HOW TO CHOOSE THE BEST STOCK VALUATION METHOD?

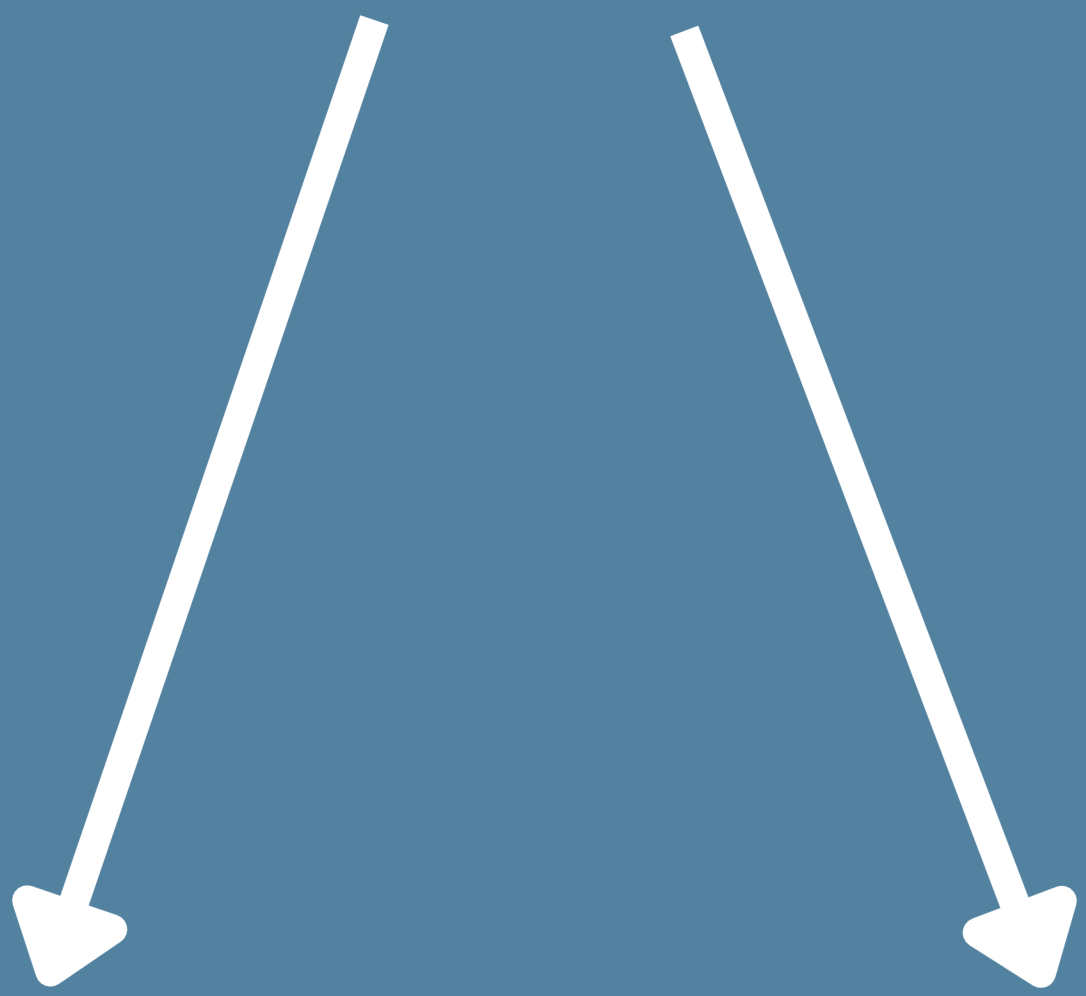
When deciding which valuation method to use to value a stock for the first time, it's easy to become overwhelmed by the number of valuation techniques available to investors.

There are fairly straightforward valuation methods, while others are more complicated.

Unfortunately, no method is best suited for every situation. Each stock is different, and each industry or sector has unique characteristics that may require multiple valuation methods.

Today, we'll explore the most common valuation methods and when to use them.

Categories of Valuation Models



Absolute Valuation

Relative Valuation

Absolute Valuation

Absolute valuation models attempt to find the intrinsic or "true" value of an investment based only on fundamentals.

Looking at fundamentals simply means you would only focus on such things as dividends, cash flow, and the growth rate for a single company—and not worry about any other companies.

Valuation models that fall into this category include the dividend discount model, discounted cash flow model, residual income model, and asset-based model.

Relative Valuation

Relative valuation models, on the other hand, operate by comparing the company in question to other similar companies. These methods involve calculating multiples and ratios, such as the price-to-earnings (P/E) ratio, and comparing them to the multiples of similar companies.

For example, if the P/E of a company is lower than the P/E of a comparable company, the original company might be considered undervalued.

Typically, the relative valuation model is a lot easier and quicker to calculate than the absolute valuation model, which is why many investors and analysts begin their analysis with this model.

Let's take a look at some of the more popular valuation methods available to investors, and see when it's appropriate to use each model.

