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

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?
Appendix: Porter’s Five Forces