PRACTICAL APPLICATION OF MODERN APPROACHES TO BUSINESS VALUATION

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Every day, thousands of participants in the investment profession — investors, portfolio managers, regulators, researchers — face a common and often perplexing question: What is the value of a particular asset? The answers to this question usually determine success or failure in achieving investment objectives.

In general, the valuation process involves the following five steps:

Understanding the business. Industry and competitive analysis, together with an analysis of financial statements and other company disclosures, provides a basis for forecasting company performance.

Forecasting company performance. Forecasts of sales, earnings, dividends, and financial position (pro forma analysis) provide the inputs for most valuation models.

Selecting the appropriate valuation model. Depending on the characteristics of the company and the context of valuation, some valuation models will be more appropriate than others.

Converting forecasts to a valuation. Beyond mechanically obtaining the output of valuation models, estimating value involves judgment.

Applying the valuation conclusions. Depending on the purpose, an analyst may use the valuation conclusions to make an investment recommendation about a particular stock, provide an opinion about the price of a transaction, or evaluate the economic merits of a potential strategic investment.

Discounted cash flow (DCF) is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them (most often using the weighted average cost of capital, to arrive at a present value, which is then used to evaluate the potential for investment. If the value arrived at through DCF analysis is higher than the current cost of the investment, the opportunity may be a good one.

In simple terms, discounted cash flow tries to work out the value of a company today, based on projections of how much money it's going to make in the future. DCF analysis says that a company is worth all of the cash that it could make available to investors in the future. It is described as "discounted" cash flow because cash in the future is worth less than cash today.

DCF models are powerful, but they do have shortcomings. Small changes in inputs can result in large changes in the value of a company. Investors must constantly second-guess valuations; the inputs that produce these valuations are always changing and are susceptible to error. Meaningful valuations depend on the user's ability to make solid cash flow projections. While forecasting cash flows

more than a few years into the future is difficult, terminal value techniques are often used. Also, the DCF model focuses on long-range investing; it isn't suited for short-term investments.

Investors shouldn't base a decision to buy a stock solely on discounted cash flow analysis – it is a moving target, full of challenges. Any time expectations change, the DCF-generated value is going to change.

Even if one believes that DCF is the final word in assessing the value of an equity investment, it is very useful to supplement the approach with multiple-based target price approaches. If you are going to project income and cash flows, it is easy to use the supplementary approaches. It is important to assess which trading multiples (P/E, price/cash flow, etc.) are applicable based on the company's history and its sector. Choosing a target multiple range is where it gets tricky.

While this is analogous to arbitrary discount rate selection, by using a trailing earnings number two years out and an appropriate P/E multiple to calculate a target price, this will entail far fewer assumptions to "value" the stock than under the DCF scenario. This improves the reliability of the conclusion relative to the DCF approach. Because we know what a company's P/E or price/cash flow multiple is after every trade, we have a lot of historical data from which to assess the future multiple possibilities. In contrast, the DCF model discount rate is always theoretical, and we do not really have any historical data to draw from when calculating it.

Although technical analysis and fundamental analysis are seen by many analysts as polar opposites – the oil and water of investing – we believe the best way is to combine both types of analysis. You do not need to choose one approach over the other. To be honest, neither one is superior to the other.

Technical analysis is a method of evaluating securities by analyzing the statistics generated by market activity. Unlike fundamental analysts, technical analysts don’t care whether a stock is undervalued – the only thing that matters is a security's past trading data and what information this data can provide about where the security might move in the future.

The field of technical analysis is based on three assumptions:

1) the market discounts everything;

2) price moves in trends;

3) history tends to repeat itself.

Technical analysis employs models and trading rules based on price and volume transformations, such as the relative strength index, moving averages, regressions, inter-market and intra-market price correlations, business cycles, stock market cycles or, classically, through recognition of chart patterns.

That's why using fundamental analysis (DCF & peers analysis) to select healthy companies and technical analysis as a timing tool can be well utilised if you know what to look for.

Економічні проблеми сталого розвитку : матеріали Міжнародної науково-практичної конференції, присвяченої пам'яті проф. Балацького О.Ф., м. Суми, 24-26 квітня 2013 р. / За заг. ред. О.В. Прокопенко. — Суми : СумДУ, 2013. — Т.2. — С. 213-215.