Successful investing
The difference between price and value

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Studies suggest that around a third of transactions fail to return their cost of capital, meaning that the acquirer is destroying shareholder value.

Many cited reasons for transaction failure come down to a lack of understanding of the difference between market price and intrinsic value. If a third of deals fail, and markets are not always efficient, a critical investment factor is measuring the gap between market price and intrinsic value.

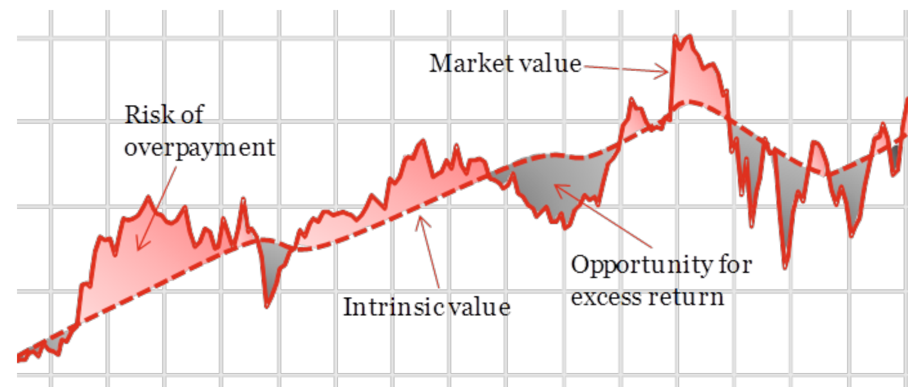
Warren Buffet is often cited as the author of the following quote: "Price is what you pay. Value is what you get." This is an apt description of the difference between market price (i.e., the price that the market requires to effect a transaction) and intrinsic value (i.e., the intrinsic worth of a business, which is a function of cash flow to be generated by the acquired business, which in turn is a function of core operations, expected synergies, integration success, and other factors).

The fundamental finance equation of "buy low, sell high" therefore requires a benchmark value–e.g., a low price relative to what ***value?***

Buyers and sellers need to focus on the gap between market price and intrinsic value, because that gap may decide the ultimate winners and losers in a given transaction:

- If intrinsic value is greater than market price – the buyer has got a good deal, or the seller has undersold
- If market price is greater than intrinsic value – the seller has got a good deal, or the buyer has overpaid

What do we mean by market price versus intrinsic value?



> **"Price is what you pay; value is what you get."**
>
> Warren Buffett

Determining the intrinsic value of a business

It follows that best practice in valuation can help mitigate the risks of mispricing a transaction and improve the odds of deal success.

We highlight some considerations that are important when reflecting on the equation of market price versus intrinsic value. Although many of these are straightforward, in our experience, buyers and sellers frequently fail to apply them consistently.

1 Uncovering bias

The single biggest threat to sound transactions is bias. In a recent PwC survey of 1,500 M&A professionals, the majority of respondents indicated bias poses the greatest risk to pricing in a transaction. Identifying and managing bias is key to successful transactions.

Often described as "judgment" by deal participants, bias is ever-present in deal making. For example, chief executives have big visions, which sometimes result in narrow consideration of alternate views; bankers are motivated by closing deals and sellers are selling.

These behaviours are commonplace and are often in response to legitimate incentives. But bias creates additional deal risks, most typically by producing biased valuations. Forecasted cash flows may reflect stronger performance than industry trends reasonably support. Speculative synergies may be included, and costs to achieve the synergies understated. Required returns may fail to properly account for market risks. Selected market peers, with higher value multiples, may not be comparable.

You can't eliminate bias, but you can strive to:

- Understand how bias may be impacting a deal
- Counter bias in a valuation model
- Challenge bias with a data-driven, objective approach

2 Buying the future, not the past

Investors naturally focus on what is known: actual historical results. Too often, they give only a high level review to what is unknown: expected future results. Yet the future matters more, because current intrinsic value is a function of future cash flow. To be sure, historical results can give an indication of future performance. But transactions often signal changing competitive forces and industry trends, which may challenge the applicability of historical results.

Successful investing therefore demands a detailed assessment of the future and, in this respect smart investors understand projections should not be optimistic or pessimistic, aggressive or conservative, best-case or worst-case. Instead, projections should reflect *expected* cash flows, which are a probability-weighted average of possible outcomes. Expected cash flows require a more robust and challenging forecasting process but enhance the understanding of the equation between market price and intrinsic value.

3 Balancing science and art in valuation

Valuation has traditionally been described as part science, part art (sometimes even dark art!). The "science" portion is rooted in widely accepted theories about the relationship between risk and return. The "art" portion is an appropriate reflection of the need to consider experience.

Smart investing requires practitioners to have a deep understanding of finance theory and risk to ensure judgement is supported in a credible and compelling way.

4 Understanding risk

What is risk?–It is the degree of uncertainty of achieving future expectations at the times and in the amounts expected. Expected future cash flows should therefore be discounted to take into account such risk.

Even a small range of discount rates can drive material differences in valuation output – so smart investors spend time on developing and understanding the discount rate for a given businesses risk profile.

5 Redefine success?

Transactions can create value, conserve value, or destroy value. Investment success is frequently defined only in terms of creating value. For a buyer, investment success by this standard implicitly means paying less than intrinsic value for a business – e.g., not paying for synergy value, but then realising that value nonetheless. A successful investment in this context means a buyer earns a return in excess of a required return. However, empirical evidence suggests that, by this definition, a majority of investments fail for buyers. This should come as no surprise because in competitive markets, with knowledgeable buyers and sellers, significant bargain purchases should be unusual. On the contrary, the risk of overpayment is clearly more pronounced in competitive situations.

The same empirical evidence suggests the majority of transactions succeed for buyers if the definition of success includes not only creating value, but simply conserving it. In this case, a buyer can pay what a business is worth, including value associated with expected synergies, and earn a normal return for shareholders.

Paying over a fair value is not uncommon as a strategy, for example, to maintain the value of the buyer's *existing business* – i.e., the joining together of the buyer and a target, positions the combined company to compete, but, alone, the buyer's business may decline. A transaction may be the only path to maintaining value of the existing business for existing shareholders.

The search for excess returns as the sole definition of success is commonly the source of extreme bias in many transactions. A recognition that conservation of value is also rewarding to shareholders could improve investment analysis and execution.

Conclusion

Investors are well served by investing time and effort in valuation on the front end of transactions to avoid surprises later. The potential for value growth can be realised only through robust valuation diligence that effectively considers the relationship between market price and intrinsic value, and a proper understanding of the value drivers.

Although most investors understand the elements of a successful deal, fewer are able to translate that understanding into action, given the multiple and sometimes conflicting forces at play. When an acquirer gets caught up in the momentum of a deal and the promise of synergies, an objective point of view can be of great value.

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