Equity Valuation

Models from Leading Investment Banks

Edited by

Jan Viebig
Thorsten Poddig
and
Armin Varmaz

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Every student of finance or applied economics learns the lessons of Franco Modigliani and Merton Miller. Their landmark paper, published in 1958, laid out the basic underpinnings of modern finance and these two distinguished academics were both subsequently awarded the Nobel Prize in Economics. Simply stated, companies create value when they generate returns that exceed their costs. More specifically, the returns of successful companies will exceed the risk-adjusted cost of the capital used to run the business. Further, these returns and the securities of the underlying companies must be judged against an uncertain backdrop, such that the risk-adjusted expected returns are attractive.

Investors seek to identify these successful companies. They strive to calculate the appropriate pricing of securities. How can this best be done? Every practitioner knows that the two simple declarative sentences at the beginning of this paragraph belie the complexity of the search for successful companies and financial instruments that offer favorable prospects for investors. The world is messier than models. Accounting data can be unreliable, economic conditions can change, investor risk tolerance can shift, and low-probability scenarios can occur.

This book is written from the perspective of practitioners, and the editors have chosen leaders in the field who can describe the theory and implementation behind their various approaches. The contributors to *Equity Valuation: Models from Leading Investment Banks* also describe the potential weakness of different models. This perspective is essential to understanding why there is no single magical solution. Investors are urged to use models as tools, often very powerful tools, but not as replacements for sound analysis and common sense.

Most successful investors believe that the fundamentals of economic and company performance will ultimately determine the performance of financial assets. Indeed, models are typically constructed in the hope of identifying deviations from fundamentally determined prices for entire classes of financial assets as well as specific securities. In Part I, Jan Viebig and Thorsten Poddig, the lead authors of this book, describe the basics of many valuation models, which are linked to key metrics such as cash flow, earnings and book value.

To paraphrase the authors, valuing a company would be simple if balance sheets and income statements were always accurate. In the real world, balance sheets may not fully reflect the fair value of assets, debt and equity, and earnings per share may not capture the sustainable earnings power of the company. Even when there is no intention to deceive, there is an underlying tension between corporate accounting, which seeks to take a snapshot at a specific point in time and to do so in a timely way, and the economic reality.

Even well-constructed models can lead to errors if the inputs to the model are wrong. This happens most often when there are notable changes, for example, in the macroeconomic