

FIN 6438 Study in Valuation

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Course Objective:

The objective of this course is to apply the concepts and analytic techniques taught in other courses offered in the Graham-Buffett course sequence to create a professional valuation analysis.

Materials for Course:

Course Packet available at Target Copy – contains a number of articles pertaining to first three lectures.

Valuation: Measuring & Managing Value the Value of Companies, Tome Copeland, Tim Koller, and Jack Murrin (3rd edition). This book was used in the Measuring & Managing Value Course with Joel Houston. I did not order the book since most of you have it. It is available on Amazon.com. You need not have THIS text, but you should have access to a book (or notes) that discuss detailed valuations. We will go through this process in our in-class valuations and I will spend some time on the details of a valuation analysis in my valuation analyses.

The Valuation Analysis

The course requires that each student analyze one stock in depth in a particular industry or two students analyze two stocks in a particular industry in-depth. The valuation analysis will consist of a detailed economic analysis of an industry as well as a valuation study of the one or two companies in that industry. Students may select the industry and companies that they wish to evaluate (with instructor approval). The results of this analysis will be presented in a written report to be entitled: *Valuation Analysis of “Name of stocks”*.

Many of the things that should be considered in this valuation analysis, as well as the procedures used in the valuation, have been discussed in other courses in the Graham-Buffett Course Sequence. It would be very useful to review your notes from these classes. This syllabus contains the critical considerations in your Valuation Analysis.

The advantage of analyzing more than one firm in an industry of your choice is that the desirability of any one firm as an investment vehicle may be conditional on the quality of its primary industry rivals. Besides, one method of valuation – multiples of comparable firms - will require you to collect some information on at least 3 or 4 firms that are similar to the firm you are analyzing. I suggest that the industry be one that you have some familiarity with and that you have some confidence in your ability to make ballpark projections about the future earnings profile of firms in the industry. If you have not already chosen an industry and companies in that industry, I have a few suggestions at the end of this write-up.

Course Description

This course stresses the practical applications of valuation to those that participate in the

practice of money management. The course is particularly geared toward the following audiences:

- individual investors
- those who wish to work for mutual funds (hedge funds) that actively manage money
- security analysts
- those who wish to participate in the private buyout industry or mergers & acquisitions

The approach of the course is as follows. First, why is it possible that active money management can beat “passive” asset management? A rationale for why the efficient market theory “does not always rule” is given. Second, we follow the methodology that a value oriented mutual fund might follow. We identify a set of stocks through mechanical sorting mechanisms that might, on average, outperform (or underperform) the overall market. We demonstrate that many of these sorting procedures could have been used **HISTORICALLY** to identify **PORTFOLIOS** of stocks that over and underperform market indices.

We talk about the strengths and weaknesses of these sorting techniques and generate sorts using current stock market data to identify a set of stocks that you might find attractive or that you might want to avoid. We will also use some variants of an EVA based valuation model to do some crude valuations of a number of notable companies and a number of companies that are identified by the sorting mechanisms. We also review evidence on the effectiveness of using these EVA models as a means of distinguishing stock market winners and losers. While the sorts and the EVA valuations are most helpful, they all are susceptible to various problems and are generally devoid of detailed economic analysis. Hence, we turn our attention to more “detailed” valuation methodologies like DCF.

A number of class sessions will be devoted to instructor presentations of what constitutes a good valuation analysis. This will give you a good idea of what I am looking for in your projects and will also serve as a review of key valuation concepts you were exposed to in prior courses. I currently plan to conduct fairly in-depth valuation analyses on Frisch’s Restaraunt and/or Fresh Del Monte, and probably EBAY. Fresh Del Monte and Frisch’s are good cases of valuing firms that appear to fall into a “value stock” criteria. In fact, Both stocks fall out of sorting procedures that might be used to identify stock market winners and seem pretty cheap based on various permutations of an EVA valuation model as well. Are they really bargains and is this a good time to buy a stock like Frisch’s or Fresh Del Monte? Both firms also have pensions – an important element to incorporate in many valuations.

