OVERVIEW AND CONCLUSION

The problem in valuation is not that there are not enough models to value an asset, it is that there are too many. Choosing the right model to use in valuation is as critical to arriving at a reasonable value as understanding how to use the model. This chapter attempts to provide an overview of the valuation models introduced in this book and a general framework that can be used to pick the right model for any task.

**Choices in valuation models**

In the broadest possible terms, firms or assets can be valued in one of four ways – asset based valuation approaches where you estimate what the assets owned by a firm are worth currently, discounted cashflow valuation approaches that discount cashflows to arrive at a value of equity or the firm, relative valuation approaches that base value upon multiples and option pricing approaches that use contingent claim valuation. Within each of these approaches, there are further choices that help determine the final value.

There are at least two ways in which you can value a firm using *asset based valuation techniques*. One is liquidation value, where you consider what the market will be willing to pay for assets, if the assets were liquidated today. The other is replacement cost, where you evaluate how much it would cost you to replicate or replace the assets that a firm has in place today.

In the context of *discounted cashflow valuation*, cashflows to equity can be discounted at the cost of equity to arrive at a value of equity or cashflows to the firm can be discounted at the cost of capital to arrive at the value for the firm. The cashflows to equity themselves can be defined in the strictest sense as dividends or in a more expansive sense as free cashflows to equity. These models can be further categorized on the basis of assumptions about growth into stable growth, two-stage and three-stage models. Finally, the measurement of earnings and cashflows may be modified to match the special characteristics of the firm/asset - current earnings for firms/assets which have normal earnings or normalized earnings for firms/ assets whose current earnings may be distorted either by temporary factors or cyclical effects.

In the context of *multiples*, you can use either equity or firm value as your measure of value and relate it to a number of firm-specific variables – earnings, book value and sales. The multiples themselves can be estimated by using comparable firms in the same business or from cross-sectional regressions that use the broader universe. For
other assets, such as real estate, the price can similarly expressed as a function of gross income or per square foot of space. Here, the comparables would be other properties in the same locale with similar characteristics.

*Contingent claim models* can also be used in a variety of scenarios. When you consider the option that a firm has to delay making investment decisions, you can value a patent or an undeveloped natural resource reserve as an option. The option to expand may make young firms with potentially large markets trade at a premium on their discounted cashflow values. Finally, equity investors may derive value from the option to liquidate troubled firms with substantial debt.
Figure 35.1: The Choices in Valuation Models

Valuation Models

Asset Based Valuation
  - Liquidation Value
  - Replacement Cost

Discounted Cashflow Models
  - Stable
  - Two-stage
  - Three-stage or n-stage

Relative Valuation
  - Equity
  - Frmr
  - Normalized
  - Earnings
  - Book Value
  - Revenues
  - Sector specific

Contingent Claim Models
  - Option to delay
  - Option to expand
  - Option to liquidate
    - Young firms
    - Equity in troubled firm
    - Undeveloped land

Equity Valuation Models

Firm Valuation Models
  - Cost of capita approach
  - APV approach
  - Excess Return Models

Dividends

Free Cashflow to Firm
Which approach should you use?

The values that you obtain from the four approaches described above can be very different and deciding which one to use can be a critical step. This judgment, however, will depend upon several factors, some of which relate to the business being valued but many of which relate to you, as the analyst.

Asset or Business Characteristics

The approach that you use to value a business will depend upon how marketable its assets are, whether it generates cash flows and how unique it is in terms of its operations.

Marketability of Assets

Liquidation valuation and replacement cost valuation are easiest to do for firms that have assets that are separable and marketable. For instance, you can estimate the liquidation value for a real estate company because its properties can be sold individually and you can estimate the value of each property easily. The same can be said about a closed end mutual fund. At the other extreme, consider a brand name consumer product like Gillette. Its assets are not only intangible but difficult to separate out. For instance, you cannot separate the razor business easily from the shaving cream business and brand name value is inherent in both businesses.

You can also use this same analysis to see why the liquidation or replacement cost value of a high growth business may bear little resemblance to true value. Unlike assets in place, growth assets cannot be easily identified or sold.

