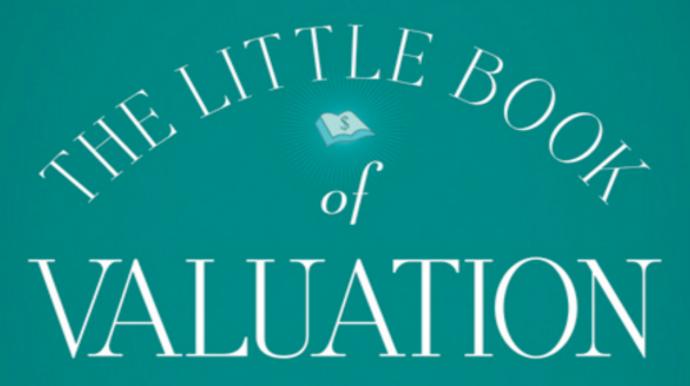
"I can say without hesitation that Aswath Damodaran is the best teacher of valuation I have ever encountered. . . . The Little Book of Valuation may not be large but it packs a lot of punch."

-FROM THE FOREWORD

Michael Mauboussin, Chief Investment Strategist, Legg Mason Capital Management



How to Value a Company, Pick a Stock, and Profit



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In the *Little Book Big Profits* series, the brightest icons in the financial world write on topics that range from tried-and-true investment strategies to tomorrow's new trends. Each book offers a unique perspective on investing, allowing the reader to pick and choose from the very best in investment advice today.

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VALUATION

How to Value a Company, Pick a Stock, and Profit

Aswath Damodaran



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1. Corporations—Valuation. 2. Stocks—Prices. 3. Investment analysis. I. Title.

HG4028.V3D3535 2011 332.63'221—dc22 2010053543 To all of those who have been subjected to my long discourses on valuation, this is my penance.

Foreword

If you take a moment to think about it, stock exchanges provide a service that seems miraculous. They allow you to exchange cash that you don't need today for a share in a claim, based on the future cash flows of a company, which should grow in value over time. You can defer consumption now in order to consume more in the future. The process also goes in reverse. You can sell shares in a company for cash, effectively trading tomorrow's potential for a certain sum today. Valuation is the mechanism behind this wondrous ability to trade cash for claims. And if you want to invest thoughtfully, you must learn how to value.

As a student and practitioner of valuation techniques throughout my career, I can say without hesitation that Aswath Damodaran is the best teacher of valuation I have ever encountered. I have attended his lectures, consulted his books, pored over his papers, and scoured his web site. He combines remarkable breadth and depth with clarity and practicality. He intimately knows valuation's big ideas as well as its nooks and crannies, and delivers the content in a useful and sensible way. If you are looking to learn about valuation from the master, you have come to the right place.

The Little Book of Valuation may not be large, but it packs a lot of punch. You'll start off learning about the basics of discounted cash flow and quickly move to valuation multiples. Professor Damodaran also frames a proper mind-set—valuations are biased and wrong, and simpler can be better—and emphasizes the difference between intrinsic and relative approaches. His discussion of the pros and cons of popular valuation multiples is especially useful.

Valuing businesses at different stages of their lives is tricky. For example, how do you compare the relative

attractiveness of a hot initial public offering of a company boasting the latest whiz-bang technology to a stable but staid manufacturer of consumer products? In the heart of the book, Professor Damodaran helps you navigate the valuation issues that surround companies at different points in their life cycles, providing vivid and relevant examples that help cement the ideas.

The book's final section guides you in dealing with some of the special situations that you are likely to encounter. For instance, valuing a company that relies on a commodity that rises and falls like a roller coaster is an inherently thorny problem. So, too, is valuing a company that pours money into research and development with little that is tangible to show for it. These are some of the valuation challenges you will face as a practitioner, but are also among the most rewarding.

Don't put the book down until you have read, and internalized, the "10 Rules for the Road" in the conclusion. They effectively meld good theory and practice, and will guide you when you reach a point of uncertainty.

