# BIAS AND PRECONCEPTIONS: THE BIGGEST BARRIER TO VALUATION

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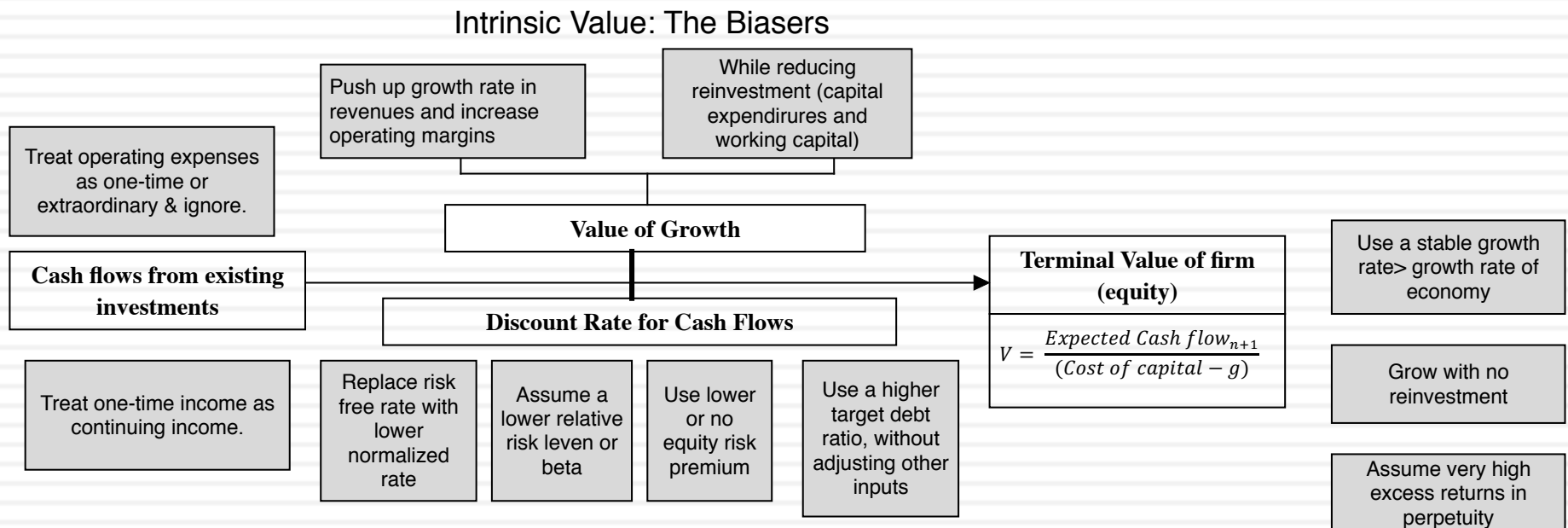
# Bias: The Effects

- <u>Preconceptions and priors</u>: When you start on the valuation of a company, you almost never start with a blank slate. Instead, your valuation is shaped by your prior views of the company in question.
  - Corollary 1: The more you know about a company, the more likely it is that you will be biased, when valuing the company.
  - Corollary 2: The "closer" you get to the management/owners of a company, the more biased your valuation of the company will become.
- <u>Value first, valuation to follow</u>: In principle, you should do your valuation first before you decide how much to pay for an asset. In practice, people often decide what to pay and do the valuation afterwards.

# Bias: The Sources

- **The power of the subconscious**: We are human, after all, and as a consequence are susceptible to
  - **Herd behavior**: For instance, there is the "market price" magnet in valuation, where estimates of intrinsic value move towards the market price with each iteration.
  - **Hindsight bias**: If you know the outcome of a sequence of events, it will affect your valuation. (That is why teaching valuation with cases is an exercise in futility)
- **The power of suggestion**: Hearing what others think a company is worth will color your thinking, and if you view those others as more informed/smarter than you are, you will be influenced even more.
- **The power of money**: If you have an economic stake in the outcome of a valuation, bias will almost always follow.
  - Corollary 1: Your bias in a valuation will be directly proportional to who pays you to do the valuation and how much you get paid.
  - Corollary 2: You will be more biased when valuing a company where you already have a position (long or short) in the company.