Figure 35.2: Asset Marketability and Valuation Approaches

<table>
<thead>
<tr>
<th>Mature businesses</th>
<th>Growth businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separable &amp; marketable assets</td>
<td>Linked and non-marketable assets</td>
</tr>
</tbody>
</table>

| Liquidation & Replacement cost valuation | Other valuation models |

Cash Flow Generating Capacity

You can categorize assets into three groups based upon their capacity to generate cash flows – assets that are either generating cash flows currently or are expected to do so
in the near future, assets that are not generating cash flows currently but could in the future in the event of a contingency and assets that will never generate cash flows.

- The first group includes most publicly traded companies and these firms can be valued using discounted cash flow models. Note that we do not draw a distinction between negative and positive cash flows and young, start-up companies that generate negative cash flow can still be valued using discounted cash flow models.

- The second group includes assets such as drug patents, promising (but not viable) technology, undeveloped oil or mining reserves and undeveloped land. These assets may generate no cash flows currently and could generate large cash flows in the future but only under certain conditions – if the FDA approves the drug patent, if the technology becomes commercially viable, if oil prices and commercial property values go up. While you could estimate expected values using discounted cash flow models by assigning probabilities to these events, you will understate the value of the assets if you do so. You should value these assets using option pricing models.

- Assets that are never expected to generate cash flows include your primary residence, a baseball card collection or fine art. These assets can only be valued using relative valuation models.

Figure 35.3: Cash Flows and Valuation Approaches

<table>
<thead>
<tr>
<th>Cashflows currently or expected in near future</th>
<th>Cashflows if a contingency occurs</th>
<th>Assets that will never generate cashflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discounted cashflow or relative valuation models</td>
<td>Option pricing models</td>
<td>Relative valuation models</td>
</tr>
</tbody>
</table>

Uniqueness (or presence of comparables)

In a market where thousands of stocks are traded and tens of thousands of assets are bought and sold every day, it may be difficult to visualize an asset or business that is so unique that you cannot find comparable assets. On a continuum, though, some assets and businesses are part of a large group of similar assets, with no or very small differences across the assets. These assets are tailor-made for relative valuation, since
assembling comparable assets (businesses) and controlling for differences is simple. The further you move from this ideal, the less reliable is relative valuation. For businesses that are truly unique, discounted cash flow valuation will yield much better estimates of value.

**Figure 35.4: Uniqueness of Asset and Valuation Approaches**

Unique asset or business

- Large number of similar assets that are priced

Discounted cashflow or option pricing models

Relative valuation models

**Analyst Characteristics and Beliefs**

The valuation approach that you choose to use will depend upon your time horizon, the reason that you are doing the valuation in the first place and what you think about markets – whether they are efficient and if they are not, what form the inefficiency takes.

**Time Horizon**

At one extreme, in discounted cash flow valuation you consider a firm as a going concern that may last into perpetuity. At the other extreme, with liquidation valuation, you are estimating value on the assumption that the firm will cease operations today. With relative valuation and contingent claim valuation, you take an intermediate position between the two. Not surprisingly, then, you should be using discounted cash flow valuation, if you have a long time horizon, and relative valuation, if you have a shorter time horizon. This may explain why discounted cash flow valuation is more prevalent in valuing a firm for an acquisition and relative valuation is more common in equity research and portfolio management.
Reason for doing the valuation

Analysts value businesses for a number of reasons and the valuation approach used will vary depending upon the reason. If you are an equity research analyst following steel companies, your job description is simple. You are asked to find the most under and over valued companies in the sector and not to take a stand on whether the sector overall is under or over valued. You can see why multiples would be your weapon of choice when valuing companies. This effect is likely to be exaggerated if the way you are judged and rewarded is on a relative basis, i.e., your recommendations are compared to those made by other steel company analysts. If you are an individual investor setting money aside for retirement or a private businessperson valuing a business for purchase, on the other hand, you want to estimate intrinsic value. Consequently, discounted cash flow valuation is likely to be more appropriate for your needs.

