What is Absolute or Intrinsic Valuation?

What is Absolute or Intrinsic Valuation?

- When discussing valuation it is important to understand what is meant by Absolute or Intrinsic valuation
- This is in contrast to Relative valuation which we shall discuss next

What is Absolute or Intrinsic Valuation?

- The Absolute or Intrinsic approach uses the future cash flows of a business or an asset discounted to the present day to calculate its value
  - Discounted Cash Flow Model
  - Dividend Discount Model

What is Absolute or Intrinsic Valuation?

- Another way of looking at it is to ask;
- What price is a rational investor willing to pay for an investment, given its level of risk?
- This is very much the approach taken by Benjamin Graham in his book The Intelligent Investor and so successfully adopted by the "Sage of Omaha", Warren Buffet

What is Absolute or Intrinsic Valuation?

- The method attempts to evaluate the probability or the "risk" that a future cash flow will be delivered
- If we are investing in a US Government Bond or a UK Gilt, we regard the risk as very low - hence this forms the basis for the "Risk Free Rate"

What is Absolute or Intrinsic Valuation?

- As we will see the "Discount Rate" comprises a number of elements
  - Risk Free Rate
  - Market Risk Premium
  - Beta
- We also have to make assumptions in our modelling to create the forecast cash flows

What is Absolute or Intrinsic Valuation?

- Finally we will need to calculate a Terminal Value, which can be a substantial portion of the total value
- This is done in one of two ways
  - Perpetual Growth
  - Transaction Multiple

What is Absolute or Intrinsic Valuation?

- While the method appears to deliver a "value" or a "value range", we cannot escape the fact that the entire method is highly subjective as it is based on so many variables and assumptions

What is Absolute or Intrinsic Valuation?

- This approach focuses on the company in isolation and does not take into account market forces or competitors
- External forces such as new technology, disruptive innovations, transformative M&A transactions can materially affect the value of a business, without materially affecting its short to medium term cash flows

What is Absolute or Intrinsic Valuation?

- This approach focuses on the company in isolation and does not take into account market forces or competitors
- External forces such as new technology, disruptive innovations, transformative M&A transactions can materially affect the value of a business, without materially affecting its short to medium term cash flows

What is Absolute or Intrinsic Valuation?