EBAY has many of the characteristics of a fast growing, seemingly overvalued “glamour” stock. EBAY appears to have a great business model, but is the price too steep? I am not terribly enthusiastic about an EBAY valuation because my prior is that it is NOT undervalued and because forecasts of cash flow for EBAY are quite speculative, but attempting to value a firm like EBAY is an interesting exercise and illustrates the inherent speculation involved in placing a value on such firms.

Depending on time, I may also value one additional firm or substitute an LBO case for one of the valuations mentioned.

Two additional meetings of the class will be devoted to outside speakers. These talks will occur during the scheduled class periods. One speaker is Mason Hawkins, who has headed one of the leading mutual fund families of the past 25 years. Hawkins definitely falls into the “value” investing camp. The second speaker is the CFO from Florida Rock, John Milton. This speaker will give us some perspective on how at least one CFO uses valuation tools and how a CFO interfaces with the investment community.

We may have one open class date before your class projects are due. On that day, I will have extended office hours. I have regular office hours, but you can also arrange to meet me by appointment. **YOU SHOULD PLAN ON MEETING WITH ME WHENEVER YOU ARE HAVING DIFFICULTY WITH YOUR PROJECT.** This class should be viewed as an opportunity to get the basics of valuation right before you leave campus. Most of you have listened to lectures, taken notes, and read relevant materials. Few of you have done a detailed valuation analysis of a company.

The final two/three class sessions (days) are reserved for you to make class presentations of your findings. We may also use the Final exam session to finish up presentations.

Grades will be based on two tasks. First, 80% of your grade is determined by your valuation analysis. I expect very good work since this is the only real course requirement. Another 20% will be based on a 10-15 minute presentation of your research. Much like a “real world” analyst, you have a very limited period of time to make your point. Class enrollment may also affect time available for presentations. If you work in a group of two, each member of the group must discuss one stock. I will give you further guidelines on this presentation at a later date. By the way, the written analysis is due April 20 in class.

Any “breaking news” about class scheduling will be posted on the MBA Website. This site will include some limited class notes as well.

Below is a suggested outline of what your analysis should look like. (NOTE: Your analysis should be handed in with a 10K for the company and a disk with a spreadsheet valuation

Table of Contents

Executive Summary

For each firm you should briefly assess each firm’s business prospects and issue a trading recommendation (Buy, Neutral, Sell). You should briefly give the basis for your recommendations including a brief summary of the major opportunities and risks facing your companies. Remember a buy recommendation should be used with great care: Recall the “Margin of Safety!” Your cover sheet should also include book to market of

equity, 6 month relative strength, market cap, price to lag earnings, price to forward consensus earnings and consensus 5 year EPS growth forecast.

Overview of each firm

- Business Overview
- Recent Stock price performance

Industry Competitive Analysis

- Prospects for industry growth
- Rivalry Among Existing Firms
- Threat of New Entrants
- Threat of Substitute Products or Services
- Bargaining Power of Buyers
- Bargaining Power of Suppliers

Strategies of your firm

- Cost Leadership strategy
- Product differentiation strategy
- Focus (niche) Strategy

Management Quality

- Past Track record of success or failure
- Management integrity (if possible to assess)
- Past track record on use of firm free cash flows (Are managers good capital allocators?)
- Depth of management team

Key Items in Financial Statements

- Income Statements: Key trends in sales growth and profit margins
- Balance Sheet: Key trends in assets and liabilities as a percent of sale
- Firm's historic profitability: ROIC (may want to cash adjust)
- Statement of Cash Flow: Key trends in Sources & Uses of Cash
- Shareholder Equity: Payout policy, options, share issuances
- Key Notes to financial statements (e.g., operating leases, litigation)
- Financial Flexibility: Cash Position, Leverage Ratio

Valuation and Earnings Forecasts

- Comparable Price Multiples
 - Price to year ahead consensus earnings forecast
 - Value to EBIT, Value to EBITDA (with lease adjustment if needed)
- Discounted Cash Flow Valuation based on spreadsheet model
 - Entity Valuation

