VALUATION OF SHARES

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What is the Valuation of Shares?

Valuation of shares is the process of estimating the fair value of a company's shares. The "fair price" of a share refers to the price at which the stock is neither overvalued nor undervalued.

It symbolises the equilibrium point where the supply and demand for the stock are balanced. This equilibrium is achieved by considering all available market information and conditions.

Valuation of shares is important for investors, analysts, and companies. You can pick from multiple valuations of shares methods. Share valuation involves using quantitative techniques and financial data to assess the company's performance, growth potential, risk, and competitive advantage. However, there are multiple Factors Affecting the Valuation of Shares. Valuation of shares is the process of knowing the value of a company's shares. Share valuation is done based on quantitative techniques and share value will vary depending on the market demand and supply. The share price of the listed companies which are traded publicly can be known easily. But w.r.t private companies whose shares are not publicly traded, valuation of shares is important and challenging.

When is Valuation of shares required

- One important reason is when you are about to sell your business and want to know how much it is worth.

- When you approach your bank for a loan with shares as collateral,

- Merger, acquisition, reconstruction, amalgamation, etc. – share valuation is critical.

- When your company's shares are to be converted, i.e., from preferred to common stock,

- When implementing an employee stock ownership plan, valuation is required (ESOP)

- For tax assessments under the acts imposing the wealth tax or the gift tax

- In the event of a lawsuit, where share valuation is legally required

- Shares owned by an investment company

- The company is nationalised to compensate the shareholders.

Even publicly traded shares must sometimes be valued because market quotations do not always reflect the true picture, or large blocks of shares are being transferred, and so on.

Let us understand the concept in a simple way:

Imagine you own a bakery, and you want to sell a part of it to your friend.

You both agree on a price for a share of the bakery.

That price is based on how much your bakery is worth. It can include things such as equipment, reputation, and how much money it makes.

In the stock market, it's similar.

When a company decides to sell a piece of itself to the public, they divide it into shares.

The price of each share depends on how much the company is worth.

Investors must consider a company's profits, growth potential, and industry trends to decide if they want to buy shares and at what price.

What is the Need For Valuation of Shares

Share valuation is very relevant in the stock market.

- **Facilitating Investment Decisions-**Valuation of shares helps investors decide whether a stock is a good buy based on its true value.

- **Supporting Mergers and Acquisitions (M&A)-**Companies use share valuation to determine fair prices during mergers, acquisitions, or partnerships.

- **Ensuring Accurate Financial Reporting-**Integral to financial reporting, the valuation of shares usually impacts balance sheets and income statements. This ensures transparency and compliance with reporting standards.

- **Enhancing Investor Relations-**Most companies utilise valuation metrics to attract investors and stakeholders. This showcases their financial health and potential for growth.

- **Managing Risk Effectively-**Valuation provides clarity on asset values. It helps businesses and investors make smart decisions and implement risk management strategies.

Types of Valuation of Shares

There are different types of valuation of shares, depending on the perspective and purpose of the valuation.

• **Intrinsic value:** This is the true or fair value of the shares. It is based on the fundamental analysis of the company's financial performance, risk, and future prospects. It is independent of the market price and reflects the intrinsic worth of the company.

• **Market value:** This is the current or prevailing price of the shares in the market.

It is based on the market forces of demand and supply.

• **Relative value:** This is the value of the shares relative to other comparable companies or assets in the same industry or sector.

It helps to assess the relative attractiveness of the shares.

• **Book value:** This is the value of the shares as recorded in the company's balance sheet.

It represents the net worth of the company from an accounting perspective.

• **Liquidation value:** This is the value of the shares if the company is liquidated and its assets are sold at their market value.

Methods of Valuation of Shares with Examples

There are different methods of valuation of shares.

You can choose the best method of valuation of shares based on your purpose, data availability, and assumptions.

Net Asset Method

This method values the shares based on the net assets of the company, i.e., the difference between the total assets and the total liabilities.

Net asset method of valuation of shares assumes that the company can be liquidated and its assets can be sold at their book value or market value.

This method is suitable for capital-intensive companies or companies that are going to be dissolved or merged.

Example

If a company's total assets are valued at Rs. 200 crore and liabilities at Rs. 50 crore, the net asset value is Rs. 150 crore.

This approach is useful for companies with substantial physical assets or valuable intellectual property.

Earnings Per Share (EPS)

This method looks at how much profit each share of a company is making. If a company is making a lot of profit per share, its shares might be more valuable.

Earning per share helps calculate the stock value and profitability of a company.

Example

If a company's EPS is Rs. 20 and the stock price is Rs. 200, the EPS ratio is 10 (200 / 20).

