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RESEARCH AND KNOWLEDGE CENTRE

# VALUATION

## INTRODUCTION

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# INTRODUCTION

## Understanding valuation

Valuation refers to the process of determining the present value of an asset, investment, or company. It involves assessing the worth of an entity based on various factors such as its financial performance, market conditions, future prospects, and risk considerations. Valuation is crucial for investors, businesses, and financial professionals as it helps them make informed decisions regarding buying, selling, or holding assets.

### Market Value:

- Market value, also known as fair market value, is the current price at which an asset can be bought or sold in the open market.
- It is determined by the forces of supply and demand and reflects the perceptions, expectations, and sentiment of market participants.
- For publicly traded companies, market value is often represented by the company's market capitalization, which is calculated by multiplying the current share price by the total number of outstanding shares.
- Market value can fluctuate frequently due to changes in market conditions, investor sentiment, economic factors, and company-specific news.

### Intrinsic Value:

- Intrinsic value is the perceived or calculated true worth of an asset based on its fundamental characteristics, such as cash flows, earnings, dividends, growth prospects, and risk.
- It is determined by analyzing the underlying financial and operational factors that drive the future cash flows or benefits generated by the asset.
- Intrinsic value is often estimated using various valuation models, such as discounted cash flow (DCF), earnings multiples, comparable company analysis (CCA), and asset-based approaches.
- Investors seek to identify assets whose market prices are below their intrinsic values and offer potential for long-term gains.

## Book Value:

- Book value represents the accounting value of an asset or a company based on its historical cost less accumulated depreciation, amortization, and impairment.
- It is derived from the balance sheet and reflects the net value of assets reported by the company.
- Book value is primarily used for accounting and financial reporting purposes and may not necessarily reflect the true economic worth or market value of the asset.
- For tangible assets like property, plant, and equipment, book value is adjusted for depreciation over time, while for intangible assets, it may be adjusted for amortization or impairment charges.
- Book value per share is calculated by dividing the total equity (assets minus liabilities) by the number of outstanding shares, and it provides a measure of the company's net asset value on a per-share basis.

In summary, while market value reflects the current price of an asset in the market, intrinsic value represents its true worth based on fundamental analysis, and book value is the accounting value of an asset based on historical cost.

## Types of valuation models

### Absolute Valuation Models:

Absolute valuation models estimate the intrinsic value of an asset independent of its market value. These models typically focus on forecasting future cash flows or earnings generated by the asset and discounting them to their present value. Absolute valuation models are commonly used for valuing individual stocks, bonds, projects, or entire companies. Some prominent absolute valuation models include:

- **Discounted Cash Flow (DCF) Model:** This model estimates the present value of future cash flows generated by an asset or a business.
- **Dividend Discount Model (DDM):** The DDM estimates the intrinsic value of a stock based on the present value of its expected future dividends.

- **Discounted Earnings Models:** These models estimate the intrinsic value of an asset based on its expected future earnings, such as earnings per share (EPS) or net income.

**Absolute valuation models provide a fundamental approach to valuation and are based on the underlying economic principles of the asset being valued. They require detailed financial forecasts and assumptions about future performance, making them more complex and subjective compared to relative valuation models.**

### **Relative Valuation Models:**

Relative valuation models, also known as comparables or multiples valuation models, estimate the value of an asset by comparing it to similar assets in the market. Rather than focusing on absolute measures of value, relative valuation models use multiples such as price-to-earnings (P/E), price-to-book (P/B), or enterprise value-to-EBITDA (EV/EBITDA) ratios to assess the relative attractiveness of the asset compared to its peers or industry averages.

- **Price-to-Earnings (P/E) Ratio Model:** The P/E ratio compares the market price of a stock to its earnings per share (EPS).
- **Price-to-Book (P/B) Ratio Model:** The P/B ratio compares the market price of a stock to its book value per share.
- **Enterprise Value-to-EBITDA (EV/EBITDA) Ratio Model:** The EV/EBITDA ratio compares the enterprise value (market value of equity plus debt minus cash) of a company to its EBITDA.
- **Price-to-Sales (P/S) Ratio Model:** The P/S ratio compares the market price of a stock to its revenue per share or total sales.

**Relative valuation models rely on the principle of market efficiency, assuming that similar assets should have similar valuations in the market. They are often used to benchmark a company's valuation against its peers, industry averages, or historical multiples. However, relative valuation models may overlook differences in growth prospects, risk, and other qualitative factors.**

## Types of valuation methods

### Discounted Cash Flow (DCF):

The DCF method is a valuation technique that estimates the intrinsic value of an investment by considering its projected future cash flows. It essentially discounts these future cash flows back to their present value, reflecting the time value of money. In simpler terms, a dollar today is worth more than a dollar tomorrow. The DCF method factors this time value principle by applying a discount rate to the future cash flows.