Beliefs about Markets

Embedded in each approach are assumptions about markets and how they work or fail to work. With discounted cash flow valuation, you are assuming that market prices deviate from intrinsic value but that they correct themselves over long periods. With relative valuation, you are assuming that markets are on average right and that while individual firms in a sector or market may be mispriced, the sector or overall market is
fairly priced. With asset-based valuation models, you are assuming that the markets for real and financial assets can deviate and that you can take advantage of these differences. Finally, with option pricing models, you are assuming that markets are not very efficient at assessing the value of flexibility that firms have and that option pricing models will therefore give you an advantage. In each and every one of these cases, though, you are assuming that markets will eventually recognize their mistakes and correct them.

**Figure 35.7: Views on market and Valuation Approaches**

<table>
<thead>
<tr>
<th>Markets are correct on average but make mistakes on individual assets</th>
<th>Asset markets and financial markets may diverge</th>
<th>Markets make mistakes but correct them over time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative valuation</td>
<td>Liquidation value</td>
<td>Discounted Cashflow value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Option pricing models</td>
</tr>
</tbody>
</table>

**Bridging the Philosophical Divide**

Philosophically, there is a big gap between discounted cash flow valuation and relative valuation. In discounted cash flow valuation, we take a long term perspective, evaluate a firm’s fundamentals in detail and try to estimate a firm’s intrinsic value. In relative valuation, we assume that the market is right on average and estimate the value of a firm by looking at how similar firms are priced. There is something of value in both approaches and it would be useful if we could borrow the best features of relative valuation while doing discounted cash flow valuation or vice versa.

Assume that your instincts lead you to discounted cash flow valuation, but that you are expected, as an analyst, to be market neutral. You can stay market neutral in a discounted cash flow framework, if you use the implied risk premium for the market (which we described in Chapter 7) to estimate the cost of equity for the valuation. You can also bring in information about comparable firm margins and betas, when estimating fundamentals for your firm. Your estimate of intrinsic value will then be market-neutral and include information about comparables.

Alternatively, assume that you prefer relative valuation. Your analysis can carry the rigor of a discounted cash flow valuation, if you can bring in the details of the fundamentals into your comparisons. We attempted to do this in the chapters on relative
valuation by noting the link between multiples and fundamentals and also by examining how best to control for these differences in our analysis.

Choosing the Right Discounted Cash flow Model

The model used in valuation should be tailored to match the characteristics of the asset being valued. The unfortunate truth is that the reverse is often true. Time and resources are wasted trying to make assets fit a pre-specified valuation model, either because it is considered to be the 'best' model or because not enough thought goes into the process of model choice. There is no one 'best' model. The appropriate model to use in a particular setting will depend upon a number of the characteristics of the asset or firm being valued.

Choosing a cashflow to discount

With consistent assumptions about growth and leverage, you should get the same value for your equity using the firm approach (where you value the firm and subtract outstanding debt) and the equity approach (where you value equity directly). If this is the case, you might wonder why you would pick one approach over the other. The answer is purely pragmatic. For firms that have stable leverage, i.e., they have debt ratios that are not expected to change during the period of the valuation, there is little to choose between the models in terms of the inputs needed for valuation. You use a debt ratio to estimate free cashflows to equity in the equity valuation model and to estimate the cost of capital in the firm valuation model. Under these circumstances, you should stay with the model that you are more intuitively comfortable with.

For firms that have unstable leverage, i.e., they have too much or too little debt and want to move towards their optimal or target debt ratio during the period of the valuation, the firm valuation approach is much simpler to use because it does not require cashflow projections from interest and principal payments and is much less sensitive to errors in estimating leverage changes. The calculation of the cost of capital requires an estimate of the debt ratio, but the cost of capital itself does not change as much as a consequence of changing leverage as the cost of equity. If you prefer to work with assumptions about dollar debt rather than debt ratios, you can switch to the adjusted present value approach.
In valuing equity, you can discount dividends or free cashflows to equity. You should consider using the dividend discount model under the following circumstances.

- You cannot estimate cashflows with any degree of precision either because you have insufficient or contradictory information about debt payments and reinvestments or because you have trouble defining what comprises debt. This was our rationale for using dividend discount models for valuing financial service firms.
- There are significant restrictions on stock buybacks and other forms of cash return, and you have little or no control over what the management of a firm does with the cash. In this case, the only cashflows you can expect to get from your equity investment are the dividends that managers choose to pay out.

