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**Chapter 2 : Damodaran On-line Home Page**

*1 CHAPTER 1 INTRODUCTION TO VALUATION Every asset, financial as well as real, has a value. The key to successfully investing in and managing these assets lies in understanding not only what the value is but also the.*

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Introduction to Valuation 3 Chapter 2: Approaches to Valuation 16 Chapter 3: Understanding Financial Statements 37 Chapter 4: The Basics of Risk 81 Chapter 5: Option Pricing Theory and Models Option Pricing Theory and Models Chapter 6: Theory and Models Chapter 7: Riskless Rates and Risk Premiums Chapter 8: Measuring Earnings Chapter From Earnings to Cash Flows Chapter Estimating Growth Chapter Estimating Terminal Value Chapter Dividend Discount Models Chapter Free Cashflow to Equity Models Chapter Fundamental Principles of Relative Valuation Chapter Earnings Multiples Chapter Book Value Multiples Chapter If the retention ratio is adjusted, New retention ratio after year 5 The price-book value ratio is also influenced by the cost of equity, with higher costs of equity leading to lower price-book value ratios. The influence of the return on equity and the cost of equity can be consolidated in one measure by taking the difference between the two  $r - k_e$  a measure of excess equity return. The larger the return on equity relative to the cost of equity, the greater is the price-book value ratio. In the illustration above for instance, the firm, which had a cost of equity of  $k_e = 10\%$  and a return on equity of  $r = 17\%$ , had a price-book value ratio of 7. Consequently, its price-book value ratio declined from 7. The following graph shows the price-book value ratio as a function of the difference between the return on equity and required rate of return. The Determinants of Return on Equity The difference between return on equity and the required rate of return is a measure of a firm's capacity to earn excess returns in the business in which it operates. Corporate strategists have examined the determinants of the size and expected duration of these excess profits and high ROE using a variety of frameworks. One of the better known is the "five forces of competition" framework developed by Porter. In his approach, competition arises not only from established producers producing the same product but also from suppliers of substitutes and from potential new entrants into the market. The analysis of the return on equity of a firm can be made richer and much more informative by examining the competitive environment in which it operates. There may also be clues in this analysis to the future direction of the return on equity. This spreadsheet allows you to estimate the price earnings ratio for a stable growth or high growth firm, given its fundamentals. Applications 16 There are several potential applications for the principles developed in the last section and we will consider three in this section. We will first look at what causes price to book ratios for entire markets to change over time and when a low high price to book ratio for a market can be viewed as a sign of under over valuation. We will next compare the price to book ratios of firms within a sector and extend this to look at firms across the market and what you need to control for in making these comparison. Finally, we will look at the factors that cause the price to book ratio of an individual firm to change over time and how this can be used as a tool for analyzing restructurings. PBV ratios for a Market The price to book value ratio for an entire market is determined by the same variables that determine the price to book value ratio for an individual firm. Other things remaining equal, therefore, you would expect the price to book ratio for a market to go up as the equity return spread  $r - k_e$  Cost of equity earned by firms in the market increases. Conversely, you would expect the price to book ratio for the market to decrease as the equity return spread earned by firms decreases. Over that period, the price to book value ratio for the market has also increased. Comparisons across firms in a Sector Price-book value ratios vary across firms for a number of reasons - different expected growth, different payout ratios, different risk levels and most importantly, different returns on equity. Comparisons of price-book value ratios across firms that do not take into account these differences are likely to be flawed. The most common approach to estimating PBV ratios for a firm is choose a group of comparable firms, to calculate the average PBV ratio for this group and to base the PBV ratio estimate for a firm on this average. The adjustments made to reflect differences in fundamentals between the firm being valued and the comparable group are usually subjectively. There are several problems with this approach. First, the definition of a comparable firm is essentially a subjective one. The use of other firms in the industry as the control group is often not a complete solution because firms within the same

industry can have very different business mixes, risk and growth profiles. There is also plenty of Figure Second, even when a legitimate group of comparable firms can be constructed, differences will continue to persist in fundamentals between the firm being valued and this group. Adjusting for differences subjectively does not provide a satisfactory solution to this problem, since these judgments are only as good as the analysts making them. Given the relationship between price-book value ratios and returns on equity, it is not surprising to see firms which have high returns on equity selling for well above book value and firms which have low returns on equity selling at or below book value. There are two ways in which we can bring home these mismatches – a matrix approach and a sector regression.

