The Anchor of Value -- Constructing the Logical Framework of the Stock Valuation Method

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Abstract: The existing stock valuation methods, including absolute valuation method and relative valuation method, are widely used in investment research and practice. But there is a huge gap between its simple theoretical assumptions and the practice.Referring to Buffett's value investment theory， this paper reflects on the assumptions of the stock valuation methods, trying to build a logical framework of stock valuation methods that is more suitable for practical application.
Keywords: Stock Valuation; Relative Valuation; Absolute Valuation; Monopoly

Introduction

Stock valuation is the core of equity investment， also the most difficult part. The existing stock valuation methods can be divided into two types: absolute valuation method and relative valuation method. Both of these methods have strict theoretical basis and applicable conditions, but there is a huge gap between the theory and the latest equity investment practice. This paper reflects on the essence of stock valuation from the perspective of investment practice and tries to build a logical framework of stock valuation methods.

1. Analysis framework of absolute valuation method based on monopoly

The logical basis of the absolute valuation method for stock valuation is the discount of the future cash flow of the enterprise(Ong C Z et al., 2021). In investment practice, the simple assumptions about sustainable operation and future cash flow are seriously disconnected from the real world. However, its valuation logic focusing on the enterprise is valuable. This is consistent with Buffett's investment philosophy that regards stocks as a part of the enterprise.Strenuous efforts should be made to make sure you have thoroughly understanding of the enterprise in the Concentrate Investment Model. The important problem is how to accurately predict the future cash flow in the long run.

The art of using the absolute valuation method is to capture a flash of certainty in the sea of uncertainty. The certainty of the future is the logical premise of the absolute valuation method. The enterprise operates in a highly complex socio-economic system.Any minor change in one of the parameters will have a huge impact on the cash flow of the enterprise, that is, the butterfly effect. In this regard, Buffett put forward three important concepts: "capability circle", "margin of safety" and "moat". People's cognitive ability is extremely limited, so we must focus on a narrow field ("capability circle") to build a deeper understanding of the enterprise than others. On this basis, through continuous research, a reliable forecast of the future cash flow can be established at the moment of certainty. Even so, the limited cognitive ability still makes mistakes, so it is necessary to make up for the prediction deviation through the reserved "margin of safety"(J Emblemsvåg, 2020).

Smart investors tend to grasp the certainty in simplicity rather than predict uncertainty in complexity. Buffett's "moat" concept focuses on the stability of long-term cash flow of enterprises, namely the "slow industry". In fact, the "moat" theory can be seen as the popular interpretation of the more general concept of monopoly in economics. Competition erodes corporate profits and threatens the stability of future cash flows(H Habiburrochman et al., 2020). The ability of enterprises to monopolize is the most important source of certainty,which is the basis of the absolute valuation method. The following describes the analysis framework based on monopoly from three levels.

1.1 Business level monopoly

If an enterprise adjusts its current industry and specific business, it will lose the ability to monopolize, then it only has business level monopoly.For example, technology patents, franchising, secret formulas, etc. all belong to business level monopoly. When the industry encounters systematic risk, the future cash flow of enterprises with only business level monopoly will encounter significant uncertainty, thus threatening the reliability of stock valuation.

1.2 Personnel level monopoly

If an enterprise enters a new industry, as long as the core team remains unchanged and can regain the monopoly ability within a certain period of time, then the enterprise has personnel level monopoly. As a part of the core competence, the core team can establish and maintain the monopoly power in complex situations. Therefore, the future cash flow will not be affected by industry level disturbances in the long run, which brings more certainty to future cash flow. However, personnel changes will threaten the monopoly at this level.

1.3 Culture level monopoly

If an enterprise enters a new industry and changes its core team, it can still regain its monopoly ability within a certain period of time, then the enterprise has culture level monopoly. To put it another way, the monopoly power of an enterprise can exist independently of its founders or core management team, which is the key to the sustainable operation. Culture level monopoly can come from specific institutional norms, tacit knowledge, values, etc. As a mysterious force of the organization, when the internal and external environment of the organization changes significantly, these specific cultural elements can attract top talents and re-establish the monopoly ability on a new track. This ensures that the enterprise can exist beyond the life cycle of individuals, which is closer to the assumption of sustainable operation. Neither industry risk nor personnel change can shake the certainty of the future cash flow, so culture level monopoly is the most effective moat for enterprises.