In all other cases, you will get much more realistic estimates of a firm’s value using the free cashflow to equity, which may be greater than or lower than the dividend.

**Should you use current or normalized earnings?**

In most valuations, we begin with the current financial statements of the firm and use the reported earnings in those statements as the base for projections. There are some firms, though, where you may not be able to do this, either because the firm’s earnings are negative or because these earnings are abnormally high or low - a firm’s earnings are abnormal if they do not fit in with the firm’s own history of earnings.

When earnings are negative or abnormal, you can sometimes replace current earnings with a normalized value, estimated by looking at the company’s history or industry averages and value the firm based upon these normalized earnings. This is the easiest route to follow if the causes for the negative or abnormal earnings are temporary or transitory, as in the following cases.

(a) A cyclical firm will generally report depressed earnings during an economic downturn and high earnings during an economic boom. Neither may capture properly the true earnings potential of the firm.
(b) A firm may report abnormally low earnings in a period during which it takes an extraordinary charge.
(c) A firm in the process of restructuring may report low earnings during the restructuring period, as the changes made to improve firm performance are put into effect. The presumption here is that earnings will quickly bounce back to normal levels and that little will be lost by assuming that it will occur immediately.
For some firms, though, the negative or low earnings may reflect factors that are unlikely to disappear quickly. There are at least three groups of firms where the negative earnings are likely to be a long term phenomena and may even threaten the firm’s survival.

a. Firms with long term operating, strategic or financial problems can have extended periods of negative or low earnings. If you replace current earnings with normalized earnings and value these firms, you will over value them.

- If a firm seems to be in a hopeless state, and likely to go bankrupt, the only models that are likely to provide meaningful measures of value are the option pricing model (if financial leverage is high) or a model based upon liquidation value.
- If on the other hand, the firm is troubled but unlikely to go bankrupt, you will have to nurse it back to financial health. In practical terms, you will have to adjust the operating margins over time to healthier levels and value the firm based upon its expected cash flows.

b. An infrastructure firm may report negative earnings in its initial periods of growth, not because it is unhealthy but because the investments it has made take time to pay off. The cashflows to the firm and equity are often also negative, because the capital expenditure needs for this type of firm tend to be disproportionately large relative to depreciation. For these firms to have value, capital expenditure has to drop once the infrastructure investments have been made and operating margins have to improve. The net result will be positive cashflows in future years and a value for the firm today.

c. Young start-up companies often report negative earnings early in their life cycles, as they concentrate on turning interesting ideas into commercial products. To value such companies, you have to assume a combination of high revenue growth and improving operating margins over time.

**Growth Patterns**

In general, when valuing a firm, you can assume that your firm is already in stable growth, assume a period of constant high growth and then drop the growth rate to stable growth (two-stage growth) or allow for a transition phase to get to stable growth (3-stage or n-stage models). There are several factors you should consider in making this judgment.
a. **Growth Momentum**

The choice of growth pattern will influence the level of current growth in earnings and revenues. You can categorize firms, based upon growth in recent periods, into three groups.

(a) Stable growth firms report earnings and revenues growing at or below the nominal growth rate in the economy that they operate in.

(b) Moderate growth firms report earnings and revenues growing at a rate moderately higher than the nominal growth rate in the economy – as a rule of thumb, we would consider any growth rate within 8-10% of the growth rate of the economy as a moderate growth rate.

(c) High growth firms report earnings and revenues growing at a rate much higher than the nominal growth rate in the economy.