Investment Intangibles

This might include whether management is “signaling” that they are confident (or not) in the firm’s prospects. Examples include recent insider trading activity, recent stock issues, recent adoption of stock or profit based incentive schemes, and stock repurchase activity. You might also note recent earnings and price momentum registered by the stock

Recommendations: (Buy, Sell, Neutral)

- Include a brief summary of major opportunities and risk facing the firms.
- May also distinguish between long and short term investment prospects (as odd as that may seem)

Comments:

The material on competitive industry analysis and firm business strategy relates largely to the work of Michael Porter. Later in the class I will hand out an outline of the Porter approach that you have probably encountered in other classes.

The valuation models will be based on DCF analysis of the type stressed in your prior courses and outlined in the McKinsey valuation text. You should use the entity valuation model discussed in prior courses. This requires deriving a WACC for each company and cash flow forecasts based on a clearly illustrated set of assumptions. This also requires a set of assumptions to justify a continuing value calculation. I also have suggested comparing the multiple on your stock to those of competitors. In a class presentation (and in your write-up) it might be worth explaining why the multiples differ among competitors. This may relate to earnings quality issues!

Sources of information:

Below is a list of potential sources. The best data source in my estimation is the SEC Edgar files that give the raw filings of companies. This beats computerized data bases that sometimes lump accounting numbers together in a questionable fashion. Also, getting the raw SEC files (10-Ks) is necessary to get a look at a firm’s financial statement footnotes, a good initial introduction to each firm and its strategies, competitors, etc...

Most firms nowadays, also have access to their 10-ks and/or annual reports in PDF format in the investor relations section of their websites.

To dig deeper about individual companies, I suggest the following strategies. First, read trade publications (if available) that talk about a firm in the context of its industry. Second (if possible), talk to customers and workers of the firm. Third, talk to security analysts that follow a particular firm. These people might (or might not) be helpful with respect to getting information. Some companies also list the security analysts (and their phone numbers) that follow them on their websites. You might also download at least one analyst’s report on the firm and get its Value Line sheet from the library (business website). This will give you a feel for how other informed parties are forecasting future performance variables. Look for initiating reports by analysts. These often go into great detail about the firm. Investor relations may be helpful in getting a list of names and numbers of analysts. IR people may also give their estimation of their business rivals or refer you to the CFO. For smaller companies, the CFO might even talk to you if you have

questions about the company. Company websites can also be a good source of information about the company and recent press releases about the firm. Many websites also contain a link to the firm's most recent conference call with analysts. You can hear the questions analysts have about the business and how management responds to those questions. Management will also frequently give "guidance" at these events. NOTE: Be informed when you talk to investor relations and/or security analysts. These are busy people and they will not suffer fools lightly!

Other valuable internet sources include:

UF library on-line <http://web.uflib.ufl.edu/cm/business> Lots of great stuff here – including:

The Company center prompt at the UF business library (online) has lots of great links that talk about the company and its industry. Click on the Company tutorial and it will give you lots of tips for researching firms. Among the websites of value.

Investext plus: Firm and Industry information and some analyst reports online. These reports can be downloaded as PDF files. They give you some nice (if possibly too optimistic) examples of spreadsheet forecasts. You can also often get hardcopy of company conference calls with analysts. This is an opportunity to learn about what issues analysts find important and to see how the company officials see these issues.

Hoover's – UF online library also has a link to this service. This is an excellent online service. In-depth company profiles can be had and lots of links to other worthwhile research tools (industry trade magazines, insider trading, etc..) can be found. Also detailed financials for the last 5 years are also available for downloading. The data can be adjusted if necessary, but for the most part is accurate. The Hoover's site also has access to insider trading information, competitors, comparable firm data, etc... The Hoover site also has the capability to download 10-ks (which are essential and must accompany your final project).