Dividend Discount Model (DDM)

The dividend discount model (DDM) is one of the most basic of the absolute valuation models.

The dividend discount model calculates the "true" value of a firm based on the dividends the company pays its shareholders.

The justification for using dividends to value a company is that dividends represent the actual cash flows going to the shareholder, so valuing the present value of these cash flows should give you a value for how much the shares should be worth.

The first step is to determine if the company pays a dividend.

The second step is to determine whether the dividend is stable and predictable since it's not enough for the company to just pay a dividend. The companies that pay stable and predictable dividends are typically mature blue-chip companies in well-developed industries. These types of companies are often best suited for the DDM valuation model.

For instance, review the dividends and earnings of company XYZ below and determine if the DDM model would be appropriate for the company:

	2015	2016	2017	2018	2019	2020
Dividends Per Share	$0.50	$0.53	$0.55	$0.58	$0.61	$0.64
Earnings Per Share	$4.00	$4.20	$4.41	$4.63	$4.86	$5.11

In the above example, the earnings per share (EPS) is consistently growing at an average rate of 5%, and the dividends are also growing at the same rate.

The company's dividend is consistent with its earnings trend, which should make it easy to predict dividends for future periods. Also, you should check the payout ratio to make sure the ratio is consistent. In this case, the ratio is 0.125 for all six years, which makes this company an ideal candidate for the dividend discount model.

The Gordon Growth Model (GGM) is widely used to determine the intrinsic value of a stock based on a future series of dividends that grow at a constant rate. It is a popular and straightforward variant of a dividend discount model (DDM).

Discounted Cash Flow Model (DCF)

What if the company doesn't pay a dividend or its dividend pattern is irregular? In this case, check if the company fits the criteria to use the discounted cash flow (DCF) model.

Instead of looking at dividends, the DCF model uses a firm's discounted future cash flows to value the business.

The big advantage of this approach is that it can be used with a wide variety of firms that don't pay dividends, and even for companies that do pay dividends, such as company XYZ in the previous example.

The DCF model has several variations, but the most commonly used form is the Two-Stage DCF model. In this variation, the free cash flows are generally forecasted for five to 10 years, and then a terminal value is calculated to account for all the cash flows beyond the forecasted period.

The first requirement for using this model is for the company to have positive and predictable free cash flows. Based on this requirement alone, you will find that many small high-growth companies and non-mature firms will be excluded due to the large capital expenditures these companies typically encounter.

For example, let's take a look at the cash flows of the following firm:

	2015	2016	2017	2018	2019	2020
Operating Cash Flow	438	789	1462	890	2565	510
Capital Expenditures	785	995	1132	1256	2235	1546
Free Cash Flow	-347	-206	330	-366	330	-1036

In the above example, the firm has produced an increasing positive operating cash flow, which is good. However, you can see by the large amounts of capital expenditures that the company is still investing much of its cash back into the business in order to grow.

As a result, the company has negative free cash flows for four of the six years, which makes it extremely difficult or nearly impossible to predict the cash flows for the next five to 10 years.

To use the DCF model most effectively, the target company should generally have stable, positive, and predictable free cash flows. Companies that have the ideal cash flows suited for the DCF model are typically mature firms that are past the growth stages.

The Comparables Model

The last model is sort of a catch-all model that can be used if you are unable to value the company using any of the previous models, or if you simply don't want to spend the time crunching the numbers.

This model doesn't attempt to find an intrinsic value for the stock like the previous two valuation models.

Instead, it compares the stock's price multiples to a benchmark to determine if the stock is relatively undervalued or overvalued. The rationale for this is based on the Law of One Price, which states that two similar assets should sell for similar prices. The intuitive nature of this model is one of the reasons it is so popular.

The reason why the comparables model can be used in almost all circumstances is due to the vast number of multiples that can be used, such as the price-to-earnings (P/E), price-to-book (P/B), price-to-sales (P/S), price-to-cash flow (P/CF), and many others.

Of these ratios, the P/E ratio is the most commonly used because it focuses on the earnings of the company, which is one of the primary drivers of an investment's value.

When can you use the P/E multiple for a comparison?

1. You can typically use it if the company is publicly traded since you'll need both the stock price and the earnings of the company.
2. The company should be generating positive earnings because a comparison using a negative P/E multiple would be meaningless.
3. The earnings quality should be strong.

These are just some of the main criteria investors should look at when choosing which ratio or multiples to use. If the P/E multiple cannot be used, choose a different ratio, such as the price-to-sales or price-to-cash flow multiples.

Conclusion

No single valuation model fits every situation, but by knowing the characteristics of the company, you can select a valuation model that best suits the situation.

Additionally, investors are not limited to just using one model. Often, investors will perform several valuations to create a range of possible values or average all of the valuations into one.

With stock analysis, sometimes it's not a question of the right tool for the job but rather how many tools you employ to obtain varying insights from the numbers.

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