales to Europe and the United States of America. In addition to these two regions, the company exports to Latin America, the Middle East, Asia and some African countries such as Morocco, Egypt, Tunisia and Algeria.

From Image 1, on the left, one can verify the above-mentioned information. There has been an increase in UWF demand in the markets where The Navigator Company operates between 2014 and 2016. The prospect is that the increase will continue to occur, with emerging markets contributing heavily to this effect. In order to give some robustness to the demand projections, an average of all inputs taken from the market studies was performed.

An implicit market share in the above markets was calculated by dividing the annual quantity sold in the last three years by the demand figure shown in the graph. Not having disclosed any short-term expansion plan for this business segment, the company assumed a constant market share value between 2017 and 2022, calculated based on historical values. The market share average was calculated between 2014 and 2016, and the same value was assumed for future projections, 4.2%.

The process for calculating the selling price was similar. The sales value of the UWF segment was divided by the physical quantity sold, calculated through the relation between purchases, initial inventory and final inventory ( $\text{Sales} = \text{Purchases} + \text{Initial Inventory} - \text{Final Inventory}$ ). The process was repeated for the three years of history, 2014 to 2016, and at the end an average value was calculated, which was used to calculate sales projections. Between 2017 and 2022, the value was updated to the Portuguese consumer price index. The value was corroborated by the employee of the management control department of the company.

Regarding Tissue, at the beginning of 2015, the company completed the acquisition of MAS BR Star Paper S.A.<sup>4</sup>, a company producing this type of paper, with a paper production capacity of 60 mTon / year and a processing capacity of 65 mTon / year.

According to the information provided by the company's Management Control Department, in order to gain market scale, the company invested in a new production line at its factory in Cacia, with the aim of increasing production and processing capacity in 70 mTon / year. The investment amount is € 120m, and will be made between 2017 (€ 48M) and 2018 (€ 72M), and the new line will be ready to start work from August 2018. With this new investment, the group intends to integrate BEKP pulp production into the production of Tissue paper, thus achieving a competitive advantage for the production price of this type of paper.

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[http://www.jornaldenegocios.pt/empresas/industria/detalhe/portucel\\_\\_compra\\_ams\\_por\\_80\\_milhoes\\_de\\_euros](http://www.jornaldenegocios.pt/empresas/industria/detalhe/portucel__compra_ams_por_80_milhoes_de_euros)

According to the company's market analyst, due to the high transport costs inherent in this type of product, Navigator intends to satisfy only the European market, with a special focus on Portugal and Spain.

The paper is sold in two ways, by the company, in reels and in the form of finished product. The reel is the raw material of the transformation process, which gives rise to the said finished product. In the historical data for 2014, 2015 and 2016, taken from the reports and accounts for 2016 and 2015, there was an average transformation coefficient of the total production of reels in finished product of 85%, with the remaining 15% being sold in the market, in the state in which they are. The sale price of the reels, as it is the target of less operational treatment, is lower than the sale price of the finished product by around 30%, value considered for the development of the present work.

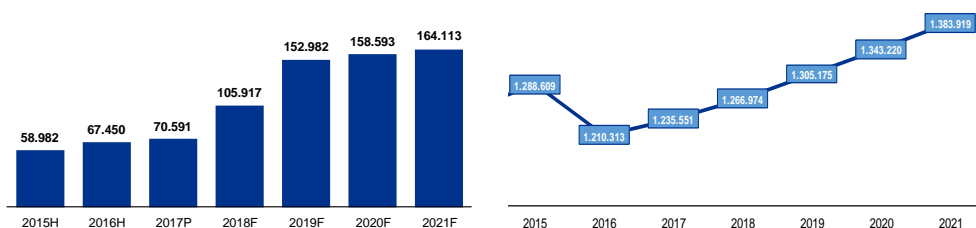


Image 4 – Tissue paper sales on the left, UWF sales on the right.

