Valuation

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What is a Valuation

Valuation is the process of determining the current worth of an asset or a company. There are many techniques used for doing a valuation. An analyst placing a value on a company looks at the business's management, the composition of its capital structure, the prospect of future earnings, and the market value of its assets.

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BREAKING DOWN Valuation

A valuation can be useful when trying to determine the fair value of a security, which is determined by what a buyer is willing to pay a seller, assuming both parties enter the transaction willingly. When a security trades on an exchange, buyers and sellers determine the market value of a stock or bond. The concept of intrinsic value, however, refers to the perceived value of a security based on future earnings or some other company attribute unrelated to the market price of a security. That's where valuation comes into play. Analysts do a valuation to determine whether a company or asset is overvalued or undervalued by the market.

How Earnings Affect Valuation

The earnings per share (EPS) formula is stated as earnings available to common shareholders divided by the number of common stock shares outstanding. EPS is an indicator of company profit because the more earnings a company can generate per share, the more valuable each share is to investors. Analysts also use the price-to-earnings (P/E) ratio for stock valuation, which is calculated as market price per share divided by EPS. The P/E ratio calculates how expensive a stock price is relative to the earnings produced per share.

For example, if the P/E ratio of a stock is 20 times earnings, an analyst compares that P/E ratio with other companies in the same industry and with the ratio for the broader market. In equity analysis, using ratios like the P/E to value a company is called a multiples-based, or multiples approach, valuation. Other multiples, such as EV/EBITDA, are compared with similar companies and historical multiples to calculate intrinsic value.

Discounted Cash Flow Valuation