

WHAT IS VALUATION?



Valuation is a process by which we can value the assets of a company. There are many methods to value a company. While valuing a company, an analyst looks at the company's management, capital structure, future earnings, and the market value of the assets.

Fundamental analysis is often used in valuation, while other methods can also be used such as **Capital Asset Pricing Model (CAPM)** or the **Dividend Discount Model (DDM)**.



Types of Valuation Models

#1. Absolute Valuation Models

- These models find the intrinsic value or "true value" of an investment based only on the fundamentals such as dividends, cash flow, and the growth rate of the company.
- This category includes Dividend Discount Model (DDM), Discounted Cash Flow Model (DCF), Residual Income Model, and Asset-based Model.



#2. Relative Valuation Models

- We compare the company that we are valuing with other similar companies (also called peer companies).
- In this model, we calculate multiples and ratios, such as the price-to-earnings (P/E) multiple, and comparing them to the multiples of other similar companies.



Types of Valuation Methods

#1. Comparables Methods

Look at similar companies, in size and industry, and how they trade to determine a fair value for a company or asset.

In investments, a comparables approach is similar to relative valuation



#2. Discounted Cash Flow Method

- This method can only be used if an asset generates cash flows.
- These cash flows are discounted using a discount rate (which is an assumption about interest rates or a minimum rate of return assumed by the investor) to get the current value of the asset.

#3. Precedent Transactions Method

- This method compares the company being valued other similar companies that have recently been sold.
- The comparison will work best if the companies are in the same industry/sector.
- This method is often used in M&A transactions.

How Earnings Affect Valuation?

- The earnings per share (EPS) is the indicator of company's profitability.
- Analysts also use price-to-earnings (P/E) ratio for stock valuation. The P/E ratio calculates how expensive a stock price is relative to the earnings produced per share.

For example, if the P/E ratio of a stock is 20 times earnings, an analyst compares that P/E ratio with other companies in the same industry/sector. In equity analysis, using ratios like the P/E to value a company is called a multiples-based, or multiples approach, valuation. Other multiples, such as EV/EBITDA, are compared with similar companies and historical multiples to calculate intrinsic value.



Limitations of Valuation

- Some valuation methods are fairly straightforward while others are somewhat complicated
- There is no one method that is best suited for every situation.
- Different valuation method will produce different values for the same underlying asset or company.

Conclusion

- Valuation is the process of determining the value of an asset or company.
- Valuation is important because it provides buyers with an idea of how much they should pay for an asset or company and for sellers, how much they should sell for.



Conclusion

- Valuation plays an important role in the M&A industry, as well as in regard to the growth of a company. There are many valuation methods, all of which come with their pros and cons.





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