

# Thoughts on Valuation

## Discounted Cash Flow

- Present value of a 10-year Treasury note
- Same analysis for a stock or bond
- Focus 90% of your attention here

## Public Company Comps

- Make sure comps are valid
- Make sure entire sector isn't misvalued

## Acquisition Comps

- What multiples are acquirers (other companies or LBO firms) paying for similar companies?
- Strategic vs. financial buyers

## Historical Comps

- What multiples has this company traded at in the past?
- Has the business changed?
- Careful to exclude bubble periods

## Sum of the Parts

- Often useful to break business down into its parts and value each part separately

## Rules of Thumb

- Pay no more than 10x trailing earnings (normalized) for a fair business and no more than 20x trailing earnings for even the greatest business
- Paychex, Google, eBay

# A Valuation Rule of Thumb

**What kind of earnings multiple should an investor be willing to pay for a decent company? While this may be different for every investor, Whitney Tilson shares his rule of thumb and explains how he hopes to refrain from overpaying for even the best companies. “With few exceptions,” wrote Peter Lynch, “an extremely high P/E ratio is a handicap to a stock, in the same way that extra weight in the saddle is a handicap to a racehorse.”**

By Whitney Tilson

Published on the Motley Fool web site, 7/31/01

(<http://www.fool.com/news/foth/2001/foth010731.htm>)

I'm a value investor. This simply means I attempt to buy stocks at steep discounts to their intrinsic value, which Warren Buffett defines as “the discounted value of the cash that can be taken out of a business during its remaining life.” To do this, all I have to do is plug estimates of companies' future free cash flows into an Excel spreadsheet, apply a reasonable discount rate to determine intrinsic value, and buy stocks that trade at a goodly discount to this figure. What could be easier?

Not so fast. As Buffett notes, “intrinsic value is an estimate rather than a precise figure, and it is additionally an estimate that must be changed if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts, moreover... will almost inevitably come up with at least slightly different intrinsic value figures.”

Given this uncertainty, it's critical to buy stocks only when their valuation is so low that there's a huge “margin of safety,” to use Ben Graham's famous saying. Consider this exchange from the 1996 **Berkshire Hathaway** ([NYSE: BRK.A](http://www.nyse.com/quote/NYSE:BRK.A)) annual meeting:

“Warren talks about these discounted cash flows,” said Vice Chairman Charlie Munger. “I've never seen him do one.”

“It's true,” replied Buffett. “If [a company's value] doesn't just scream out at you, it's too close.”

## **When is a stock screaming?**

Unfortunately, stocks don't scream, “I'm really, really cheap. Buy me!” Instead, investors have to figure this out for themselves. While every investment opportunity is unique, I find it helpful to have rules of thumb regarding what I might be willing to pay for different types of businesses. One I use: Pay no more than 10 times earnings for a decent business, and no more than 20 times earnings for even the greatest business.

But this statement is extremely broad, and carries with it numerous caveats. Before applying it, one must think about these questions:

- How does one define “decent” or “great” business? I've shared thoughts on this topic in articles written in [Feb. 2000](#) and [this March](#) that discuss sustainable competitive advantage.

- Should one use trailing earnings or future earnings estimates to generate a price-to-earnings (P/E) ratio? I generally use trailing earnings rather than analysts' estimates -- unless I have good reason to believe future earnings will be materially different.
- Does the company have any debt or excess cash? If so, adjust for this, since one should compare earnings to enterprise value, not market capitalization. (Enterprise value is market cap + debt - excess cash.)
- Is free cash flow significantly different from net income? If so, depending on the circumstances, you may want to use the former as the "E" in the P/E. (I've written [a series of columns](#) on free cash flow.)
- Is this a cyclical stock, which tends to move with economic cycles? If so, ignore my rule of thumb. As Peter Lynch noted in [Beating the Street](#), "buying a cyclical... when the P/E ratio has hit a low point is a proven method for losing half your money in a short period of time. Conversely, a high P/E ratio, which with most stocks is regarded as a bad thing, may be good news for a cyclical. Often, it means that a company is passing through the worst of the doldrums, and soon its business will improve."
- Are there any unusual gains or losses that one should adjust earnings for? Be careful following a company's guidance in this area -- an increasing number of companies seem to report "one-time charges" every year. What's one-time about that?
- Does one need to adjust for stock options?

In addition to all of these caveats, there are no studies endorsing the numbers I've picked. This is my personal rule of thumb, based on my own experience, which I hesitate to share because I can't defend it in an objective, rigorous way.

