Key Valuation Methods

CS. Amar Kakaria *ACS, ACA, ACWA*
amar@fusionadvisors.in

Whether the capital markets are bearish or bullish, most of the investors generally face a common problem as to when to take position in a particular stock and when to exit so that they can maximize their profits. For that investors need to know the value of stock that they are going to deal. The value of the stock may be the current value or future value. Every investor likes to buy stock at a cheaper price and sell at a higher price than its actual value. However, the million dollar question is **"How to value a particular stock?"** Though, there are several methods of valuation, all of them need valuation of the business of company as a whole.

Business valuation is a process and a set of procedures used to determine the economic value of promoter's interest in the business. Various valuation tools and techniques used by financial experts to determine the price they are willing to pay or receive to consummate a sale of a business. In addition, these valuation tools are also used to resolve family disputes, Mergers & Acquisitions, and many other business and legal purposes. As observed in various recent capital market booms usually share prices peak during boom phase and subsequently crash once the sentiment changes which results into major losses for the investors. Investor can avoid such situation if they know how to value the stock. Some of the most popular methods of valuation are as below:

> Warren Buffet has rightly said – "Price is what you pay. Value is what you get."
>
> Valuation is a highly subjective concept. There are several methods of stock valuation. However it should be noted that valuation can never be constant. Some of the most popular methods of valuation are discussed in this article.

(1) **Discounted Cash Flow Method (DCF):** This is a widely used method to value the companies tracked by them. Estimated future cash flows of the company over a period of next 3-5 years are taken into consideration and further adjusted for time value of money. These cash flows are discounted by the weighted average cost of capital for that company in order to arrive at the present value of expected future cash flows. On dividing total cash flows by total number of issued shares, the investor can arrive at the intrinsic value of the stock as on date. If market price is lower than the intrinsic value then the stock is undervalued and vice-versa.

Despite complexities involved, DCF is considered to be most reliable method of arriving at the fair value after taking into account future performance of the organization.

(2) **Price Earnings Ratio (P/E Ratio):** It is one of the most popular methods used by retail investors to value the stock. It is calculated by dividing market price by Earnings per Share (EPS). Lower P/E ratio usually means that the stock is undervalued and there is a scope for appreciation in future. Every industry has a particular trend with respect to P/E ratio and hence, investors compare P/E ratio of companies in the same industry to decide whether a particular stock is undervalued or overvalued.

It may be noted that P/E ratio alone can not be used for decision making and investors should check quality of profits, sustainability and outstanding liabilities of the Company because P/E fails to cover the same before taking a final call.

(3) **Enterprise Value to Operating Profits (EV/EBITDA):** Enterprise Value (EV) is sum total of market capitalization and outstanding long term liabilities. Operating Profit means Earnings Before Interest, Taxes, Depreciation and Amortization. EV/EBITDA is a valuation multiple that is often used in parallel with, or as an alternative to, the P/E ratio. Typically, this ratio is applied while valuing cash-based businesses. An advantage of this multiple is that it is capital structure-neutral. Therefore, this multiple can be used for direct cross-companies application.

(4) **Enterprise Value to Sales Ratio (EV/Sales):** EV/Sales is calculated by dividing Enterprise Value by annualised sales of the Company. Generally, EV/Sales method is used for valuation of companies with lower profits / losses, but large turnover.

(5) **Sum of the Parts Valuation:** In case of diversified companies, instead of using only one valuation method, each of their businesses are valued separately using appropriate valuation methods and finally total of all businesses is considered for valuation of stock. Example: L&T, ICICI Bank, Mahindra & Mahindra, etc.

Valuation is highly subjective. Different people may have different perception of value for the same stock. Capital market move randomly at its own pace based on external factors like liquidity, general sentiments, economic scenario, Government Policies etc and internal factors like financial stability, productivity, innovation, risk management, diversification, compliances, etc. Hence, valuation can never be constant.