

Why is Fundamental Value so Fundamental to Directors?

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Fundamental value for a firm is that range of value based upon the present value of estimated future cash flows. Fundamental value and market value may differ.

Where market value is above fundamental value, the firm may create wealth from judiciously timed equity issues to parties who are currently non-shareholders, particularly in takeover situations. Where market value exceeds fundamental value, return of surplus funds should logically be via a special dividend rather than a share repurchase.

Where fundamental value per share exceeds market value per share, the firm may create shareholder value for continuing equity investors by timely buybacks.

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Fundamental Value (aka Intrinsic Value)

Why did Marconi pay cash, rather than shares, in its acquisition of US high technology companies? Why did France Telecom do much the same in its programme of high tech acquisitions? Why did advertising giant WPP fund its 2001 acquisition of Tempus with cash as opposed to offering its equity as consideration? Why did Rentokil Initial undertake a share buyback programme? And why did Cable and Wireless do the same? Not all of these financing decisions are examples of logical managerial tactics. We conclude that two appear to fall into the creditable category and three are examples promising value destruction for shareholders who continue to

hold the shares of the firms concerned. Why do we reach these conclusions? Because we apply the ideas of fundamental value to takeover financing and share buybacks.

But what do we mean by fundamental value? And why is it so important? Initially, in this paper, we focus upon the former question. We define fundamental value (or intrinsic value, as it is sometimes known) for a firm and demonstrate how it may be approximated. We then move on to highlight its importance. We argue that a clear idea of fundamental value is of central relevance to the implementation of a logical financial strategy designed to enhance value for shareholders. We conclude that individual members of corporate boards are less than reasonably equipped to carry out their duties in the interests of equity investors if they are not up to speed on the topic of fundamental value. In this area, we would place fundamental value as a central building block in numerous top-level decisions ranging from acquisitions to divestments, from the financing of takeovers to share repurchases. If our view of its pivotal role in these strategic areas of potential value creation — or destruction — is convincingly argued and accepted, our claim for its critical importance to boards of directors cannot be denied.

The order of topics considered in this paper is as follows:

- ❖ definition of fundamental value
- ❖ how fundamental value may be approximated
- ❖ why fundamental value is so important in investment and divestment decisions
- ❖ why fundamental value is so important in financing acquisitions and other funding decisions
- ❖ why fundamental value is so important in share repurchase decisions

What is Fundamental Value?

Fundamental value per share for a firm can be defined as the value that derives from an analysis based upon the present value of estimated future cash flows for the firm. The key underpinning of such an analysis is discounted cash flow, the gold standard of valuation.

Fundamental value is akin to the concept of intrinsic value widely encountered in the writings of Benjamin Graham — see, for example, [Graham \(1973\)](#). But the term was first coined by [Armstrong \(1848\)](#). According to [Arnold \(2002\)](#), although others express the same sentiment, ‘Graham is regarded as the most influential of investment philosophers’. And Graham earned the description the ‘smartest man I ever knew’ from Warren Buffett — see [Lowe \(1997\)](#).

In [Graham et al. \(1962\)](#), the authors state that ‘a general definition of intrinsic value would be that value which is justified by the facts, e.g., assets, earnings, dividends, definite prospects, including the factor of management’. They go on to say that ‘the primary objective in using the adjective intrinsic is to emphasise the distinction between *value* and *current market price*, but not to invest this value with an aura of permanence. In truth, the computed intrinsic value is likely to change . . . as the various factors governing that value are modified. But in most cases intrinsic value changes less rapidly and drastically than market price’.

They subsequently say that ‘the most important single factor determining a stock’s value is now held to be the *indicated average future earning power*, i.e. the estimated average earnings for a future span of years. Intrinsic value would then be found by first forecasting this earning power and then multiplying that prediction by an appropriate capitalisation factor’.

At the time of their writing, the approach of these pioneers of investment valuation was innovative and it would justify a range of value, given the inevitable uncertainties in forecasting.

How is Fundamental Value Approximated?

At an unsophisticated level, a range may be estimated for fundamental value by forecasting future cash flows at optimistic, medium and pessimistic levels. Following discounting and the use of subjective probabilities, a weighted average value may result. At a much more sophisticated level, Monte Carlo simulation or real options valuation may be resorted to in order to arrive at a spectrum of value — see [Damodaran \(2002\)](#) for more details. Of course, further complications arise in choosing the appropri-

ate discount rate and, maybe, in estimating terminal values.

Whether equity values are arrived at via a dividend discount model with a terminal value or via free cash flows, the figure arrived at should be comparable — for detailed methodology see [Damodaran \(2002\)](#). His text also shows how varying growth rates may be incorporated into the valuation.

Different discounting approaches, such as pure discounted cash flow, adjusted present value or free cash flow to equity, if implemented correctly, should arrive at the same bottom line valuation — see [Ross et al. \(2002\)](#). Using the basic discounted cash flow method, a template for equity valuation appears in [Table 1](#). This begins with a valuation of each of the firm’s operations aggregated together. With surplus assets added in and with the present value of debt and non-equity shareholders’ interests and minority interests eliminated, we arrive at the fundamental value of the company’s equity. After allowing for options and the like and dividing by the numbers of equity shares involved, an estimate of fundamental value per share is obtained. Naturally, this process may require some refinement where individual circumstances vary from the basic model.

It is worth mentioning that a further complication arises in respect of liabilities versus assets in the firm’s pension fund. This is particularly the case where the company runs a final salary scheme (or any other fund offering defined benefits). Based on stock market levels of assets at a particular point in time, pension fund liabilities might exceed assets — or vice versa. Building in this factor will usually create a wider range of fundamental value. So will various sensitivity analysis exercises in this area. For example, the preferred method of dealing with the problem might be to assess the deficit or surplus in the pension fund by valuing assets in accordance with long-run average market levels and returns. So the base case value may be in line with long-run equity levels reflecting a price/earnings ratio¹ of between 13 and 14 and an equity return of around 6 per cent in² real terms — see [Dimson et al. \(2002\)](#). Around these long-run inputs, further sensitivities might be built.

We would stress that using the template in the table should ideally be accompanied by pinpointing and appraising assumptions, business logic and using ratio analysis and other reality checks. Remember that firms achieving high relative returns on capital or high margins versus their reference group rarely continue to do so for long unless their market position is underpinned by substantial barriers to entry, monopoly positions granted by governments, or by patent protection or the like. With this background, questioning and shading of forecast returns and/or margins may be called for in the modelling exercise. In support of the reference to the unsustainability of

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