**Matrix Approach** If the essence of misvaluation is finding firms that have price to book ratios that do not go with their equity return spreads, the mismatch can be brought home by plotting the price to book value ratios of firms against their returns on equity. **Price to Book Ratios and Returns on Equity** 19 If we assume that firms within a sector have similar costs of equity, we could replace the equity return spread with the raw return on equity. **Regression Approach** If the price to book ratio is largely a function of the return on equity, we could regress the former against the latter. This regression can be enriched in two ways. The first is to allow for non-linear relationships between price to book and return on equity - this can be done by either transforming the variables natural logs, exponentials, etc. The second is to expand the regression to include other independent variables such as risk and growth.

**Comparing Price to Book Value Ratios: Integrated Oil companies** In Table We will begin by plotting price to book ratios against returns on equity for these firms in Figure **Price to Book versus ROE: Regressing the price to book against return on equity for oil companies**, we obtained the following: **Comparing firms across the market** In contrast to the comparable firm approach, you could look at how firms are priced across the entire market to predict PBV ratios for individual firms. The simplest way of summarizing this information is with a multiple regression, with the PBV ratio as the dependent variable and proxies for risk, growth, return on equity and payout forming the independent variables. Past studies The relationship between price-book value ratios and the return on equity has been highlighted in other studies. Wilcox posits a strong linear relationship between price-to-book value plotted on a common logarithmic scale and return on equity. Using data from for Value Line stocks, he arrives at the following equation. These PBV ratio regressions were updated in the last edition of this book using data from to The betas were obtained from the CRSP tape for each year. All firms with negative book 24 values were eliminated from the sample and the regression of PBV on the independent variables yielded the following for each year. **Updated Regressions** In July , we regressed the price to book ratio against the fundamentals identified in the last section – the return on equity, the payout ratio, the beta and the expected growth rate over the next 5 years from analyst forecasts. The strong positive relationship between price to book ratios and returns on equity is not unique to the United States. In fact, the following table summarizes regression for other countries of price to book against returns on equity. **Price to Book and Returns on Equity: Valuing a private firm using the cross-sectional regression** Assume that you had been asked to value a private firm early in and that you had obtained the following data on the company: This reports the results of the latest regression of PBV ratios against fundamentals, using all firms in the market. While it is convenient to focus on current returns, the market value of equity is determined by expectations of future returns on equity. To the extent that there is a strong positive correlation between current ROE and future ROE, using the current return on equity to identify under or over valued companies is appropriate. Focusing on the current ROE can be dangerous, however, when the competitive environment is changing, and can lead to significant errors in valuation. In such cases, you should use a forecast return on equity that can be very different from the current return on equity. There are several ways in which you can obtain this forecast. Specifically, firms that increase their returns on equity should increase their price to book ratios and firms that see their returns on equity deteriorate should see a fall in their price to book ratios as well. Another way of thinking about this 27 is in terms of the matrix presented in Figure **Changes in ROE and Changes in PBV Ratio**

Return on Equity	Cost of Equity	High Price to Book	High Equity return spread	Low Price to Book	Low Equity return spread
As return on equity increases,					
the price to book ratio will increase					
As return on equity drops,					
the price to book ratio will drop					

Thus, one way to measure the effect of the restructuring of a poorly performing firm with low return on equity and low price to book ratio is to see where it moves on the

matrix. In 1999, IBM had a price which was three times its book value, one of the highest price-book value multiples among the Dow 30 stocks at that time. By 2002, the stock was trading at roughly book value, significantly lower than the average ratio for Dow 30 stocks. In the years following Lou Gerstner becoming CEO, the firm has recovered dramatically and was trading at 9 times book value in 2007. An investor buying IBM at its low point would have obtained a stock with a low price to book and a low return on equity, but her bet would have paid off. As the return on equity improved, IBM migrated from the bottom left quadrant to the top right quadrant in the matrix above. As its price to book ratio improved, the investor would have seen substantial price appreciation and profits. Use in Investment Strategies Investors have used the relationship between price and book value in a number of investment strategies, ranging from the simple to the sophisticated. Some have used low price-book value ratios as a screen to pick undervalued stocks. Others combine price to book value ratios with other fundamentals to make the same judgment. Finally, the sheer persistence of higher returns earned by low price to book stocks is viewed by some as an indication that price to book value ratio is a proxy for equity risk. The Fall and Rise again 0. Rosenberg, Reid and Lanstein find that the average returns on U. Fama and French, in examining the cross-section of expected stock returns between 1963 and 1998, establish that the positive relationship between book-to-price ratios and average returns persists in both the univariate and multivariate tests and is even stronger than the small firm effect in explaining returns. Chan, Hamao and Lakonishok find that the book-to-market ratio has a strong role in explaining the cross-section of average returns on Japanese stocks. Capaul, Rowley and Sharpe extend the analysis of price-book value ratios across other international markets and conclude that value stocks, i.

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