A higher EPS ratio may indicate the stock is potentially undervalued compared to its earnings.

Price-to-Earnings (P/E) Ratio

This financial ratio compares the price of a company's shares to its earnings per share.

A high P/E ratio could mean investors expect high growth from the company.

On the other hand, a lower P/E ratio might indicate that investors are cautious about its future prospects.

Example

If a company's stock is trading at Rs. 100 and its earnings per share (EPS) is Rs. 10, then the P/E ratio is 10 (100 / 10).

Investors can compare this P/E ratio with similar companies to judge if the stock is priced reasonably.

Dividend Discount Model (DDM)

This method focuses on the dividends a company pays to its shareholders.

It estimates the present value of all future dividends to determine the value of a share today.

Example

If a company pays annual dividends of Rs. 5 per share and the required rate of return is 10%, the present value of the stock would be Rs. 50 (5 / 0.10).

This method is valuable for assessing income-generating stocks.

Discounted Cash Flow (DCF)

DCF looks at how much cash a company is expected to generate in the future and discounts it back to its present value.

It considers factors like future profits, expenses, and investments.

It's like figuring out the current value of all the money your bakery is expected to make in the future.

Example

Suppose a company is expected to generate cash flows of Rs. 50 crore annually for the next 10 years.

By discounting these cash flows to their present value using an appropriate discount rate (say 12%), analysts can determine the company's current value.

Comparable Company Analysis (CCA)

This method compares a company's financial metrics, like revenue and earnings, to similar companies in the same industry.

If a technology company is being valued, analysts might compare its P/E ratio with other technology firms in the market. If similar companies have higher P/E ratios, it could suggest that the company's stock is undervalued.

What are the Factors Affecting Valuation of Shares

There are various factors affecting the valuation of shares, such as:

• Overall Financial performance with factors such as sales, earnings, cash flows, growth rate, profitability, etc., affect the valuation of shares.

Generally, higher financial performance leads to a higher valuation of shares.

• The risk and uncertainty of the company, such as its business risk, financial risk, market risk, etc.

Generally, higher risk and uncertainty lead to lower valuation of shares.

• Demand and supply of the shares, the investor sentiment, the economic environment, the industry trends, etc., affect the valuation of shares.

Generally, favourable market conditions lead to a higher valuation of shares.

• The future prospects of the company, such as its growth potential, competitive advantage, innovation, diversification, etc., affect the valuation of shares.

Generally, brighter future prospects lead to a higher valuation of shares.

These factors are often subjective and difficult to measure and may vary depending on the method of valuation of shares used.

How to Choose the Right Valuation Method for Stocks in the Indian Market

To choose the right valuation method for stocks in the Indian market, you must follow these steps:

1. **Understand Your Goals-**You must determine what you aim to achieve with the investment—is it long-term growth, regular income, or capital preservation?

2. **Analyse the Company and Industry-**It is must to study the company's operations and the industry it belongs to. Don't forget to consider factors like market position, competition, and economic trends affecting the sector.

3. **Review Financial Statements-**Examine the company's financial statements, including revenue, expenses, assets, and liabilities.

4. **Assess Company Data Availability-**Ensure that you have access to historical prices, earnings reports, and industry benchmarks.

5. **Consider Dividend History-**Look at the company's dividend payment history. Consistent dividends may indicate stability and shareholder value.

6. **Evaluate Growth Potential-**You must also assess the company's growth prospects based on market trends, product innovations, and expansion plans.

What are the Factors that affect valuation of shares?

The valuation of shares is influenced by several factors. Firstly, a company's financial health plays a significant role; higher profits, strong cash flows, and a solid balance sheet tend to increase share value. Market sentiment also matters, as investor perception can drive prices. Industry and economic conditions impact valuations, with growth potential and stability favouring higher prices.

Furthermore, the company's management, their strategies and corporate governance practices impact investor confidence. Dividend yield and expected future earnings growth are crucial factors as well. External events like regulatory changes and geopolitical factors can swiftly alter valuations. Lastly, supply and demand dynamics within the stock market directly affect share prices, with increased demand typically leading to higher valuations and vice versa. Overall, a holistic evaluation of these factors helps determine the fair value of shares in the market.

Conclusion

Valuation of shares is a crucial skill if you want to invest in the Indian stock market. It helps to evaluate the performance, risk, and potential of a company. You can also compare it with other companies in the same industry. However, valuation of shares is not an exact science but rather an art that requires judgment, analysis, and experience. Thus, you must do a proper analysis and understand each method before using it. Always remember that proper valuation is the cornerstone of sound investment strategies.