

Version 2 valuation

Business



The manner in which companies are valued by analyst and the way managers can be affected by psychological, heuristics, and framing factors are discussed by Shefrin in Chapter two. This paper will concentrate on what is being accomplished by Shefrin, specifically in chapter two on valuation.

Thus, this paper aims at preparing and submitting the lecture notes that are required, together with the necessary examples and computations.

Furthermore, the numerical examples depicted in the chapter will be encompassed in the presentation, so as to enable attendees better comprehend the points that are being portrayed. Typically, valuation concentrates on the formula $PV = C / (-g + r)$ whereby, C refers to first-payment; g is the growth rate of future payments; and r is the discount rate.

Valuation is of necessity because it will help attendees to comprehend the following: understand why a number of monetary executives/analysts heavily depend on the valuation heuristics other than textbook techniques, which accentuate intrinsic value; depict the major heuristics that are mainly used by analyst/monetary executives to compute values; spot the prejudices that are likely to occur due to the usage of valuation heuristics; and spot prejudices that are likely to occur due to the usage of textbook techniques that are traditional, and which accentuate intrinsic value. Basically, the majority of analyst as well as monetary executives heavily depend on valuation heuristics other than textbook techniques.

This is due to the fact that textbook techniques are on the basis of calculating the intrinsic value. As a matter of fact, it is easier to use heuristics because they require fewer variables. Nonetheless, simpler formulas are involved in them and to that effect, they an instinctive appeal.

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On the other hand, textbook techniques require more details, are less instinctive, and involve formulas that are more complicated (Montier, 2002). Also, the FEI (financial executives international) is mainly published by the monetary executive and thus rely on valuation heuristic techniques, such as: price to sales; P/E; and PEG.

These techniques can either correspond to textbook book techniques, such as non-DCF (discounted cash flow) heuristics, or the DFC approach.

Idyllically, the major heuristics that monetary executives/security analyst employ in computing values are: a) P/E Heuristic This is a valuation approach that is on the basis of getting the product of an earnings-forecast and the P/E ratio. The P_0/E_1 is a forward P/E that denotes the current price and the earnings-per-share for the subsequent year. This heuristic is normally relied on by Security analyst. To get the valuation identity, we apply the following $P_0 = P_0/E_1 \times E_1$. To estimate, the price, P_1 , the following relationship should be applied: $P_1 = P_1/E_2 \times E_2$ b) PEG Heuristic This is a valuation approach that is on the basis of getting the product of earnings-forecast PEG ratio, and the predicted rate of growth.

Supremely, the formula used to compute the valuation identity is $P_0 = E \times G \times PEG$, whereby G is 100 times the rate of growth. In this kind of heuristic, we can employ the PEG heuristic to predict Price, P_1 . To do this, one has to predict the earnings-per-share, PEG ratio, and the rate of growth that will be applicable to the predicted period. c) Price to Sales Heuristic This is a valuation approach that is on the basis of getting the product of the sales forecast and the ratio of price to sales. The structure of this heuristic is similar to that of P/E heuristic, but with exception of substituting future sales

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with future earnings. To compute the valuation density, the formula that is used is $P_0 = P_0/S_1 \times S_1$, whereby S represents sales. components in Meeker's Target-Price Critique of eBay Table source: Pitz Brian and Meeker Mary, Report Analyst on eBay, 2003 As illustrated in the table above, a CDF approach was used by Meeker Mary, who then applied it to the free cash-flows of eBay. For instance, this calculation is closer to the textbook technique and it the only one that is used in deriving the target-price, particularly the intrinsic value. In this circumstance, the perpetuity formula is usually effective. By using valuation heuristics, a number of biases are likely to occur. This is also true when it comes to using textbook techniques that accentuate intrinsic value (Petty, & Martin, 2000).

Ideally, the majority of analysts normally favor the P/E heuristic approach. From the above table the P/E target price ranged from 74 to 111. The estimate for the base was 84, a value below the 2003 price and thus it is likely to generate a negative return. Superlatively, a more negative value is generated by the PEG heuristic and thus, it is deemed to be worse. The DCF approach computation is the only method that is capable of measuring the intrinsic value. In conclusion, the manner in which information is described (i. e. framing) is an aspect that is vital. For instance, Meeker Mary framed a critique of the free cash-flow in terms of free cash-flow sources, but not the applications of the free cash-flow. In view of the fact that cash flow applications are vital in valuation analysis, the cash flow applications are not salient in Meeker's critique. Thus, we can say that the main cause of valuation bias is misframing. However, bias can also be caused by the growth opportunities.