I am doing so anyway, however, because I find that many people don't have the experience to know when a stock might be cheap; and perhaps more importantly, how risky it is to pay more than 50 times earnings (in some cases more than 100 times, even today!) for stocks such as those I've expressed concerns about in [previous columns](#), among them **Krispy Kreme** ([NYSE: KKD](#)), **Siebel Systems** ([Nasdaq: SEBL](#)), **Starbucks** ([Nasdaq: SBUX](#)), and **Manugistics** ([Nasdaq: MANU](#)).

### Starbucks vs. Outback Steakhouse

Let's use a specific example to see my rule of thumb at work. When I [compared](#) Starbucks and **Outback Steakhouse** ([NYSE: OSI](#)) in February, I warned investors away from the former due to its valuation, which was 61.5x trailing EPS at the time. Instead, I suggested considering Outback, which was trading at 12.6x trailing earnings.

Outback is what I'd call a prototypical "decent" business. It has steady growth, consistently high [returns on equity](#), a clean balance sheet, and substantial free cash flows it uses to repurchase shares. "It's quite likely," I said in the column "that this is a good business (in a lousy industry,

sure) that has encountered some temporary difficulties, causing its stock to become attractively priced. That's the sort of situation I like." (Incidentally, I never ended up buying the stock because I wanted to buy it even cheaper -- at no more than 10x trailing earnings -- but the stock didn't fall to that level. In fact, it's risen 10% since then.)

There's little doubt that Starbucks, with its rapid growth and powerful brand name, is a better business than Outback. But it's far from perfect -- and even if it were, I would never consider buying it with a P/E ratio more than triple my maximum of 20x. Starbucks, I concluded, was "priced for perfection," and while it was possible "the company could grow into the stock's nose-bleed valuation," the odds were "not very good, in my opinion." Since then, Starbucks is down 26%.

### **Other examples**

Though the evidence is mostly anecdotal and short-term in nature, a look back at stocks I've discussed in columns over the past year and a half is perhaps also instructional. (More historical information can be found in a recent [column](#) and discussion board [post](#).) The lesson, to me, is clear: If you buy solid companies with stocks trading at, say, seven to 12x earnings, good things are likely to happen. Conversely, if you buy the most popular stocks -- which are invariably trading at 50 to 100x earnings -- prepare to lose your money.

To quote Lynch again, this time from *One Up on Wall Street*: "If you remember nothing else about P/E ratios, remember to avoid stocks with excessively high ones. You'll save yourself a lot of grief and a lot of money if you do. With few exceptions, an extremely high P/E ratio is a handicap to a stock, in the same way that extra weight in the saddle is a handicap to a racehorse."

My goal in this column is not to toot my horn about some successful short-term stock picks, nor to argue that one should be locked into rigid P/E ratios when thinking about valuation and evaluating investments. Instead, I hope I've given some general sense of what reasonable valuation multiples look like, and -- perhaps more importantly -- how critical it is to avoid overpaying for the stocks of even the best companies.

-- Whitney Tilson

*Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He did not own shares of the companies mentioned in this article at press time. Mr. Tilson appreciates your feedback at [Tilson@Tilsonfunds.com](mailto:Tilson@Tilsonfunds.com). To read his previous columns for The Motley Fool and other writings, visit <http://www.tilsonfunds.com>.*

# Valuation Matters

## How to beat the market

By Whitney Tilson ([Tilson@Tilsonfunds.com](mailto:Tilson@Tilsonfunds.com))

Published on the Motley Fool web site, 2/7/00

(<http://www.fool.com/boringport/2000/boringport000207.htm>)

“The market, like the Lord, helps those who help themselves. But, unlike the Lord, the market does not forgive those who know not what they do. For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments.”

-- Warren Buffett, 1982 [annual letter](#) to shareholders

“We submit to you then, Fool, that valuation isn’t half so important as quality and the durability of the business model. At least when you’re building a Rule Maker Portfolio. In fact, we’ll go so far as to say that the quality of the company is fully 100 times more important than the immediate value of its stock price.”

-- The Motley Fool ([Step 7](#) of the 11 Steps to Rule Maker Investing)

I believe in The Motley Fool’s core investment philosophy of buying the stocks of quality companies (or index funds), holding for the long run, and ignoring the hype of Wall Street and the media. But if I were to level one general critique of the Fool, it would be that there is not enough emphasis on valuation. I agree -- and I’m sure Buffett would too -- that the enduring quality of a business is more important than today’s price, but 100 times more important? C’mon! The experience of the past few years notwithstanding, that “pay any price for a great business” attitude is a sure route to underperformance.

