Value investing

From Graham to Buffett and Beyond

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John Wiley & Sons, Inc.
Chapter 3

Valuation in Principle, Valuation in Practice

Adherents to value investing as an investment discipline believe that financial securities, like all other assets, have an intrinsic value that can be determined by careful analysis. Opportunities for profitable investment emerge when the current market price of the securities deviates significantly from this intrinsic value. The essential task of the successful value investor is to determine intrinsic value with enough accuracy to take advantage of the market’s mispricing. There are methods in abundance for estimating an asset’s true value, but some work better than others. This chapter argues that the methods pioneered by Graham and Dodd possess significant practical advantages over the commonly used alternatives. Therefore, the historical success of the value approach has not been an accident.

The Present Value of Current and Future Cash Flows

There is wide agreement in theory that the intrinsic value of any investment asset—whether an office building, a gold mine, a company selling groceries at the corner or groceries over the Internet, a government bond, or a share of General Motors stock—is determined by the present value of the distributable cash flows that the asset supplies to its owner. Present value is properly calculated as the sum of present and future cash flows, both outlays and receipts, with each dollar of future cash flow appropriately
The three sources of value are:

1. The intrinsic value of money (see Appendix B for calculations).
2. The value of the company’s reported earnings.
3. The value of the company’s growth potential.

The intrinsic value of money is calculated by discounting the present value of future cash flows. The value of the company’s reported earnings is calculated by discounting the present value of future earnings. The value of the company’s growth potential is calculated by discounting the present value of future growth.

The three sources of value are related to each other in that the present value of future cash flows is influenced by the company’s reported earnings and growth potential. The present value of future earnings is influenced by the company’s growth potential. The present value of future growth is influenced by the company’s reported earnings and growth potential.

The three sources of value are also related to the risk-free rate of return. The risk-free rate of return is the rate of return that an investor can expect to earn on an investment with no risk. The risk-free rate of return is used to discount the present value of future cash flows, future earnings, and future growth.

The three sources of value are also related to the discount rate. The discount rate is the rate of return that an investor requires on an investment. The discount rate is used to discount the present value of future cash flows, future earnings, and future growth.

The three sources of value are also related to the risk premium. The risk premium is the additional return that an investor requires on an investment that has a higher risk. The risk premium is used to discount the present value of future cash flows, future earnings, and future growth.

The three sources of value are also related to the investment horizon. The investment horizon is the time period over which an investor plans to hold an investment. The investment horizon is used to determine the appropriate discount rate and risk premium.

The three sources of value are also related to the liquidity of the investment. The liquidity of the investment is the ease with which an investor can convert the investment into cash. The liquidity of the investment is used to determine the appropriate discount rate and risk premium.

The three sources of value are also related to the tax rules. The tax rules are the regulations that govern the taxation of investments. The tax rules are used to determine the appropriate discount rate and risk premium.

The three sources of value are also related to the accounting standards. The accounting standards are the rules that govern the preparation of financial statements. The accounting standards are used to determine the appropriate discount rate and risk premium.

The three sources of value are also related to the economic environment. The economic environment is the set of conditions that influence the economy. The economic environment is used to determine the appropriate discount rate and risk premium.
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Three Sources of Value

Of what then can we speak? Let us go back and look at Ford Motor Company. It would be rash to predict its cash flow now, but there are some things we can state with confidence.

Element 1: The Value of the Assets

First, we can speak about the present condition of the company. Following Graham and Dodd, we are going to start with an asset valuation for the firm. We begin with what is known as the balance sheet and examine the value of the company’s liabilities next. We know that the company’s assets are going to be more accurate for some assets than for others. Thus, as we work down, the balance sheet, the reader is likely to experience some revisions in the current value of the liabilities and assets of the company.

The balance sheet may contain the following categories:

1. Cash and Short-Term Investments
2. Accounts Receivable
3. Inventories
4. Property, Plant, and Equipment
5. Intangible Assets
6. Liabilities

Graham and Dodd, in their classic work, "Security Analysis," argue that the balance sheet is the most important part of an investor’s analysis. Without understanding the balance sheet, it is difficult to understand a company’s financial health. The balance sheet shows the company’s assets, liabilities, and owners’ equity at a specific point in time. It is a snapshot of the company’s financial situation.

1. Assets:
   - **Current Assets**:主要包括现金及现金等价物、短期投资、应收账款、存货等。这些资产是公司流动性的体现，能够快速变现。
   - **Non-Current Assets**: 包括固定资产、无形资产等。这些资产是公司长期经营的基础。

2. Liabilities:
   - **Current Liabilities**: 主要是短期借款、应付账款等。这些负债是公司短期资金来源。
   - **Non-Current Liabilities**: 包括长期借款等。这些负债是公司长期资金来源。

3. Owners’ Equity:
   - **Common Stock**: 公司的股本。
   - **Retained Earnings**: 公司历年盈余未分配部分。

The balance sheet is an important tool for understanding a company’s financial position. It provides a snapshot of the company’s assets, liabilities, and owners’ equity at a specific point in time. By analyzing the balance sheet, investors can gain insights into the company’s financial health and make informed investment decisions.

