Price and Value

Warren Buffett, a legendary investor, remarked in reference to Benjamin Graham, known for his concept of value investing: Price is what you pay, whilst value is what you get.

Hence, it is a mistake mixing up pricing with valuation: When comparing a company with another one for “valuation purposes” –, for example on the basis of trading multiples - one is actually 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 thorough analysis of a corporate. It is driven by the idea to understand the fundamentals of a business, a company, an industry, which provide the basis to estimate how much a business may be worth (i.e. intrinsic value): Among others, valuation assesses the feasibility of an investment by focusing on its yield or its payback period.

Both approaches have their merits: Valuation is a highly analytical approach and a core element of any due diligence process. Aspects such as strategy, expected market dynamics, anticipated competitive behavior are – among others - integrative components of a valuation process, frequently requiring qualitative features be translated into numerical figures.

Pricing, on the other hand, is a process driven by individuals, institutions or firms following their respective intentions to acquire an asset. Price drivers are therefore – among others – involved players´ mood, market momentum, levels of information or the liquidity of an asset. Pricing is a part of an intended transaction: Whereby it does make 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 its eventual outcome: the price agreed upon. – As a matter of fact, at times sales processes can push prices far away from fundamental values.

For instance, as a corporate goes public the first time, then a “good story” is key: Its core features 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 fact that most fundamental valuation approaches are forward looking: Based on drivers, such as future expected cash flows, such may (or may not) materialize in some far, distant future with long-term growth rates often more than uncertain.

Constellation where price and value may widely diverge can be found in assessing investments in early-stage companies: In most cases, such firms will hardly generate meaningful cash flows any time soon. And, should they ever create value, then this will be in distant future. As a matter of fact, the vast majority of startups simply vanishes in the first one or two years. – This is why venture capital funds foremost 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 not have much to do with any 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 this dynamics by selling shares, often at excessively inflated levels. In the long-term, though, investors who have fared badly when making 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 characteristics of markets finding a balance with (only) some inventions, innovative technologies and applications eventually succeeding and maturing.

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PRICE		VALUE
WILLINGNESS TO PAY	PERSPECTIVE	INVESTMENT, RETURN, YIELD
DEMAND | SUPPLY MOOD, MOMENTUM, GROUP THINKING INFORMATION, STORIES LIQUIDITY	DRIVERS	FUNDAMENTALS CASH FLOWS, GROWTH, RISK
MULTIPLES | COMPS CHARTS TECHNICAL ANALYSIS	TOOLS	DISCOUNTED CASH FLOW (DCF) FINANCIAL RATIOS

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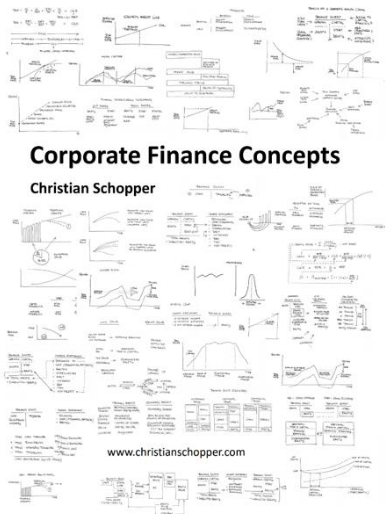

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