This Is the Best Way to Value a Company

Description

Warren Buffett is quoted as saying that investors should ‘beware of geeks bearing formulas’. In fact, the investment world seems to be moving increasingly towards a focus on a mathematical approach to evaluate the appeal of one stock over another.

While ratios such as the price-to-earnings (P/E) ratio and other ratios have been around for years and remain highly useful, there is a danger that investors become detached from the more qualitative side of analysis. In other words, an assessment of a company’s competitive advantage and strengths, rather than simply utilising a quantitative approach.

Focusing on the business

Warren Buffett seems to be more interested in a company’s qualitative appeal, rather than taking a quantitative approach. He has previously stated he would rather ‘buy a great business at a fair price than a fair business at a great price’. Certainly, assessing the quality of a company requires some use of figures in order to determine how profitable a company is versus rivals, as well as its financial strength, sustainability and growth outlook. However, considering its business requires more than figures and it could prove to be the best way to value a company.

For example, consideration of a company’s products and/or services versus rivals could provide guidance on its future profitability. If a company has built up a large degree of brand loyalty then it is reasonable to assume it will be able to charge higher prices in future so as to improve profitability. Similarly, if a company has exposure to faster growing economies or has a more diversified product offering then it may provide greater growth potential and less risk than its sector peers.

Adding value

Furthermore, it could be argued that much of the quantitative assessment of a business is already priced into its valuation. The company’s accounts and financial updates are released to all investors at the same time and this information is quickly priced in. The vast swathes of analysts who interpret that data ensure that if there are particularly positive or negative messages in the financial reports, then that is factored into the company’s valuation. As such, it could be argued that there is limited merit in focusing on quantitative analysis.

However, when it comes to areas such as strategy, business model and the identification of a competitive advantage, it could be viewed as more subjective. Therefore, investors may be able to enjoy an advantage over their peers if they spot a gap in the market for a company to grow, for example. Or, if an investor realises that a company has a higher quality product than a rival, or its customer loyalty is higher.

While such opinions may be considered simple and unsophisticated by some, they could be a means of an investor gaining a competitive advantage over rivals. Therefore, while focusing on the numbers has merit, the best way to value a company could simply be to focus on its strengths and weaknesses as a business, rather than viewing it as entity which can be broken down into numbers on a spreadsheet.

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