For firms growing at the stable rate, the steady state models that assume constant growth provide good estimates of value. For firms growing at a 'moderate' rate, the two-stage discounted cashflow model should provide enough flexibility in terms of capturing changes in the underlying characteristics of the firm, while a three-stage or n-stage model may be needed to capture the longer transitions to stable growth that are inherent in 'high' growth rate firms.

b. **Source of growth (Barriers to entry)**

The higher expected growth for a firm can come from either 'general' competitive advantages acquired over time such as a brand name or reduced costs of production (from economies of scale) or 'specific' advantages that are the result of legal barriers to entry – such as licenses or product patents. The former are likely to erode over time as new competitors enter the market place, while the latter are more likely to disappear abruptly when the legal barrier to entry are removed. The expected growth rate for a firm that has specific sources of growth is likely to follow the two-stage process where growth is high for a certain period (for instance, the period of the patent) and drops abruptly to a stable rate after that. The expected growth rate for a firm that has 'general' sources of growth is more likely to decline gradually over time, as new competitors come in. The speed with which this competitive advantage is expected is a function of several factors, including:

a. **The nature of the competitive advantage:** Some competitive advantages, such as brand name in consumer products – seem to be more difficult to overcome and consequently are
likely to generate growth for longer periods. Other competitive advantages, such as a first-mover advantage, seem to erode much faster.

*b. Competence of the firm's management* - More competent management will be able to slow, though not stop, the loss of competitive advantage over time by creating strategies that find new markets to exploit the firm's current competitive advantage and new sources of competitive advantage.

c. *Ease of entry into the firm's business* -- The greater the barriers to industry in entering the firm's business, either because of capital requirements or technological factors, the slower will be the loss of competitive advantage.

These factors are summarized and presented in the Figure 35.8, with the appropriate discounted cashflow model highlighted for each combination of the factors.

### Status Quo versus Optimal Management

In the chapters on valuing acquisitions and troubled firms, we noted that the value of a firm can be substantially higher if you assume that it is optimally run than if it is run by incumbent management. A question that you are often faced with in valuation is whether you should value the firm with incumbent management or with the optimal management. The answer is simple in some cases and complicated in others.

- **If you are interested in acquiring the firm and intend to change the management, you should value the firm with the optimal management policies in place.** Whether you will pay that amount in the acquisition will depend upon your bargaining power and how long you think it will take you change the way the firm is run.

- **If you are a small investor looking at buying stock in the firm, you cannot change incumbent management yourself but you can still pay a premium if you believe that there is a possibility of change.** If there are strong mechanisms for corporate governance – hostile takeovers are common and poor managers get replaced quickly – you can assume that the value will quickly converge on the optimal value. If, on the other hand, it is difficult to dislodge incumbent management, you should value the firm based upon their continue stewardship of the firm.

- **If you are an institutional investor, you fall between these two extremes.** While you may not intend to take over the firm and change the way it is run, you could play a role in making this change happen.
Figure 35.8: Discounted Cashflow Models

Can you estimate cash flows?

Yes

- Is leverage stable or likely to change over time?
  - Stable leverage
    - FCFE
  - Unstable leverage
    - FCFF

No

- Use dividend discount model

Are the current earnings positive & normal?

Yes

- Use current earnings as base

No

- Is the cause temporary?
  - Replace current earnings with normalized earnings
  - Is the firm likely to survive?
    - Yes
      - Adjust margins over time to nurse firm to financial health
    - No
      - Does the firm have a lot of debt?
        - Yes
          - Value Equity as an option to liquidate
        - No
          - Estimate liquidation value

What rate is the firm growing at currently?

< Growth rate of economy
  - Stable growth model
  - Is the firm likely to survive?
    - Yes
      - 2-stage model
    - No
      - 3-stage or n-stage model

> Growth rate of economy
  - Are the firm's competitive advantages time limited?
  - Yes
  - No
Choosing the Right Relative Valuation Model

Many analysts choose to value assets using relative valuation models. In making this choice, two basic questions have to be answered -- Which multiple will be used in the valuation? Will this multiple be arrived at using the sector or the entire market?

Which multiple should I use?

In the chapters on multiples, we presented a variety of multiples. Some were based upon earnings, some on book value and some on revenues. For some multiples, we used current values and for others, we used forward or forecast values. Since the values you obtain are likely to be different using different multiples, deciding which multiple to use can make a big difference to your estimate of value. There are three ways you can answer this question – the first is to adopt the cynical view that you should use the multiple that reflects your biases, the second is to value your firm with different multiples and try to use all of the values that you obtain and the third is to pick the best multiple and base your valuation on it.

