



2004 - 2005

Evaluating A Valuation

Agenda

- ☉ The Big Picture
- ☉ Speakers vs. Analysts
- ☉ Business Model
 - ☉ Underlying Economics
 - ☉ Competitive Advantage
- ☉ Financial Model
 - ☉ Appropriate Assumptions
 - ☉ Understanding the Numbers
- ☉ Appendix

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 – focus on important issues
- 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 makes money
 - Product offerings must be robust
 - Can the current business model continue to be profitable in the future
- 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)
- Competitive advantage cannot persist forever in a competitive market – did the analyst model this in the valuation

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
- Understand drivers of the valuation:
 - Cash Flows, Growth Rate, Discount Rate
- Do not let relative valuations throw you off
 - You should still understand the assumptions implied by the multiple
 - An undervalued company in an overvalued industry is not a good long term investment

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 business model
 - Does the discount rate reflect business and financial risk?
 - 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 overly optimistic

Buy the assumptions, not the value



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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 trends and anomalies
- 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

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Example: 4Kids Entertainment

Valuation - Assumptions

10 Year T-Bill Rate (9/22/04)	= 4.04%
Risk Premium	= 7.50%
Beta (2-Year Regression)	= 1.63
Cost of Equity	= 16.27%
CAGR of Sales (Hypergrowth)	= 6.46%
CAGR of Sales (Declining)	= 4.74%
CAGR of Sales (Terminal)	= 4.00%

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

Why these assumptions?

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Appendix: Porter's Five Forces

