



## Equity Valuations

Before investing, it is important to understand the value of a stock and whether it is worth your investment. The stock's value is the price that you are willing to pay for part ownership of a company. Equity valuation is a methodology which is utilised for deriving the fair value of a firm or its equity stock. If the estimated value:

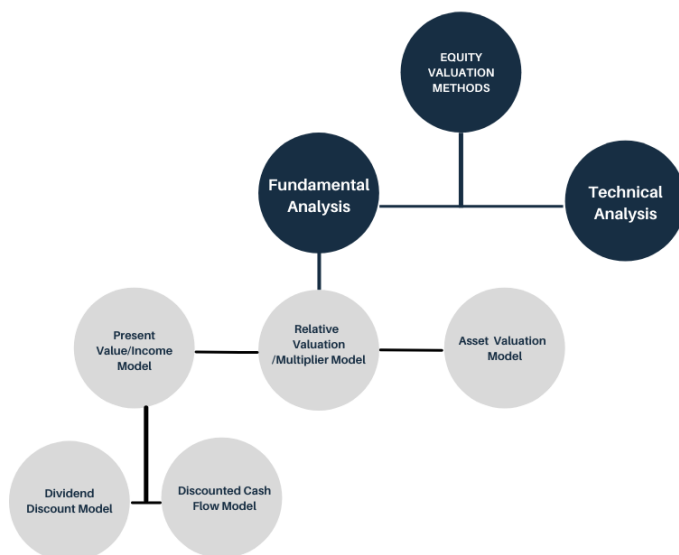
- exceeds the market price, the analyst infers the security is *undervalued*.
- equals the market price, the analyst infers the security is *fairly valued*.
- is less than the market price, the analyst infers the security is *overvalued*.

Financial analysts conduct two main types of analysis when evaluating equity investment decisions: technical analysis and fundamental analysis (see Equity Valuation Methods diagram below).

Technical analysis aims to determine the value of the equity based on its past performance. Utilising historical data, such as the equity's price movement and volume of trading, an analyst calculates statistical trends to predict future movements.

On the other hand, the fundamental analysis method attempts to find the fair market or 'intrinsic' value of the equity, by examining related economic and financial factors. It involves a study of the assets earning potential, future cash flows, magnitude, and the probability of dividend payments.

*Equity Valuation Methods*



‘intrinsic’ value of the equity, by examining related economic and financial factors. It involves a study of the assets earning potential, future cash flows, magnitude, and the probability of dividend payments.

There are three major categories of fundamental equity valuation methods: present value models, relative valuation or earnings multiples models and asset-based valuation models.

## **Present Value/Income Models**

Present Value, or Income, models estimate a stock's value based on the present value of expected future benefits. These models include the dividend discount model and the discounted cash flow model.

### Dividend Discount Model

The dividend discount model calculates the value of the equity based on the dividends the company pays its shareholders. Dividends represent the actual cash flows going to the shareholder, as such determining the present value of these dividends will give a value for the stock's price. This model can be utilised if a company pays dividends that are stable and predictable with its earnings trend, which are typically those that are mature or in well-developed industries.

### Discounted Cash Flow Model

One problem with dividend discount models is that not all companies pay dividends or pay them regularly. Some highly valuable companies do not pay dividends to their shareholders but instead reinvests this money back in their businesses. Therefore, dividends paid do not appropriately reflect the true capacity of these businesses. For such companies, an alternative to dividend discount model is the discounted free cash flow (DCF) model.

While the DCF model has several variations, the most commonly used form is the Two-Stage DCF model. In this variation, the free cash flows are generally forecasted for five to ten years, and then a terminal value is calculated to account for all the cash flows beyond the forecasted period.

Companies that are mature can utilise the DCF model to value their equities as they have stable, positive, and predictable free cash flows. However, this model will not apply to small high-growth companies and non-mature firms, due to the large capital expenditures these companies typically encounter.

## **Relative Valuation/ Multiplier Models**

Relative valuation or multiplier models estimate an intrinsic value based on a multiple of some fundamental variable. The term 'multiplier' refers to indicators or ratios that can be used to value a stock. These ratios are calculated by dividing the market or estimated value of an asset by a specific item on the financial statements, for example the Price-to-Earnings (P/E) or Price to Sales ratios.

To derive the value of the equity, an analyst assumes that a particular ratio can be applied to and compared among various companies operating within the same line of business or industry. As such, if the P/E ratio of a company is lower than the P/E ratio of a comparable company, the former might be considered undervalued. It is important, therefore, to understand that factors such as the nature and volume of the business, industry, size, financial conditions can impact the selection of comparable companies.

## Asset- based valuation Model

Asset-based valuation model is based on the value of the company's assets and liabilities which also includes intangible assets and contingent liabilities. To determine if a stock is fairly valued, we compare its net asset value per share with its market price per share. This approach may be especially useful to manufacturers or distributors, where a huge volume of capital assets is used. Using this model, the company's net assets value is divided by the number of shares to arrive at the value of each share. It should be noted that when determining the net value of assets, all external liabilities should be deducted from the total asset value of the company.

$$\text{Value per share} = (\text{Net Assets} - \text{Preference Share Capital}) / (\text{No. of Equity Shares})$$

There is no one method or model best suited for every situation. Each stock is unique, and each industry has varying characteristics that may require multiple valuation methods. Whichever method is selected, the Trinidad and Tobago Securities and Exchange Commission (TTSEC) aims to ensure that it will reflect the true and fair value of the equity, so that investors can make the best investment decisions.

END

For more information on the securities market and the role and functions of the TTSEC, please visit our corporate website at [www.ttsec.org.tt](http://www.ttsec.org.tt). To become a smart investor, [download our IPA via the Google Play and Apple Stores](#). You can also take the investor education online course on our investor education website, [www.InvestUcateTT.com](http://www.InvestUcateTT.com), and test your knowledge in our interactive investing game InvestorQuestTT at [www.InvestorQuest-tt.com](http://www.InvestorQuest-tt.com), and remember, to connect with us via Facebook; Twitter, Instagram, LinkedIn or You Tube.



**Published Article – Business Express Newspaper**

May 11<sup>th</sup>, 2022