RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

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Types of Equity Valuation Models

There are the following of Equity Valuation Models:

- Discount Models
- Multiplier Models
- Asset-based Models

Discount Models

- The discounted cash flow models, determine the value of a stock by calculating the present value of expected cash flows. These cash flows are of two types: expected cash flow to shareholders (dividend discount models), and the free cash flow to equity.

Multiplier Models

- The multiplier models determine the value of a company by analyzing and comparing the company's financial ratios. **For example**, a popular multiple is the price-earnings ratio. Other commonly used multiples are sales, book value, and cash flow per share.
- There are other multiples, which are based on the enterprise value (EV), for example, EV/EBITDA, EV/EBIT, and EV/ Unlevered free cash flow (UFCF). These multiples are commonly used for valuing private firms.
- Enterprise value, also called the firm value, is an economic measure that reflects the market value of the business. It includes claims to all security-holders, including equity, debt.

Asset-based Models

- Asset-based models determine the fair value of a stock by calculating the value of the firm's assets and subtracting the value of its liabilities and preferred stock. Since the firm's assets and liabilities will be at book value, the analysts will adjust these values to their fair value.

What Is Fundamental Analysis?

- Fundamental analysis focuses on a company's financial and market position, growth prospects, and financial performance. The concept considers all the economic factors involved in equity valuation. It looks at both financial statements and the company's market position and the political or economic climate to help investors make long-term decisions. Usually, stocks are bought when a price falls below the share's estimated intrinsic value, and then it is held for a longer time.

Assumption of Fundamental Analysis

Fundamental analysis works off two central assumptions:

- The price of a given stock will eventually correct to its intrinsic value.
- Buying an undervalued stock and holding it for long enough should earn returns as the share price converges to its intrinsic value.

What Is Technical Analysis?

- Technical analysis is a more short-term approach to investing. The concept analyzes charts, past stock pricing and volume data, and examines historical data to find patterns in an attempt to predict future trends. It is the analysis of a company’s technical indicators such as price movements and trading volume metrics, a business’s strength relative to its peers in the same sector/overall market, and other similar indices. Technical analysis is used for short-term trading rather than long-term investing and applies concepts such as the Dow Theory and trend following to determine what to buy and sell.

Golden Rules of Technical Analysis

- Rule 1: Stock prices reflect everything that has and might affect a company. All the information an investor needs is reflected in the market price.
- Rule 2: Movements in pricing are not random. Stock prices move in trends, don’t fight them.
- Rule 3: Price patterns always repeat—given enough time. The repetitive nature of price movements is down to market psychology: Investors are consistent in their reactions.