- **Future Cash Flow Projections:** This involves accurately forecasting the cash flow an investment is expected to generate over a specific period. This includes both inflows (revenue) and outflows (expenses).
- **Discount Rate:** This rate reflects the risk and time value of money associated with the investment. A higher risk or longer investment horizon typically leads to a higher discount rate.
- **Present Value Calculation:** By discounting the projected cash flows using the discount rate, the DCF method arrives at their present value, representing the investment's current worth.

### Comparable Companies Method:

This method values a company by comparing it to similar publicly traded companies (comps) in the same industry or with similar characteristics. The valuation multiples of these comparable companies, such as price-to-earnings (P/E) ratio or enterprise value-to-EBITDA (EV/EBITDA) ratio, are used as a benchmark to estimate the target company's value.

- **Company Selection:** Choosing the right comparable companies is crucial. They should be similar to the target company in terms of size, industry, profitability, growth stage, and other relevant factors.
- **Valuation Multiples:** Financial ratios like P/E ratio or EV/EBITDA ratio are calculated for the comparable companies.
- **Target Company Valuation:** The average valuation multiple of the comparable companies is applied to the target company's relevant financial metrics (e.g., earnings or EBITDA) to arrive at its estimated value.

### Precedent Transactions Method:

This method relies on the sale prices of similar companies in recent mergers and acquisitions (M&A) to estimate the value of a target company. The assumption is that the acquisition prices reflect the fair market value of the acquired companies.

- **Transaction Comparability:** The M&A deals used for comparison should involve companies that are similar to the target company in terms of size, industry, and financial performance.
- **Adjustments:** The transaction prices might need to be adjusted to account for any significant differences between the target company and the acquired companies. These adjustments could be related to factors like synergies, transaction costs, or the overall market climate.

## FURTHER ANALYSIS

### Impact of earnings on valuation

#### • Earnings as a measure of performance:

- Earnings, typically reported as net income or profit, reflect a company's profitability.
- Higher earnings indicate a well-run business with a competitive edge, which is attractive to investors.
- Conversely, lower earnings might suggest inefficiencies or struggles, leading to a lower valuation.

#### • Earnings and future cash flow:

- Investors are ultimately looking for companies that can generate future cash flow.
- Earnings serve as a historical indicator of a company's ability to produce cash.
- By analyzing earnings, investors can make predictions about the company's future cash flow potential.

- **Valuation metrics:**

- Financial metrics like earnings per share (EPS) are key factors in valuation methods.
- EPS divides a company's earnings by its outstanding shares, indicating profit per share.
- Investors use EPS to compare profitability across companies and assess their relative value.

- **Quality of earnings also matters:**

- Not all earnings are created equal. Investors go beyond just the headline number and consider the "quality" of earnings.
- This involves analyzing if earnings are sustainable and reflect core business activities, or if they are one-time events or influenced by accounting adjustments.

## Limitations of valuation

- **Reliance on assumptions:** Valuation models often depend on estimates and assumptions about the future. These can include factors like growth rates, discount rates, and projected cash flows. If the assumptions are overly optimistic or inaccurate, the valuation will be misleading.
- **Focus on historical data:** Valuation models frequently use past financial performance to predict future potential. However, past performance doesn't guarantee future success. Disruptive technologies, economic shifts, and unforeseen events can significantly alter a company's trajectory.
- **Market inefficiency:** Market-based valuation methods assume the market accurately reflects a company's worth. But markets can be influenced by emotions, speculation, and temporary trends. These factors can lead to bubbles or crashes, causing market prices to deviate from a company's intrinsic value.
- **Intangibles are tricky:** Valuation struggles to quantify certain intangible assets like brand reputation, intellectual property, and a strong company culture. These assets can significantly contribute to a company's value, but assigning a specific dollar amount can be challenging.



- **Subjectivity can creep in:** Different valuation methods can produce varying results for the same company. The choice of method and the specific assumptions used can be subjective, leading to valuation variations depending on the analyst.

**In essence, valuation provides an estimate, not a definitive answer. By understanding these limitations, you can use valuation as a guide while considering other factors for a more comprehensive understanding of a company's worth.**

## **Sell-side vs Buy-side valuation**

Valuation takes on different approaches depending on whether you're on the "buy side" or the "sell side" of the financial markets. Here's a breakdown of the key differences:

### **• Objectives:**

- **Buy-Side:** Here, the focus is on finding undervalued investments. Buy-side analysts aim to identify companies with the potential for future growth and strong cash flow generation. They want to acquire these companies at a price below their intrinsic value.
- **Sell-Side:** The sell-side is all about helping companies raise capital. Investment banks value companies to determine an offering price for new securities (stocks or bonds) being issued to investors. They typically aim for a valuation that attracts investors while maximizing the proceeds raised for the company.

