Valuation

Valuation is an important and interesting part of this course.

There are 3 ways to think about valuation. They are:

- Discounted Cash Flow (DCF) valuation,
- Multiples or Comparables valuation,
- Option valuation.

All assets including debt, equity and real estate can be valued using these techniques.

Note that an asset has just one price but many valuations by all of the different buyers and sellers. The price is actually the intersection of the supply and demand curves for the asset.

The demand and supply curves are constructed using the buyers' and sellers' valuations respectively.

DCF is also called 'net present value' or 'discounted expected value'. Arguably DCF is the most important and multiples and option valuation are just variations of the same theme.

DCF has 3 main parts: the formulas, the cash flows and the required returns.

DCF Valuation Overview

- Same as Net Present Value (NPV) of cash flows.
- Preferred when future cash flows are predictable and the required return can be easily calculated.
- Debt securities, real estate with stable rental income and stable low-growth stocks are suitable for DCF valuation.
- More of an absolute or intrinsic valuation technique, as opposed to a relative valuation technique.
- Solid mathematical foundation and theory, favoured by academics.

Multiples Valuation Overview

- Relative valuation technique. Prices assets using the prices of other, similar assets.
- Many different types of multiples can be used.
- Simple, intuitive, based on real-world prices.
- Preferred when future cash flows are unpredictable, and when there are many similar assets that are frequently traded at observable prices, such as stocks trading on a stock exchange.
- Real estate and stocks are suitable for multiples valuation.