S&P: Nice industry surveys

Onesource: Lots of great information and analyst reports also available

Factiva: On UF business library site has more extensive database of recent news about your firm. You can do news searches for all data sources in Factiva and come up with some pretty good news stories about your company.

Yahoo Finance – (<http://finance.yahoo.com>): Tons of information or links to information like insider trading activity and links to Edgar On-Line.

Edgar On-Line – You can link to this off of the Yahoo site by following the links to SEC filings. The files can be downloaded in RTF format and saved. I can show you this if you don't know how. You should definitely get the 10-k filing. In fact you must submit a copy of this with your paper.

MSN Stock Research

page(<http://moneycentral.msn.com/investor/research/welcome.asp>): This is a very easy to use sight with latest analysts forecasts, insider trading information, and other data. MSN also has an excellent Deluxe Stock Screener which you can use to fashion your own searches to look for stocks with the kind of characteristics you find appealing.

Securities Exchange Commission Edgar database (www.sec.gov): This is the SEC site for Edgar. It is similar to Edgar On-Line, but the latest filings are accessible immediately. Besides the 10Ks, other filings of interest are:

10-Qs: Quarterly earnings updates and analysis of firm performance. Right now, for many companies the most recent data available is a 10-Q. For firms with fiscal year end in December, many 10-Ks won't be available until March 31!

8-Ks: Significant events affecting the firm (important press releases, merger announcements, share repurchases, etc..)

Def-14A: Proxy statement that includes information on managerial ownership.

Value Line Publication (On Line library): Not a bad source to start with. Value Line gives you some pretty good summary

Operating numbers over the past 10 years: This is good if you want to look for stocks with a decent operating history (sustained high ROEs) that might be currently trading at historically low multiples relative to the market or the stocks own trading history. It is now available – at least for larger firms on the library website. NOTE: Value Line betas tend to make more sense than many other betas put out by other sources!

Prior Course textbooks and handouts including

Measuring and Managing Value by Copeland, Koller, and Murrin
Course notes from prior classes

Suggested Industries:

1. Office Supply Retailers: OfficeMax, Office Depot, Staples
2. Home goods retailers: Bed Bath and Beyond, Linens & Things
3. Discount Retailers: Target, Wal-Mart, Kohls, Costco
4. Restaurant/Bar: Applebees, Brinker International, Darden's
5. Supermarkets: Ruddick, Kroger, Safeway, Albertsons, Whole Food Market
6. Beverage: Coca Cola, Pepsi, Cotts
7. Brewing & Alcohol: Anheuser Busch, Coors, Brown-Forman
8. Microbrewers: Boston Brewing, Redhook Ale
9. Steakhouses: Lone Star Steakhouse, Outback Steakhouse, Rare Hospitality
10. Newspapers: Gannet, Washington Post, New York Times, Tribune, Knight-Ridder
11. Footwear: Nike, Reebok
12. Food Wholesalers: Nash-Finch, Supervalu Inc.

13. Home improvement goods: Masco, Black & Decker, Stanley Works
14. Computing hardware firms: Hewlett Packard, Dell, Gateway
15. Discount Apparel retailers: TJX, Ross Stores, Goodys, Stein-Mart
16. Apparel suppliers: Liz Claiborne, Jones Apparel, Philips Van Heusen, Kenneth Cole
17. Banking (south): Wachovia and SunTrust
18. Auto parts: Dana, Lear, Arvin-Meritor, Borg Warner Automotive
19. Cruise Lines: Royal Caribbean, Carnival Cruise Lines
20. Other retail apparel: Buckle, Pacific Sun Wear, Abercrombie & Fitch, American Eagle Outfitter

Obviously, there are many more firms to consider. I have selected industries above that are fairly easy to understand. You might also want to look at stocks that fall out of certain “value” screens using the Microsoft Screener.

Some businesses are fairly easy to understand and make some rudimentary projections on (unlike the Software business to name one example) and others are not. Each of you has a different familiarity with certain industries (a circle of competence). Stick to those that you understand best or perhaps have some great motivation to know better.