# Bias in Intrinsic Valuation (DCF)

Intrinsic Value: The Biasers



Push up growth rate in revenues and increase operating margins

While reducing reinvestment (capital expendirures and working capital)

Treat operating expenses as one-time or extraordinary & ignore.

**Value of Growth**

**Cash flows from existing investments**

**Discount Rate for Cash Flows**

**Terminal Value of firm (equity)**

$$V = \frac{Expected\ Cash\ flow_{n+1}}{(Cost\ of\ capital - g)}$$

Use a stable growth rate> growth rate of economy

Treat one-time income as continuing income.

Replace risk free rate with lower normalized rate

Assume a lower relative risk leven or beta

Use lower or no equity risk premium

Use a higher target debt ratio, without adjusting other inputs

Grow with no reinvestment

Assume very high excess returns in perpetuity

# Bias in Pricing

- In pricing, you price a company or asset, based upon how similar companies are priced, but you get to pick
  - Which companies (assets) are similar..
  - What variable you scale the pricing to (to earnings, book value or revenues)..
- The potential for abuse is immense, since you will pick a peer group and a pricing metric that gives you the answer you were looking for...

# Valuing your own business

You are valuing your own business for sale to a third person.

- ❑ High
- ❑ Low
- ❑ Unclear

You are a venture capitalist valuing this business for an investment.

- ❑ High
- ❑ Low
- ❑ Unclear

# It's personal

You are valuing your own business for divorce court; half of your estimated value will go to your spouse (soon to be ex-spouse)

- ❑ High
- ❑ Low
- ❑ Unclear

You are an appraiser for the owner, valuing a business for tax purposes.

- ❑ High
- ❑ Low
- ❑ Unclear

You are an appraiser for the IRS, valuing the business for tax purposes.

- ❑ High
- ❑ Low
- ❑ Unclear

# Equity Research and M&A

You are a sell side equity research analyst, valuing a company with the intent of putting a buy or sell recommendation on it.

- ❑ High
- ❑ Low
- ❑ Unclear

You are buy-side analyst, valuing a company for your portfolio manager, who already happens to own a million shares of its stock.

- ❑ High
- ❑ Low
- ❑ Unclear

You are buy-side analyst, valuing a company for your portfolio manager, who already happens to have shorted a million shares of its stock.

- ❑ High
- ❑ Low
- ❑ Unclear

# A Friendly Takeover

You are an M&A analyst, working for the banker for the acquirer in a friendly takeover, valuing the target company.

- ❏ High
- ❏ Low
- ❏ Unclear

You are an M&A analyst, working for the banker for the target in a friendly takeover, valuing the target company.

- ❏ High
- ❏ Low
- ❏ Unclear

# A Hostile Takeover

You are an M&A analyst, working for the banker for the acquirer in a hostile takeover, valuing the target company.

- ❑ High
- ❑ Low
- ❑ Unclear

You are an M&A analyst, working for the banker for the target in a hostile takeover, valuing the target company.

- ❑ High
- ❑ Low
- ❑ Unclear

# The Bottom Line

☐ <u>It is unavoidable</u>: If you are human, you have bias. You cannot make it go away and even if you build a machine model, your biases will be in that model.

☐ <u>No more denial</u>: Let's stop dancing around it and denying that it exists. The valuation accreditation groups and valuation professionals have to stop the delusions about being objective.

☐ <u>Let's practice Bayesian valuation</u>: Be transparent about your biases and your priors.

☐ <u>Be honest with yourself</u>: Be honest with yourself about your biases, and from personal experience, that's not easy to do.