The main competitive advantage of the company derives from the integration of pulp in the paper production process. The type of pulp produced - BEKP pulp - is a high-quality pulp used by the company in the production of UWF and Tissue paper, and the price is subject to a large fluctuation due to market volatility. The Navigator is aware of the price volatility and, in this sense, produces the necessary pulp for the production of the different types of paper. This can eliminate market volatility as well as reduce raw material costs in paper production.

Pulp production costs will always be lower than cost of purchase, and the impact of volatility on operating margins is eliminated. Historically, Navigator has interesting EBITDA margins. In the last three years it varied between 21-26%, and it is expected that in the future, it will stay between the same interval.

Regarding investment cash flow, a significant investment in CAPEX is expected between 2017 and 2018, as a result of the investments made in the increase of BEKP pulp production capacity and in the new Cacia production line.

However, investment in CAPEX will continue to be projected as 2% of sales, an amount provided by a manager of the management control department, plus annual investments of € 10m in forestry in Mozambique. The investment in Working Capital will be positive, as a result of the expected growth of the business, with the main highlight being the customer and supplier sectors, the main drivers of the working capital variation. Regarding Investment Cash Flow to Tissue segment, the same assumption was taken into account, besides the production line investment, it is expected that the maintenance Capex investments will stabilize at 2% Sales.



CAPEX investment on perpetuity will be larger than the amount of non-monetary depreciation costs, in order Assets to follow the expected business growth.

#### 4. Results

The basic principle of NPV indicator is that € 1, at risk, tomorrow, is worth less than € 1, without risk, today. Therefore, future Cash Flows are discounted at an inflation rate, which reflects the opportunity cost of invested capital. Of course, the discount rate will be higher if the associated risk is higher, since the shareholder requires greater return on invested capital for projects whose risk is higher (Zizlavski, 2015).

Discounted Cash Flows						
€'000	2017P	2018F	2019F	2020F	2021F	Perpetuity
Volume de Negócios	1.542.838	1.613.888	1.699.479	1.743.014	1.789.446	1.837.114
% Crescimento	(2,2%)	4,6%	5,3%	2,6%	2,7%	2,7%
EBIT	224.153	237.449	276.002	295.861	316.325	324.751
%mg. EBIT	14,5%	14,7%	16,2%	17,0%	17,7%	17,7%
Operational Tax	(66.351)	(70.340)	(81.906)	(87.863)	(94.002)	(96.530)
NOPAT	157.802	167.109	194.096	207.997	222.322	228.221
Add-back depreciations	131.793	151.415	150.782	150.851	150.926	154.946
OCF	289.594	318.524	344.878	358.849	373.248	383.167
ICF	(116.392)	(175.422)	(48.447)	(42.103)	(35.659)	(181.559)
FCF	173.202	143.102	296.431	316.746	337.589	201.608
Discount Factor	1,00	0,93	0,86	0,80	0,75	15,27
DCF	173.202	133.046	256.234	254.554	252.240	3.077.800

Table 1 – Company's DCFs.

DCF						
€'000	2017P	2018F	2019F	2020F	2021F	Perpetuity
Vendas	70.591	105.917	152.982	158.593	164.113	169.979
% Growth	4,7%	50,0%	44,4%	3,7%	3,5%	3,6%
EBIT	5.171	28.881	67.949	70.674	74.561	77.904
Tax	(485)	(8.411)	(19.825)	(20.635)	(21.785)	(22.761)
% Effective Tax	9,4%	29,1%	29,2%	29,2%	29,2%	29,2%
NOPAT	4.686	20.470	48.124	50.039	52.777	55.143
Depeciações	8.904	17.977	18.296	18.626	18.968	18.968
OCF	13.590	38.447	66.421	68.665	71.745	74.111
ICF	(35.412)	(53.118)	(3.060)	(3.172)	(3.282)	(22.368)
Free Cash Flow	(21.822)	(14.671)	63.361	65.494	68.463	51.743
Discount Factor	1,00	0,89	0,80	0,72	0,64	7,8
Discounted Cash Flow	(21.822)	(13.123)	50.693	46.869	43.824	402.728

Table 2 – Tissue paper segment's DCFs.