For a number of years now, we have been in a remarkable bull market where valuation hasn’t mattered. In fact, I believe that the more investors have focused on valuation in recent times, the worse their returns have been. But this hasn’t been true over longer periods historically, and I certainly don’t think it’s sustainable. While the laws of economic gravity may have been temporarily suspended, I do not believe that they have been fundamentally altered.

Don’t get me wrong -- I’m a big believer in the ways that the Internet (and other technologies), improved access to capital, better management techniques, etc., have positively and permanently impacted the economy. Nor am I the type of value investor who thinks that anything trading above 20x trailing earnings is overvalued. I simply believe in the universal, fundamental truth that the value of a company (and therefore a fractional ownership stake in that company, which is, of course, a share of its stock) is worth no more and no less than the future cash that can be taken out of the business, discounted back to the present.

I find it hard to believe that this type of thinking is present in the hottest (mostly emerging, technology-related) sectors of the market today. The enormous valuations imply phenomenal growth and profitability for numerous companies in each sector. That’s a mathematical impossibility. Sure, a few of these companies might become the next Ciscos and Microsofts, but very few will. They can’t *all* achieve 80% market share! I believe investors in these sectors are

setting themselves up for a fall, not because they're investing in bad businesses, but because the extreme valuations create a highly unfavorable risk-reward equation. I suspect many are not investing at all, but are simply speculating in a greater fool's game.

Well, if that doesn't trigger a flood of hate mail, nothing will. But before you flame me, consider this: I own some of today's hottest stocks. But I bought them at much lower (though still high, to be sure) valuations, when I felt confident that their future cash flows would justify their valuations at the time. Now, while I am not as comfortable with their valuations and am certainly not buying more, I am determined to stick to my long-term investment strategy and hang on to these stocks as long as the underlying businesses continue to prosper.

### **Overview of Valuation**

If the future were predictable with any degree of precision, then valuation would be easy. But the future is inherently unpredictable, so valuation is hard -- and it's ambiguous. Good thinking about valuation is less about plugging numbers into a spreadsheet than weighing many competing factors and determining probabilities. It's neither art nor science -- it's roughly equal amounts of both.

The lack of precision around valuation makes a lot of people uncomfortable. To deal with this discomfort, some people wrap themselves in the security blanket of complex discounted cash flow analyses. My view of these things is best summarized by this brief exchange at the 1996 Berkshire Hathaway annual meeting:

Charlie Munger (Berkshire Hathaway's vice chairman) said, "Warren talks about these discounted cash flows. I've never seen him do one."

"It's true," replied Buffett. "If (the value of a company) doesn't just scream out at you, it's too close."

The beauty of valuation -- and investing in general -- is that, to use Buffett's famous analogy, there are no called strikes. You can sit and wait until you're as certain as you can be that you've not only discovered a high-quality business, but also that it is significantly undervalued. Such opportunities are rare these days, so a great deal of patience is required. To discipline myself, I use what I call the "Pinch-Me-I-Must-Be-Dreaming Test." This means that before I'll invest, I have to be saying to myself, "I can't believe my incredible good fortune that the market has so misunderstood this company and mispriced its stock that I can buy it at today's low price."

### **Conclusion**

Since I've been quoting Buffett with reckless abandon, I might as well conclude with another one of my favorites, from his 1978 [annual letter](#) to shareholders (keep in mind the context: Buffett wrote these words during a time of stock market and general malaise, only a year before *Business Week's* infamous cover story, "The Death of Equities"):

"We confess considerable optimism regarding our insurance equity investments. Of course, our enthusiasm for stocks is not unconditional. Under some circumstances, common stock investments by insurers make very little sense.

“We get excited enough to commit a big percentage of insurance company net worth to equities only when we find (1) businesses we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) priced very attractively. We usually can identify a small number of potential investments meeting requirements (1), (2) and (3), but (4) often prevents action. For example, in 1971 our total common stock position at Berkshire’s insurance subsidiaries amounted to only \$10.7 million at cost, and \$11.7 million at market. There were equities of identifiably excellent companies available -- but very few at interesting prices. (An irresistible footnote: in 1971, pension fund managers invested a record 122% of net funds available in equities -- at full prices they couldn’t buy enough of them. In 1974, after the bottom had fallen out, they committed a then record low of 21% to stocks.)