Valuation is at the core of the economic activity in a free economy. As a consequence, a working knowledge of valuation's broad concepts as well as its ins and outs is of great utility. Aswath Damodaran has done more to bring these ideas to life than anyone I know. I hope that you enjoy *The Little Book of Valuation* and profit from its lessons.

Michael J. Mauboussin

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Introduction

Do you know what a share in Google or Apple is really worth? What about that condo or house you just bought? Should you care? Knowing the value of a stock, bond, or property may not be a prerequisite for successful investing, but it does help you make more informed judgments.

Most investors see valuing an asset as a daunting task—something far too complex and complicated for their skill sets. Consequently, they leave it to the professionals (equity research analysts, appraisers) or ignore it entirely. I believe that valuation, at its core, is simple, and anyone who is willing to spend time collecting and analyzing information can do it. I show you how in this book. I also hope to strip away the mystique from valuation practices and provide ways in which you can look at valuation judgments made by analysts and appraisers and decide for yourself whether they make sense or not.

While valuation models can be filled with details, the value of any company rests on a few key drivers, which will vary from company to company. In the search for these *value drivers*, I will look not only across the life cycle from young growth firms such as Under Armour to mature companies like Hormel Foods, but also across diverse sectors from commodity companies such as Exxon Mobil, to financial service companies such as Wells Fargo, and pharmaceutical companies such as Amgen.

Here is the bonus: If you understand the value drivers of a business, you can also start to identify *value plays*—stocks that are investment bargains. By the end of the book, I would like you to be able to assess the value of any company or business that you are interested in buying and use this understanding to become a more informed and successful investor.

Not all of you will have the time or the inclination to value companies. But this book will give you the tools if you choose to try, and it will provide you with some shortcuts in case you do not.

Let's hit the road.

In a web site to accompany this book (<u>www.wiley.com/go/littlebookofvaluation</u>), you can look at these valuation models and change or update the numbers to see the effects.

Hit the Ground Running— Valuation Basics



Value—More Than a Number!

Understanding the Terrain

Oscar Wilde Defined a Cynic as One Who "knows the price of everything and the value of nothing." The same can be said of many investors who regard investing as a game and define winning as staying ahead of the pack.

A postulate of sound investing is that an investor does not pay more for an asset than it is worth. If you accept this proposition, it follows that you have to at least try to value whatever you are buying before buying it. I know there are those who argue that value is in the eyes of the beholder, and that any price can be justified if there are other investors who perceive an investment to be worth that amount. That is patently absurd. Perceptions may be all that matter when the asset is a painting or a sculpture, but you buy financial assets for the cash flows that you expect to receive. The price of a stock cannot be justified by merely using the argument that there will be other investors around who will pay a higher price in the future. That is the equivalent of playing an expensive game of musical chairs, and the question becomes: Where will you be when the music stops?

Two Approaches to Valuation

Ultimately, there are dozens of valuation models but only two valuation approaches: *intrinsic* and *relative*. In intrinsic valuation, we begin with a simple proposition: The intrinsic value of an asset is determined by the cash flows you expect that asset to generate over its life and how uncertain you feel about these cash flows. Assets with high and stable cash flows should be worth more than assets with low and volatile cash flows. You should pay more for a property that has long-term renters paying a high rent than for a more speculative property with not only lower rental income, but more variable vacancy rates from period to period.

While the focus in principle should be on intrinsic valuation, most assets are valued on a relative basis. In relative valuation, assets are valued by looking at how the market prices similar assets. Thus, when determining what to pay for a house, you would look at what similar houses in the neighborhood sold for. With a stock, that means comparing its pricing to similar stocks, usually in its "peer group." Thus, Exxon Mobil will be viewed as a stock to buy if it is trading at 8 times earnings while other oil companies trade at 12 times earnings.

While there are purists in each camp who argue that the other approach is useless, there is a middle ground. Intrinsic valuation provides a fuller picture of what drives the value of a business or stock, but there are times when relative valuation will yield a more realistic estimate of value. In general, there is no reason to choose one over the other, since nothing stops you from using both approaches on the same investment. In truth, you can improve your odds by investing in stocks that are undervalued not only on an intrinsic basis but also on a relative one.

Why Should You Care?