Table 1, it can be verified that there is a generalized growth of the Free Cash Flows expected. The accumulated growth between 2017 and 2021 is CAGR (17-21) 23.7%. This growth is due, above all, to the expected expansion of the business, namely in the Tissue sector, where the increase in liquidity generated by the segment will have a major impact on Cash Flow.

Avaliação	
€'000	Jul-17
Enterprise Value	4.147.076
WACC	7,6%
Terminal Growth Rate	2,7%
(+) Caixa	67.542
(-) Dívida financeira	708.261
(-) Interesses minoritários	2.273
(-) Ações preferenciais	-
Market Cap.	3.504.084
Nr Ações (milhares)	717.500
Preço/ação (€)	4,88
Preço/ação transacionável (€)	4,29

Table 3 – Company's Valuation results.

Project Appraisal	
€'000	2017
NPV	509.169
WACC	11,8%
Terminal Growth	4%
Outros Indicadores	
IRR	102%
PI	193%

Table 4 – Tissue Segment profitability indexes.

Table 3 shows that the enterprise value was approximately € 4.15bn which, after the calculations shown in the table, would be reflected in a market capitalization of around € 3.5bn.

Dividing the market capitalization by the number of outstanding shares - about 717.5 million - the market value of the shares of The Navigator company is reached.

However, in the stock market, the company's stock trades at € 4.29 / share, slightly lower than the € 4.88 / share calculated, so it can be said that the company is undervalued by the stock market, compared to the value calculated based on the future prospects of Free Cash Flow.

After performing the sensitivity analysis, the main conclusion is that wacc has a more pronounced impact on NPV than the perpetuity growth rate.

It was possible to check that a variation in wacc of 5% would imply a variation of NPV by about 6-8%, while a 5% variation in perpetuity growth rate would have an impact of 1-3 %.

For robustness analysis, it was performed the same company valuation, using relative valuation methods. The different valuation methods outputs are similar, so it is possible to say that the results obtained through the DCF method are robust.

The Tissue segment NPV, shown in table 4, is € 509.17M, much higher than zero. The IRR is also much higher than the discount rate used. Regarding IR, it can be concluded that, for each monetary unit invested, approximately 2 monetary units translated into Cash Flow generated by the project are expected. Through the sensitivity analysis, it was possible to conclude that company market share is the most important factor Navigator should focus on, because it is the one with more powerful impact on the Net Present Value.

## **5. Conclusions**

After reaching the value of the company, the market capitalization value was calculated, which theoretically should be equal to the value at which stock is transacted multiplied by the number of shares in circulation. In the present work, a market price of the share of 4.88 / share was calculated, while in the market this is traded at 4.29 € / share, 12.2% lower than the calculated one.

As it was presented in the present work, the company will advance with investments in the segment Tissue and pulp, with the purpose of increasing the production capacity of both. This investment, supported by the company's strong ability to generate cash flows, is expected to provide a strong growth of business and brand. An economic feasibility study of the investment in the Tissue segment was carried out. After the study, it was concluded that it would be profitable. All the indicators, and assuming that the assumptions adopted will be verified, show that the investment would be extremely profitable.

Regarding the suitability of the methodology used, it can be concluded that the DCF model will be the most effective method to determine the value of a company, or to analyze the profitability of a given business, insofar as it considers the temporal evolution of factors, not only internal, as external, in determining the assumptions, and that may influence the result obtained.

For future development, it is advisable to carry out a parallel study of market implementation strategies, namely in the Tissue segment, where market conditions are more specific and because it is a new market for the company. With this strategic background, it would be possible to predict in a more appropriate way what could be the evolution of the company's market share and, with that, to make a more precise study on the profitability of the investment project.

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