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By: Manan Sharma 0 10 May 2018, Thursday

Valuations

Recognition



A valuation can be defined as the process of estimating the fair market value or the intrinsic value of a company. After analysing the market value (the price at which a stock can be readily bought or sold in the current market place) and the intrinsic value (actual value of the stock based on its perceived true value), one can decide whether to buy, sell or hold a company's stock. If for a company:

- The market value is greater than the intrinsic value, one should sell
- The intrinsic value is greater than the market value, one should buy

principles:

It must be noted that all valuations, regardless of the method in use, have certain

- Valuation is time specific. The value of a business changes everyday and depends on various factors such as the cash flow, earnings, working capital which are always in a state of flux
- the present value of these future cash flows • Certain market forces dictate the rate of return which is used to calculate the

• Value depends on future cash flows. These are primarily done by calculating

- present value. These include the types of purchasers and general economic conditions • Liquidity affects the value of a company. With the increase in the liquidity of a
- the stockholders in case of a bankruptcy • Value is affected by underlying assets. This is primarily because with the increase in net assets, the likelihood of a company defaulting decreases since the

company, its value increases as well since these liquid assets act as a security for

liquidity is higher **Types of valuations**

Relative Valuations Models

particular company with other companies or a benchmark with the help of ratios like the Price-Earnings Ratio (P/E).

Such models do not estimate the exact value of the stock but instead compare a

In these models, the value of an asset is estimated keeping in mind just the

Absolute Valuation Models

characteristics of that particular asset and not comparable assets which are trading in the marketplace at that point of time. Examples are Discounted Cash Flow Valuations (DCF), Discounted Dividend Model etc.

These are models which estimate the present value of the predicted future cash

Discounted Cash Flow Models

flows of a company by discounting them by an appropriate rate. Usually the Weighted Average Cost of Capital (WACC) is used as the discount rate to arrive at the present value of the cash flows. The end purpose of such analysis is to estimate the amount of money an investor would recve from an investment. Such models usually take free cash flow into consideration.

proceeds from sale of assets)

These cash flows are projected for several years and then discounted to arrive at the

Free Cash Flow = Cash Flow from Operations-(Total Capital Expenditure-After Tax

valuation of the firm. One of the drawbacks of the model is that the valuation is only as good as the inputs which may be biased in nature and a small change in these inputs can make a large difference to the end value that the model arrives at.

These models assume that the shareholders of the firm are only entitled to

Discounted Dividend Models

dividends. It takes the perspective of the shareholder and assumes the purchase price of the share as negative cash outflow and then the dividends are assumed to be positive cash inflow. It uses these predicted dividends and discounts them to arrive at their present value. **Value of Stock** = Dividend per Share / (Discount Rate – Dividend Growth Rate)

However this model can't be applied for firms that don't pay out dividends.

Capital Asset Pricing Model The CAPM Model gives us a relationship between risk and expected return for

stocks. The model is used for the pricing of risky securities, estimating returns etc. The investment of a shareholder, according to the model, must be compensated in a dual manner: risk and time value of money. The investors take an additional risk and hence must get a return which is higher than the risk free rate. This higher return is given by the risk premium which is an amount of market return higher than the risk free rate.

Where:

Re = Rf + Ba*(Rm-Rf)

Re: This signifies the Expected Return of a capital asset over time. It is a long term

Rf: This signifies the Risk-free Rate (minimum return that an investor expects) and

assumption to estimate how an investment will behave over its entire life span.

can be calculated by observing government or treasury bonds.

additional risk due to the volatile nature of the investment.

Ba: This signifies Beta of the security which is a measure of the stock's volatility and

is reflected by measuring the fluctuation of its price changes relative to that of the

market. Rm-Rf: This signifies the risk premium that an investor should get for taking an

Conclusion

There are several other valuation methods too, apart from the ones that have been discussed and the eventual choice of the method to be used should be made after

considering the characteristics of the company and the industry. For instance, one can't use the Dividend Discount Model for a company that doesn't pay out dividends in the first place. Moreover, the valuation only aims to **estimate** the value of the stock of a company

and hence one can tweak these models or use more than one model to get an insight into the company and reach that estimated value.

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