### **• Metrics Used:**

- **Buy-Side:** Buy-side analysts may use a wider range of valuation methods, including discounted cash flow (DCF) analysis, which focuses on the company's future cash flow potential. They might also consider qualitative factors like a company's competitive advantage and management team.
- **Sell-Side:** Sell-side analysts often emphasize market-based valuation methods that compare the company to similar publicly traded companies (comps) using metrics like price-to-earnings (P/E) ratio or enterprise value (EV) to EBITDA (earnings before interest, taxes, depreciation, and amortization).

- **Focus on Bias:**

- **Buy-Side:** Ideally, buy-side valuation should be objective, focusing on the company's fundamentals. However, there can be a confirmation bias where analysts favor information that confirms their initial investment thesis.
- **Sell-Side:** Sell-side analysts may have an inherent bias to inflate valuations to make the offering more attractive to investors and generate higher fees for their firm. Regulations exist to mitigate this bias, but it's a factor to consider.

- **Disclosure:**

- **Buy-Side:** Buy-side valuation research is typically not public and is used internally by the investment firm to make investment decisions.
- **Sell-Side:** Sell-side analysts publish research reports with their valuation recommendations, which are distributed to potential investors. These reports need to comply with industry regulations to avoid misleading information.

In finance, the divide is between the "buy side" and the "sell side." The buy side refers to firms like hedge funds and pension funds who invest money for clients. Their goal is to find undervalued investments with strong growth potential. The sell side, on the other hand, consists of investment banks who help companies raise capital by selling securities. Their valuation aims to attract investors while maximizing the funds raised for the company. They essentially work for opposite ends of the investment spectrum.

# CONCLUSION

## Example of valuation

Imagine you're selling your lemonade stand. Here's a super basic valuation example:

- **Scenario 1:** You sell 10 cups of lemonade a day at \$1 each, making \$10 daily. You might value your stand based on its daily earnings, so around  $\$10 \times 30 \text{ days/month} = \$300$  per month.
- **Scenario 2:** Maybe your stand has a prime location or a secret family recipe, attracting more customers. You might consider future potential and value it slightly higher than just its current earnings.

Imagine you own a dog walking business. Here's a simple valuation example:

- **Income approach (very basic):** You have 10 regular dog walking clients, charging \$15 each per walk. You walk them twice a week, so you earn  $10 \text{ clients} \times \$15/\text{client} \times 2 \text{ walks/week} = \$300$  per week. If you wanted to sell your business, you might estimate it's worth a year's worth of your current earnings, so roughly  $\$300/\text{week} \times 52 \text{ weeks/year} = \$15,600$ .

This is a very basic approach and doesn't consider factors like growth potential (could you take on more clients?), your reputation (reliable walker attracts more clients), or recurring revenue (clients likely keep using you). A more thorough valuation would account for these aspects. These are simplified examples, but it highlights the essence of valuation: estimating what something is worth based on its current performance and its potential for future earnings.

## Trends in valuation practices

The world of business valuation is keeping up with the times, here are some of the trending practices:

- **ESG Matters More Than Ever:** Companies that prioritize Environmental, Social, and Governance (ESG) factors are attracting investor interest. These factors are increasingly considered in valuations, alongside traditional financial metrics.

- **Human Capital Takes Center Stage:** The focus is shifting to a company's workforce. Valuations now take into account factors like employee satisfaction, training programs, and overall company culture, recognizing a strong team as a valuable asset.
- **Tech is Here to Help:** The rise of artificial intelligence (AI) and machine learning algorithms are making valuations faster and potentially more accurate. These tools can analyze vast amounts of data to identify patterns and trends that might be missed by traditional methods.
- **Subscription Services Gaining Traction:** Subscription-based valuation services are emerging, allowing companies to access valuation tools at a fixed cost, making the process more accessible and cost-effective.
- **Intangibles Get Their Due:** Valuing intangible assets like intellectual property and brand reputation is getting more sophisticated. These assets can significantly impact a company's worth, and analysts are developing better methods to quantify their value.

"Valuation is more like an art than a science, but a very important art. Getting it right is critical to making sound investment decisions." - Benjamin Graham (famous investor) and author of "The Intelligent Investor"



## Valuation Key Concepts

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