The Cynical View

You can always use the multiple that best fits your story. Thus, if you are trying to sell a company, you will use the multiple which gives you the highest value for your company. If you are buying the same company, you will choose the multiple that yields the lowest value. While this clearly crosses the line from analysis into manipulation, it is a more common practice than you might realize. Even if you never plan to employ this practice, you should consider ways in which how you can protect yourself from being victimized by it. First, you have to recognize that conceding the choice of multiple and comparables to an analyst is the equivalent of letting him or her write the rules of the game. You should play an active role in deciding which multiple should be used to value a company and what firms will be viewed as comparable firms. Second, when presented with a value based upon one multiple, you should always ask what the value would have been if an alternative multiple had been used.

The Bludgeon View

You can always value a company using a dozen or more multiples and then use all of the values, different thought they might be, in your final recommendation. There
are three ways in which can present the final estimate of value. The first is in terms of a range of values, with the lowest value that you obtained from a multiple being the lower end of the range and the highest value being the upper limit. The problem with this approach is that the range is usually so large that it becomes useless for any kind of decision-making. The second approach is a simple average of the values obtained from the different multiples. While this approach has the virtue of simplicity, it gives equal weight to the values from each multiple, even though some multiples may yield more precise answers than others. The third approach is a weighted average, with the weight on each value reflecting the precision of the estimate. This weight can either be a subjective one or a statistical measure – you can, for instance, use the standard error on a prediction from a regression.

The Best Multiple

While we realize that you might be reluctant to throw away any information, the best estimates of value are usually obtained by using the one multiple that is best suited for your firm. There are three ways in which you can find this multiple.

- *The Fundamentals approach:* You should consider using the variable that is most highly correlated with your firm’s value. For instance, current earnings and value are much more highly correlated in consumer product companies than in technology companies. Using price earnings ratios makes more sense for the former than for the latter.

- *The Statistical approach:* You could run regressions of each multiple against the fundamentals that we determined affected the value of the multiple in earlier chapters and use the R-squared of the regression as a measure of how well that multiple works in the sector. The multiple with the highest R-squared is the multiple that you can best explain using fundamentals and should be the multiple you use to value companies in that sector.

- *The Conventional Multiple approach:* Over time, we usually see a specific multiple become the most widely used one for a specific sector. For instance, price to sales ratios are most commonly used multiple to analyze retail companies. Table 35.1 summarizes the most widely used multiples by sector.

*Table 35.1: Most widely used Multiples by Sector*
<table>
<thead>
<tr>
<th>Sector</th>
<th>Multiple Used</th>
<th>Rationale/ Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyclical Manufacturing</td>
<td>PE, Relative PE</td>
<td>Often with normalized earnings.</td>
</tr>
<tr>
<td>High Tech, High Growth</td>
<td>PEG</td>
<td>Big differences in growth across firms make it difficult to compare PE ratios.</td>
</tr>
<tr>
<td>High Growth/Negative Earnings</td>
<td>PS, VS</td>
<td>Assume future margins will be positive.</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>V/EBITDA</td>
<td>Firms in sector have losses in early years and reported earnings can vary depending on depreciation method.</td>
</tr>
<tr>
<td>REIT</td>
<td>P/CF</td>
<td>Restrictions on investment policy and large depreciation charges make cashflows better measure than equity earnings.</td>
</tr>
<tr>
<td>Financial Services</td>
<td>PBV</td>
<td>Book value often marked to market.</td>
</tr>
<tr>
<td>Retailing</td>
<td>PS, VS</td>
<td>If leverage is similar across firms. If leverage is different.</td>
</tr>
</tbody>
</table>

In an ideal world, you should see all three approaches converge – the fundamental that best explains value should also have the highest R-squared and be the conventional multiple used in the sector. In fact, when the multiple in use conventionally does not reflect fundamentals, which can happen if the sector is in transition or evolving, you will get misleading estimates of value.

**Market or Sector Valuation**

In most relative valuations, you value a firm relative to other firms in the industry that the firm operates and attempt to answer a simple question: Given how other firms in the business (sector) are priced by the market, is this firm under or over valued? Within this approach, you can define comparable firms narrowly as being firms that not only operate in the business in which your firm operates but also look like your firm in terms of size or market served, or broadly in which case you will have far more comparable
firms. If you are attempting to control for differences across firms subjectively, you should stick with the narrower group. If, on the other hand, you plan to control for differences statistically – with a regression, for instance – you should go with the broader definition.

