VALUATION

On Price and Value

Warren Buffett, a well-known investor, states in reference to Benjamin Graham, also known for creating the concept of value investing, that price is what you pay and value is what you get.

One of the biggest mistakes made is mixing up pricing with valuation: When comparing a company with another for valuation purposes – for example, by applying stock market multiples - one is pricing a company. Pricing can be defined as the willingness to pay. It is driven by the market.

Valuation, on the other hand, starts with a corporate analysis and reaches out to understanding the fundamentals of a business, a company, an industry. Valuation assesses how much a business is worth and is therefore linked with aspects such as the yield or payback period of an investment. One also refers in this context to an "intrinsic value" of an asset.

Both approaches have their merits: Valuation is a highly analytical approach, a component of an in-depth due diligence process, in the course of which the analyst is challenged to formulate "right questions". Elements such as strategy, expected market dynamics, anticipated competitive behavior are integrative components of a valuation process, often requiring the translation of qualitative features into numbers.

A pricing process, on the other hand, is driven by individuals, institutions or firms intending to acquire an asset. Price drivers are therefore – among others - mood, momentum, levels of information or the liquidity of an asset within a market. Pricing is a part of an intended transaction. Thereby it makes a difference whether such transaction takes place in a relatively transparent environment, such as when acquiring shares in the stock market, or under strict confidentiality and discretion, such as when a private firm acquires another one. Hence, the chosen type of the selling process can have a major impact on the price agreed upon. A sale process can at times push a price far away from a fundamental value.

For example: There is a good reason that initial public offerings tend to rely on a "good story". This story shall differentiate the stock to be sold vis-à-vis (perceived) peer companies, and it shall be consistent over time. This story is the major anchor in pricing the asset, not least as a fundamental valuation is driven by components, such as future expected cash flows, most of which are in a far, distant future with their respective long-term growth rates also highly uncertain.

An obvious constellation where price and value may widely diverge, concern early stage, start-up companies: Most start-ups will not generate cash flows any time soon, so any value creation will be – if at all – happen in a distant future. Besides, the vast majority of start-ups are expected to have disappeared within a period of one to two years. Investors, such as venture capitalists, therefore accommodate their investment assessment by focusing on the most valuable asset of a start-up: The management team and its anticipated skills to grow the firm, a highly qualitative aspect. – When the founders of the start-up and a venture capital investor bargain on a price in a fund raising process, such will almost certainly have nothing to do with a fundamental valuation approach.

Also, we may observe periods when particular industries or stocks are in fashion, with demand vastly outpacing supply. Naturally, corporate issuers may be tempted to exploit such moments by selling shares, sometimes for excessively inflated prices. In the long-term, though, investors who have fared badly with an initial investment will probably remember and sooner than anticipated the stock may be out of fashion again. – Having said this, fashions or bubbles as well as shake-outs and price corrections are essential elements of markets finding a balance and of new technologies succeeding and eventually maturing.

PRICE		VALUE
WILLINGNESS TO PAY	PERSPECTIVE	INVESTMENT RETURN, YIELD
FUNDAMENTALS CASH FLOWS, GROWTH	DRIVERS	MOOD, MOMENTUM INFORMATION LIQUIDITY
MULTIPLES COMPS CHARTS	APPROACH	DCF