“The past few years have been a different story for us. At the end of 1975 our insurance subsidiaries held common equities with a market value exactly equal to cost of \$39.3 million. At the end of 1978 this position had been increased to equities (including a convertible preferred) with a cost of \$129.1 million and a market value of \$216.5 million. During the intervening three years we also had realized pretax gains from common equities of approximately \$24.7 million. Therefore, our overall unrealized and realized pretax gains in equities for the three-year period came to approximately \$112 million. During this same interval the Dow-Jones Industrial Average declined from 852 to 805. It was a marvelous period for the value-oriented equity buyer.”

It is clear that Buffett’s unparalleled investment track record over many decades is the result of buying high-quality businesses *at attractive prices*. If he can’t find investments that have both characteristics, then he’ll patiently wait on the sidelines. That’s what’s happening today. As in 1971, Buffett has again largely withdrawn from the market, refusing to pay what he considers to be exorbitant prices for stocks. This is a major reason why the stock of **Berkshire Hathaway** ([NYSE: BRK.A](http://NYSE:BRK.A)) has been pummeled. And Buffett himself is ridiculed as being an out-of-touch old fogey (you should read some of the e-mails I get every time I write a favorable word about him). Only time will tell who is right, but I’ve got my money on Buffett.

Next week, I will take this discussion of valuation from the theoretical to the practical by analyzing **American Power Conversion’s** ([Nasdaq: APCC](http://Nasdaq:APCC)) valuation.

--Whitney Tilson

*Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at [Tilson@Tilsonfunds.com](mailto:Tilson@Tilsonfunds.com). To read his previous guest columns in the Boring Port and other writings, click [here](#).*

#### **Related Links:**

- Boring Portfolio, 11/8/99: [Slightly More Optimistic: Comments on Buffett’s Fortune Article](#)
- Boring Portfolio, 11/15/99: [The Debate Over Buffett’s Fortune Article](#)
- Boring Portfolio, 11/22/99: [Buffett’s Prescient Market Calls](#)
- Fool’s School: [How to Value Stocks](#)
- Fool’s School: [Security Analysis](#)

# Valuation STILL Matters

**Are companies such as Siebel Systems the best bet for the Rule Maker Portfolio? Whitney Tilson is wary of tech stocks that are priced to perfection, and fears that focusing on everyone's favorite stocks -- at the expense of valuation -- is a sure path to underperformance. He likes the idea of identifying dominant businesses with strong franchises, but prefers to wait until the price is just right.**

By Whitney Tilson

Published on the Motley Fool web site, 2/20/01

(<http://www.fool.com/news/foth/2001/foth010220.htm>)

Almost exactly a year ago, I wrote a column called [Valuation Matters](#). In it, I said:

“I believe in The Motley Fool’s core investment philosophy of buying the stocks of quality companies (or index funds), holding for the long run, and ignoring the hype of Wall Street and the media. But if I were to level one general critique of the Fool, it would be that there is not enough emphasis on valuation... The experience of the past few years notwithstanding, [the] ‘pay any price for a great business’ attitude is a sure route to underperformance.”

Since I wrote those words on February 7, 2000, here’s what has happened:

Portfolio/Index	% change
S&P 500	-9%
Nasdaq	-44%
Rule Maker	-48%
Rule Breaker	-45%
Berkshire Hathaway	+36%

My goal in showing these figures is not to gloat, but to make a point that I’ve made over and over again: valuation really does matter.

Regular readers might think, “You’re beating a dead horse, Whitney. After the events of the past year, everyone already understands and agrees with you.” I’m not so sure.

As evidence, consider that in a survey TheStreet.com conducted recently to determine which stocks its readers wanted more articles about, 47 of the top 50 were tech stocks. The Fool’s own Rule Maker portfolio has dedicated [three recent columns](#) to a potential purchase of **Siebel Systems** ([Nasdaq: SEBL](#)) -- an exceptional company, but also one whose stock is trading at either 126 or 264 times trailing earnings per share (depending on whether you use the company’s adjusted figures or actual GAAP numbers) and 85x analysts’ (very optimistic, in my opinion) estimates for 2001.