In the chapters on relative valuation, we presented an alternative approach to relative valuation, where we valued firms relative to the entire market. When we do this, we are not only using a much larger universe of questions, but asking a different question: Given how other firms in the market are priced, is this firm under or over valued? A firm can be under valued relative to its sector but overvalued relative to the market (or vice versa), if the entire sector is mispriced.

The approach you use for relative valuation will depend again upon what your task is defined to be. If you want to stay narrowly focused on your sector and make judgments on which stocks are under or over valued, you should stick with sector based relative valuation. If you have more leeway and are trying to find under or overvalued stocks across the market, you should look at the second approach – perhaps in addition to the first one.

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**Can a firm be under and over valued at the same time?**

If you value a firm using both discounted cash flow and relative valuation models, you may very well get different answers using the two – the firm may be under valued using relative valuation models but over valued using discounted cash flow models. What do we make of these differences and why do they occur? If a firm is overvalued using a discounted cash flow model and undervalued using relative valuation, it is usually an indication that the sector is over valued, relative to its fundamentals. For instance, in March 2000, we valued Amazon at $30 a share using a discounted cash flow model, when it was trading at $70 a share – it was clearly overvalued. At the same time, a comparison of Amazon to other dot com firms suggested that it was undervalued relative to these firms.

If a firm is undervalued using a discounted cashflow model and overvalued using relative valuation, it usually indicates that the sector is under valued. By March 2001, Amazon’s stock price had dropped to $15 but the values of other internet stocks dropped by almost 90%. In March 2001, a discounted cash flow valuation suggested that Amazon
was under valued but a relative valuation indicated that it was now over valued relative to the sector.

As an investor, you can use both discounted cash flow and relative valuation to value a company. Optimally, you would like to buy companies that are under valued using both approaches. That way, you benefit from market corrections both across time (which is the way you make money in discounted cash flow valuation) and across companies.

**When should you use the option pricing models?**

In the chapters on applying option pricing models to valuation, we presented a number of scenarios where option pricing may yield a premium on traditional discounted cash flow valuation. We do not intend to revisit those scenarios, but offer the following general propositions that you should keep in mind when using option pricing models.

- **Use Options sparingly:** Restrict your use of options to where they make the biggest difference in valuation. In general, options will affect value the most at smaller firms that derive the bulk of their value form assets that resemble options. Therefore, valuing patents as options to estimate firm value makes more sense for a small biotechnology firm than it does for a drug giant like Merck. While Merck may have dozens of patents, it derives much of its value from a portfolio of developed drugs and the cash flows they generate.

- **Opportunities are not always options:** You should be careful not to mistake opportunities for options. Analysts often see a firm with growth potential and assume that there must be valuable options embedded in the firm. For opportunities to become valuable options, you need some degree of exclusivity for the firm in question – this can come from legal restrictions on competition or a significant competitive edge.

- **Do not double count options:** All too often, analysts incorporate the effect of options on fundamentals in the company value and then proceed to add on premiums to reflect the same options. Consider, for instance, the undeveloped oil reserves owned by an oil company. While it is legitimate to value these reserves as options, you should not add this value to a discounted cashflow valuation of the
company, if your expected growth rate in the valuation is set higher because of the firm’s undeveloped reserves.

**Conclusion**

The analyst faced with the task of valuing a firm/asset or its equity has to choose among three different approaches -- discounted cashflow valuation, relative valuation and option pricing models; and within each approach, they must also choose among different models. These choices will be driven largely by the characteristics of the firm/asset being valued - the level of its earnings, its growth potential, the sources of earnings growth, the stability of its leverage and its dividend policy. Matching the valuation model to the asset or firm being valued is as important a part of valuation as understanding the models and having the right inputs.

Once you decide to go with one or another of these approaches, you have further choices to make – whether to use equity or firm valuation in the context of discounted cashflow valuation, which multiple you should use to value firms or equity and what type of option is embedded in a firm.