Evaluating a Valuation
Don’t always buy what is being sold

Joshua Li
Matt Cheng
Agenda

- The Big Picture
- Speakers vs. analysts
- Business model
  - Underlying economics
  - Competitive advantage
- Financial model
  - Appropriate assumptions
  - Understanding the numbers
- Appendix
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Striking a balance

- Importance of both qualitative and quantitative aspects of a valuation
  - What the company does
    - Good story vs. good company
  - How well the company is doing
    - Top-line growth vs. bottom-line growth

A comprehensive valuation cannot be lacking in either component
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A good speaker does not make a good analyst. But a good analyst should be able to convey his/her idea:
- Be confident
- Know your material
- Convey your points effectively

A good pitch can have no meaningful content:
- What is being sold?
- What is being left out?
- What is *really* being said?

*Buy the stock, not the pitch*
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The business model drives the company forward

- Understand how the company conducts its business
  - Product offerings must be robust
  - Resources must be used efficiently
- A good business model ensures the longevity of the company
  - All financial models are based on the idea that the company will be a “going concern”

*A good business model is an essential part of a good investment*
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Microeconomics: what happens between the lines

- Key number: Operating Profit
  - Net Income takes into account the firm’s capital structure, while Operating Profit demonstrates the effectiveness of the business model
- Don’t get sold on growth rates
  - Growth of what?
    - Time horizon
    - Sales vs. Earnings
    - Arithmetic vs. Geometric

The business model must capture value
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Good business models generate above-average returns

- Sustainable competitive advantage is achieved when it is unique and not easily imitable
  - Creates excess returns for investors
- Does the analyst explain the competitive dynamics of the industry?
  - Porter’s Five Forces (see Appendix A)

A good business model should create sustainable competitive advantage
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No matter what valuation method you use, fundamentals matter

- Discounted Cashflow Valuation and Relative Valuation are driven by the same components
- Do not buy without reviewing all three components
  - Do not just focus on “growth”
- Do not let relative valuations throw you off
  - Good companies in a bad industry
  - Do not compare apple to oranges

Don’t be confused by fancy valuations - they all boil down to fundamentals
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Garbage In, Garbage Out

- The assumptions must reflect the true situation
  - Is the discount rate too low?
  - Are the growth rates too high?
    - Must be supported by fundamentals
    - Especially important in the stable growth phase
  - Are the cashflows realistic?
- All valuations are biased
  - In most cases, valuations are over optimistic

*Always be skeptical about the assumptions*
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Learn the intuition, not the method

- Learn what is behind the numbers
  - There is no meaning in memorizing equations - they are in books
- Understand the relationships between the numbers
  - What drives growth?
  - What numbers would make a company look cheap?
  - What are characteristics of a high/stable growth firm?

Understand the numbers, and sniff for signs that the analyst does not
Example: Johnson & Johnson

- What is the capital structure?
- Are there country/currency risks?
- Are the numbers coming out of a black box?
  - Don’t just show the results, show the process
- Do you understand?

**The Financials**

**Valuations**

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Why these assumptions?

When done right, the intrinsic values should all be the same
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Appendix A: Porter’s Five Forces

- Intensity of Competition
- Power of Suppliers
- Threat of Substitutes
- Threat of Entrants
- Power of Buyers