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# Swiss Finance Institute
# Practitioner Roundups


## The Choice of Valuation Techniques in Practice: Education versus Profession

How is valuation carried out in practice? How influential, if at all, is higher-level finance education? A new, survey-based research publication reveals some answers—and the importance of the "sociological hypothesis".

The valuation of firms, projects, and transactions is a core topic in business and finance. How it is carried out in practice directly affects investment decisions and the allocation of resources in the economy. As a consequence, the topic has generated a vast body of academic work, which is widely communicated in textbooks and taught at all levels of higher education. Yet it is no secret that academics and those that carry out valuation for a living—valuation professionals—do not always agree when it comes to the implementation or relevance of theoretical concepts. This is illustrated by the following comment from a survey respondent working in the consulting industry, as reported by Mukhlynina and Nyborg (2016, p. 1):[1]

"There seem to be lots of academics asking how analysts in the real world use [the] CAPM or calculate the cost of capital. The answer is, people don't waste time on this. No one ever lost/made money because they calculated the WACC better than consensus. You accademic [sic] guys are wasting your time."
—A consultant.

If such views are widespread, this raises questions about what is being taught, the effectiveness of higher-level finance education, and the valuations that the professionals come up with. However, there is not much systematized knowledge that reveals how valuation professionals typically go about the business of valuation. What are their favored techniques and what are the factors that affect their choices in practice? This matters because valuation professionals function as intermediaries in the capital allocation process.

"Profession trumps education—"where" the valuation is carried out may be a key influence."

Lilia Mukhlynina and SFI's Kjell Nyborg use a survey approach to shed light on the choice and implementation of valuation techniques in practice. Background questions allow them to control for a respondent's professional subgroup (consulting, investment banking, private equity, asset man-

[1] Mukhlynina, L. and K. G. Nyborg (2016), "The choice of valuation techniques in practice: Education versus profession," Working Paper, University of Zurich, Swiss Finance Institute, and CEPR. Downloadable at http://bit.ly/2edU1Uv. A condensed version of the survey on which the paper is based can be found at www.nyborg.ch.

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The full paper can be found at http://bit.ly/2edU1Uv.

agement), education, experience, and valuation purpose characteristics. In broad terms, they find support for what they call the "sociological hypothesis"—namely, that profession matters more than education. Different professions have different valuation cultures. Thus, in practice, the values attached to different firms and projects and, ultimately, resource allocation may depend on "where" the valuation is carried out.

The most established valuation methods are relative valuation, what people refer to as "multiples", and multi-period models. Finance textbooks emphasize the latter; especially the technique of discounted cash flows (DCFs). These approaches differ on several levels: with regard to the inputs one needs to consider, the caveats one has to be aware of, and—most crucially—the results one gets. Anecdotally, some practitioners are of the opinion that DCFs are too academic and theoretical to be of practical relevance. In contrast, multiples are viewed as delivering market-oriented results in addition to being easier to implement. However, it is unclear how widely held these views are. The authors' working paper fills that knowledge gap and provides substantial details with respect to how valuation professionals implement valuations using multiples and DCFs. Most employ both techniques, but the details vary.

"Valuation professionals are guided by their peers and the standards of their profession—not by what they learned at University."

Intuitively, one may expect those with more advanced academic degrees to use more sophisticated methods and to implement them with fewer conceptual mistakes. But it is also plausible that different cultural norms within professional subgroups affect preferred valuation approaches. Sociology and social psychology have long recognized that professions have identifiable cultures and that individuals are prone to influence from peers and groups. In finance, Bob Shiller was an early proponent of some of these ideas. The authors "sociological hypothesis" expands on the standard peer effect hypothesis, since the influence is hypothesized to come from the profession as a whole, not just from co-workers at the same firm.

The primacy of profession over education that the authors document mirrors results from social psychology and, in particular, the pioneering work of Harris (1998).[2] In an interview in *Scientific American* in 2009, she summarizes her work as follows: "I've put together a lot of evidence showing that children learn at home how to behave at home (that's where parents do have power!), and they learn outside the home how to behave outside the home. Parents matter much less, [...] a child's peer group is far more important."[3] Analogously, the authors' results suggest that valuation professionals learn how to approach valuation in practice from their peers at work and the standards of their profession rather than from what they learned as advanced students at University.

"In fields where disparate theories abound, higher-level education may be best carried out in the workplace."

These findings matter because they imply that there is a degree of arbitrariness about valuations in practice in that they are influenced by "where" the valuation is carried out. Survey respondents also exhibit confusion with respect to important issues in valuation, such as interest rate tax shields and the WACC. Higher education levels do not reduce the confusion. The authors' findings suggest that higher-level finance education may have the most impact if pursued in the workplace. This may well also hold true for other business and management disciplines where disparate theories and approaches flourish. The documented relative lack of importance of education also raises the general question as to what the role of finance education beyond the bachelor level might be. Is it merely a sideshow?

2 Harris, J. (1998), *The nurture assumption: Why children turn out the way they do*, Free Press, New York.

3 *Scientific American*, "Do Parents Matter?" Interview with J. Harris by J. Lehrer, July/August 2009, pp. 61-63, https://www.scientificamerican.com/article/parents-peers-children/.

**Key Words**
Discounted cash flows
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