

Quick Reference Card (QRC)

Benefits and Limitations of Popular Valuation Methods

Details by Valuation Method

Method	Benefits	Limitations
All Multiple-based methods below (all but DCF and Residual Income)	<ul style="list-style-type: none"> Relatively simple and quick to perform 	<ul style="list-style-type: none"> Rarely incorporates financial forecasts beyond the next 18 months Unlike DCF and RI (below), a company's expected growth rate and risk are not explicitly captured in the valuation (except for the "G" in the PEG ratio), making it difficult to compare companies on these important dimensions Multiple may not be computed in the same manner by all market participants, namely, the underlying financial data can be trailing, forward, or current year Other than P/E, difficult (or impossible) to analyze historical relative valuation levels for a given stock
P/E	<ul style="list-style-type: none"> Understood by all because it's the most commonly used valuation method Can analyze historical relative valuation levels over time (P/E relative to a broad market P/E ratio) 	<ul style="list-style-type: none"> Company management has more flexibility to manipulate earnings than cash flow Does not capture cash available to shareholders
PEG	<ul style="list-style-type: none"> Incorporates earnings growth rate (preferably over multiple future periods), which makes comparisons among companies and, potentially across sectors, more plausible (but not perfect) 	<ul style="list-style-type: none"> Earnings growth is not the same as the more important free cash flow growth No widely-accepted method to compute the growth rate (next 12-months, 2-years, 3-years?) If using consensus estimates, may be difficult to find reliable long-term growth forecasts
P/FCF	<ul style="list-style-type: none"> Incorporates free cash flow, which is the best measure of value 	<ul style="list-style-type: none"> Unlike DCF, it considers only one-time period of free cash flow Methodology can vary for reasons mentioned above as well as in estimating level of capital expenditures (maintenance vs. forecast)
P/S	<ul style="list-style-type: none"> Can be helpful if there are no earnings or cash flow 	<ul style="list-style-type: none"> Sales do not equate to free cash flow, which is the true measure of value
P/B	<ul style="list-style-type: none"> For select industries where assets and liabilities (debt) can be valued using a public-market price, may be a good proxy for measuring a firm's value 	<ul style="list-style-type: none"> For most sectors, book value rarely equates to the company's market value of equity Book value can be subjectively influenced by interpretation of accounting rules, which can make comparisons between companies meaningless
EV/EBITDA	<ul style="list-style-type: none"> Allows for comparisons of companies with very different capital structures Can be helpful when company does not generate pre-tax income 	<ul style="list-style-type: none"> EBITDA is not a measure of the all-important free cash flow or earnings
Dividend yield	<ul style="list-style-type: none"> Can be helpful to measure a floor when stocks collapse 	<ul style="list-style-type: none"> Dividends are not the same as free cash flow, although they can move in tandem over the long run Difficult to forecast when management will cut a dividend

Explore these concepts in our workshop: [Apply Practical Valuation Techniques for More Accurate Price Targets](#)

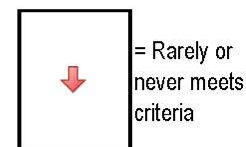
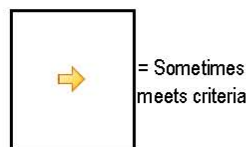
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Benefits and Limitations of Popular Valuation Methods

Method	Benefits	Limitations
DCF and RI	<ul style="list-style-type: none"> • Capture a company's ability to generate free cash flow over the life of the enterprise, which is the best measure of value • Helps to place the focus on the level of, and returns from, incremental capital spending (ROIC) • More likely to identify overheated and oversold stocks and markets than multiples-based methods 	<ul style="list-style-type: none"> • Can be highly sensitive to minor input changes for factors often difficult to quantify • Time consuming because multiple periods are required for forecast • Complex models are prone to mistakes and reverse engineering • During times of highly-priced equity markets, may be challenging to find attractive equity investments using these methods

Comparison of Valuation Methods by Specific Criteria

Benefit	Relevance*	P/E	PEG	P/FCF	EV/EBITDA	DCF	P/B	P/S	Dividend Yield
Good proxy for free cash flow to shareholders	3	→	→	↑	↓	↑	↓	↓	→
Captures multi-period growth	2	↓	↑	↓	↓	↑	↓	↓	↓
Relatively simple and quick to perform (low risk of mistakes)	2	↑	↑	→	→	↓	↑	↑	↑
Can be utilized when comparing companies not in the same sector	1	→	→	→	→	↑	↓	↓	→
Captures risk/volatility	1	↓	↓	↓	↓	↑	↓	↓	↓
Eliminates potential effects of management using aggressive accounting tactics (not fraud)	1	↓	↓	↑	→	↑	↓	↓	↑
Not overly-sensitive to minor changes to assumptions	1	↑	→	↑	↑	↓	↑	↑	↑
Allows for accurate valuation of company's assets at current market prices	0	↓	↓	↓	↓	↓	→	↓	↓
Helpful in identifying attractively valued stocks in an overheated market	0	→	→	→	→	↑	→	→	↑
In general, computation is consistent by all market participants	0	→	→	↓	→	↓	→	↑	↑
Useful if there are no earnings or cash flow during the forecast period	0	↓	↓	↓	↑	↓	↑	↑	↑
Total, weighted		→	↑	↑	↓	↑	↓	↓	→



* Relevance in helping accurately measure long-term free cash flow on a regular basis for multiple stocks