

On Price and Value

Warren Buffett, a well-known investor, stated in reference to Benjamin Graham, known for his concept of value investing that: Price is what you pay. Whilst 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, on the basis of 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 aims to understand the fundamentals of a business, a company, an industry. Valuation assesses how much a business is worth: Therefore, valuation focuses on aspects such as the yield or the payback period of an investment. In this context, one also refers to the “intrinsic value” of an asset.

Both approaches have their merits: Valuation is a highly analytical approach and one of the elements of an in-depth due diligence process, in the course of which an analyst or investor is to come up with critical, “right” questions. Aspects such as strategy, expected market dynamics, anticipated competitive behavior are integrative components of a valuation process, often requiring the translation of qualitative elements into numbers.

A pricing process, on the other hand, is driven by individuals, institutions or firms following their respective intentions to acquire an asset. Price drivers are therefore – among others – the players’ 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 (e.g. acquiring shares in the stock market) or under strict confidentiality and discretion (e.g. a private firm acquiring another one). Hence, the chosen type of the selling process can have a major impact on the eventual price agreed upon. Whereby, a sale process

can at times push a price far away from a fundamental value.

For example, when going public with a corporate first time, a “good story” is key: This shall differentiate the new stock vis-à-vis (perceived, already listed) peer companies, be unique, credible and consistent. Therefore, the story (e.g. anticipated growth, quality of management, brand awareness) will serve as an important anchor in pricing the asset (ideally, at a premium). This is not least also due to most fundamental valuation approaches being driven by components, such as future expected cash flows, most of which are anticipated to materialize only in a far, distant future with respective long-term growth rates equally uncertain.

A constellation where price and value often widely diverge, concerns, for instance, early-stage companies: Such will not generate cash flows any time soon. And any value creation – if ever at all – lies in a far away, distant future. As a matter of fact, the vast majority of startups disappears within a period of one to two years. – Therefore, investors, such as venture capital funds, focus their assessment on a startup’s most valuable, qualitative asset: The management team and its anticipated skills to grow the firm. – Once the startup’s founders and an investor bargain on price during a round of fund raising, the eventual price agreed will almost certainly have not much to do with a fundamental valuation approach.

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

PRICE

WILLINGNESS
TO PAY

PERSPECTIVE

VALUE

INVESTMENT
RETURN, YIELD

FUNDAMENTALS
CASH FLOWS, GROWTH

DRIVERS

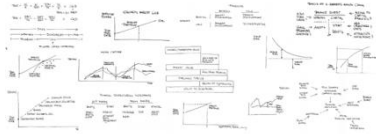
MOOD, MOMENTUM
INFORMATION,
LIQUIDITY

MULTIPLES
CHARTS

APPROACH

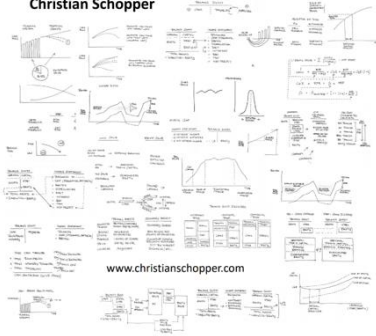
DISCOUNTED
CASH FLOW (DCF)

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