1.4 Comprehensive valuation analysis based on monopoly

To sum up, the ability of enterprises to monopolize is the premise of adopting the absolute valuation method. Enterprises without monopoly ability will lose their profits in the cruel market competition either far or near. Monopoly is the guarantee of certainty.The prediction based on certainty is the logical premise of future cash flow discount. The accuracy of the absolute valuation method depends on the accuracy of the future cash flow estimation, while the strength of the enterprise's monopoly power determines the extent to which the future cash flow can be accurately predicted.

2. Analysis framework of relative valuation method based on comparability

The current popular relative valuation methods include PE, PB, PEG, EV/EBITDA, etc. The basic logic is to find comparable enterprises and the market valuations.Then referring to the core variables selected, such as profits, sales, etc., to obtain the target enterprise's valuation according to certain rules. The relative valuation method is based on two independent assumptions. The first is the accuracy of the current valuation of comparable enterprises.The second is the correlation between enterprise valuation and the core variables. These two assumptions are discussed below

2.1 Accuracy of valuation of comparable enterprises

The current valuation of comparable enterprises generally comes from the capital market. The efficient market hypothesis holds that the market can effectively gather information and give an accurate price(Xu J, 2021). Buffett's "Mr. Market" theory believes that the market is like an irrational person who is extremely optimistic or pessimistic at different times(Jones C Al et al., 2022), so it hardly ever prices accurately.Investment practice proves that the latter theory is closer to the actual situation. Therefore, the relative valuation method is closer to the short-term market valuation of the target assets, including the influence of "Mr. Market" sentiment,which is highly subjective.

From the vertical perspective, the same market will give different valuation for the comparable enterprise in different periods, so the relative valuation method is not applicable to long-term stock pricing. From the horizontal dimension, different types of capital markets in different regions will also give different valuation. Therefore, when using the relative valuation method, it is necessary to carefully select the comparable enterprises and the capital markets.

2.2 Correlation between enterprise valuation and the core variables

According to the absolute valuation method, enterprise valuation is affected by internal and external factors. In the relative valuation method, the differences between comparable enterprises and target enterprises are mainly reflected by the selected core variables. Due to the similarity and comparability between comparable enterprises and target enterprises, the relative valuation method holds that there is a simple proportional relationship between enterprise valuation and the core variables.So the target enterprise valuation can be derived from the valuation of comparable enterprises.The strict assumptions and limited number of core variables (only one variable in many cases) blur the important differences in quality between comparable enterprises and target enterprises. The selection of core variables is also highly subjective, which may lead to large deviations.

2.3 Comprehensive valuation analysis based on comparability

To sum up, the relative valuation method is based on the known valuation of comparable enterprises. By selecting core variables (profits, net assets, etc.), it establishes a stable relationship between the enterprise valuation and the variables to derive the valuation of the target enterprises. The anchor of value is the price given by the market for the comparable enterprises, which may have been far away from the true value . At the same time, a limited number of core variables are not enough to summarize the differences between comparable enterprises and target enterprises. Therefore, the relative valuation method reflects the overall views of many trading entities on asset prices in the short term. It’s suitable for rough estimation of the market value of stocks in the short term. The differences in industries, enterprise life cycles and corporate profitability must be carefully considered in the selection of comparable enterprises and key variables.

3. Conclusion

The absolute valuation method is based on the assumptions of future cash flow discount and sustainable operation. Although the estimation is accurate, it requires high prediction accuracy for the future cash flow of the enterprise, which affects its practicability. In investment practice, the analytical framework of the absolute valuation method is centered on certainty to approximate the theoretical assumptions as much as possible.The monopoly power of enterprises improves the accuracy of future cash flow prediction and different levels of monopoly are distinguished in this paper.

The relative valuation method is suitable to those who have limited understanding of the enterprise and need to provide a rough valuation close to the market in a short time. The result is affected by the valuation accuracy of comparable enterprises and the selection of core variables.The relative valuation method can be used in preliminary estimation or in combination with the absolute valuation method.

Referrence

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