## **Siebel is almost certainly overvalued**

My answer to the question posed by the title of the Rule Maker’s most recent [column](#) on Siebel, “Is Siebel Overvalued?,” is “Almost certainly, yes.” In my mind, Siebel falls into the same category of stocks I raised questions about in [a column](#) last October. That column named some

of the most popular tech stocks at that time -- **Cisco** ([Nasdaq: CSCO](#)), **Oracle** ([Nasdaq: ORCL](#)), **EMC** ([NYSE: EMC](#)), **Sun Microsystems** ([Nasdaq: SUNW](#)), **Nortel Networks** ([NYSE: NT](#)), and **Corning** ([NYSE: GLW](#)) -- and claimed:

“It is a virtual mathematical certainty that these six companies, as a group, cannot possibly grow into the enormous expectations built into their combined \$1.2 *trillion* dollar valuation... Even if the companies perform exceptionally well, their stocks -- in my humble opinion -- are likely *at best* to compound at a low rate of return, and there’s a very real possibility of significant, permanent loss of capital. Investing is at its core a probabilistic exercise, and the probabilities here are very poor.”

I received more hate emails from that column than any other -- which should have been a clue that I was on to something. Less than five months later, here’s how these stocks have performed:

<b>Stock</b>	<b>% change</b>
Cisco	-50%
Oracle	-29%
EMC	-39%
Sun	-57%
Nortel	-68%
Corning	-64%
<b>Average</b>	<b>-51%</b>
<b>Nasdaq</b>	<b>-28%</b>

These numbers certainly highlight the dangers of investing in the most popular stocks that are priced for perfection -- like Siebel.

### **Does valuation still matter?**

One might argue that with so many stocks so far off their highs, perhaps one needn’t focus as much on valuation today. I think the opposite is true. A year ago, you could argue that even if you bought an overvalued stock, it didn’t matter since someone would come along and buy it from you at a higher price. As silly as that argument might sound, a rapidly rising stock market over the previous few years had lulled many into believing it. But today, with the market psychology broken, I don’t think a reasonable argument can be made that the “greater fool theory” of investing is likely to be very rewarding going forward.

### **My kind of Rule Maker: IMS Health**

So am I rejecting Rule Maker investing? Not at all. I wholeheartedly agree with the strategy of buying and holding for many years the stocks of exceptionally high-quality companies. But I won’t pay any price. In fact, I will only buy a stock when I think it is so undervalued that I’m [trembling with greed](#). Let me give you an example: a stock I bought last summer and still own, **IMS Health** ([NYSE: RX](#)).

IMS Health is the world’s leading provider of information solutions to the pharmaceutical and healthcare industries. Its core business -- in which it has built approximately 90% market share over the past half-century -- is providing prescription data to pharmaceutical companies, which use the data to compensate salespeople, develop and track marketing programs, and more. More than 165 *billion* records per month flow into IMS databases worldwide.

The company has offices in 74 countries, tracks data in 101 countries, and generates 58% of sales overseas. IMS Health has a near-monopoly and there are very high barriers to entry. As a person I interviewed at one of the largest pharmaceutical companies (who is in charge of its relationship with IMS) said, "There will be no more entrants into this market."

Due to its powerful competitive position, IMS mints money: It has a healthy balance sheet, very high returns on capital, huge 19% net margins, and solid growth. Revenues in the first three quarters of 2000 (IMS reports Q4 00 earnings after the close today) increased 14%, or 16% in constant currency, and net income rose 16%. With large share buybacks -- in the latest quarter, shares outstanding fell 7% year-over-year -- EPS grew 25% in the first three quarters of 2000 and is projected to grow 19% in 2001. (All figures are pro forma, as IMS has spun off a number of entities.)

At Friday's close of \$25.45, I don't think the stock of IMS Health is cheap enough to buy at this time, but it sure was last July when I bought it for \$16, equal to approximately 16x estimated 2001 EPS. It was cheap because management was widely disliked by Wall Street, due in large part to an ill-conceived merger that was subsequently called off.

While I wasn't thrilled with the management team either, I figured this was already reflected in the stock price, and I could not find a single element of weakness in IMS' financials. I couldn't see much downside to owning the stock and, over time, if the business continued to grow strongly, I suspected that management and Wall Street would smooth out their differences. This is exactly what happened. Even better, new management is now in place.

This was my kind of Rule Maker: a company with a bulletproof franchise that meets most of the key Rule Maker [criteria](#), but which is priced very attractively due to the market overreacting to a short-term issue.

-- Whitney Tilson

*Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owned shares of IMS Health at the time of publication. Whitney appreciates your feedback at [Tilson@Tilsonfunds.com](mailto:Tilson@Tilsonfunds.com). To read his previous columns for The Motley Fool and other writings, visit [www.tilsonfunds.com](http://www.tilsonfunds.com).*