The next step is to determine the value of the company’s assets. This involves calculating the market value of each asset and subtracting the book value from the market value. The difference between the market value and the book value represents the company’s capital gains or losses.

Finally, we need to consider the company’s liabilities. Liabilities are claims against the company’s assets. They represent the company’s obligations to others.

1. **Current Liabilities**: 短期负债，通常包括短期借款、应付账款等。
2. **Non-Current Liabilities**: 长期负债，通常包括长期借款、应付债券等。

The company’s assets and liabilities are classified into two categories: current and non-current. Current assets and liabilities are those that are expected to be converted into cash within one year, while non-current assets and liabilities are those that are not expected to be converted into cash within one year.

Another aspect of asset valuation is the relative importance of each asset type. For our Ford Motor Company example, the choice depends on the strategic judgment regarding the nature of the business. If the company plans to increase its sales in the near future, then investments in current assets, particularly inventory, may be more important. On the other hand, if the company plans to expand its manufacturing facilities, then investments in non-current assets, particularly property, plant, and equipment, may be more important.

The most speculative view is the one where we think in terms of the balance sheet. The discrepancy between what we see on the balance sheet and the accounts receivable, the inventory, and the investments will determine how much of the stock we will be worth buying.
Element 21: Earnings Power

The second most reliable measure of a firm’s intrinsic value is the second earnings calculation made by Graham and Dodd, namely the value of its current earnings, properly adjusted. This value is established by first reducing the firm’s payables and payables receivable — and perhaps its equity reserves as well — to a number of its current earnings, and then applying to the earnings a cost of capital rate appropriate for the firm’s asset base. This second earnings calculation is the only one that attempts to put the firm’s earnings on a profit or cost basis, which is different from the first earnings calculation that attempts to determine the firm’s asset and cash value. The second earnings calculation requires the firm to estimate its future earnings and to adjust them for the company’s asset base and its capital structure. This calculation is widely considered to be the most reliable and accurate method of determining a firm’s intrinsic value.

The traditional Graham and Dodd earnings assumption is that the earnings level is fixed and that the earnings level remains constant and that the firm’s earnings are related to its current earnings, which are the firm’s future earnings. Using these assumptions, the equation for the earnings value is:

\[ \text{Earnings Value} = \text{Adjusted Earnings} \times \text{Cost of Capital} \]

This equation is used to determine the firm’s earnings value, which is then applied to the firm’s asset base to determine its intrinsic value.

1. Intrinsic calculations are often subject to the same errors as earnings calculations. We make absolutely no claim that the earnings level is fixed. We are just using the earnings calculation to determine the intrinsic value of the firm. The earnings calculation is widely considered to be the most reliable and accurate method of determining a firm’s intrinsic value.

2. Resolving discrepancies between depreciation and amortization as
3. Taking into account the current position in the business cycle and other important factors that affect the earnings experienced by the company, the method described in the other approach reduces earnings by 2,5%.

4. Considering other modifications we discuss in Chapter 5.

The goal is to arrive at an accurate estimate of the current distributable earnings. The company should be in a strong financial position and the earnings generated should be more reliable than the pure based valuation. It is considerably more accurate, but this form of calculating is very difficult to achieve in practice. It has the advantage of being based on a conservative valuation and is unaccommodated by more uncertain companies about the future.

Also, there is an important and close connection between the EVA and the cash flow, which management is doing in the firm. In the second, the EVA and the cash flow are often equal. This is particularly true for the companies where there are no new investments. There is a strong correlation between the EVA and the future earnings. This correlation is based on the principle of the value of the franchise, that the future earnings are much less than the current earnings. The franchise is the value of the firm's ability to earn more than the average return on capital. The franchise is unaccommodated by current earnings and is based on the Future earning power. We have ignored here the value of the franchise of earnings.
free entry, a $1 billion investment, should produce $1 billion in added value to the firm. The returns are in the order of magnitude of $1 billion in added value, in terms of the firm's existing business. However, the increase in value is not immediate. It occurs over several years as the new investment is integrated into the existing business. The new investment increases the firm's overall value, but it takes time to realize the full benefits.

The firm's growth strategy can be divided into three main stages:
1. **Initial Growth Stage**: This stage is characterized by rapid growth and significant investments in new technologies, infrastructure, and human capital. The firm expands its capacity to meet the increased demand for its products and services. During this stage, the firm's value is primarily driven by the growth in sales revenue and the resulting increase in cash flows.
2. **Mature Growth Stage**: In this stage, the firm's growth slows down as the market becomes saturated and the demand for its products and services stabilizes. The firm's value is now driven by its efficiency, cost control, and ability to maintain high margins. The firm may also focus on diversification and horizontal integration to maintain its competitive advantage.
3. **Decline Stage**: In the decline stage, the firm's growth slows down further due to increased competition, obsolescence of its products, or changes in consumer preferences. The firm's value may be eroded as its profitability declines. The firm may need to divest unprofitable segments or explore new growth opportunities.

The firm's growth strategy is also influenced by its competitive environment. The presence of strong competitors can limit the firm's ability to achieve high growth rates. However, the firm can differentiate itself by offering unique products or services, or by developing strong customer relationships. The firm's ability to adapt to changes in the competitive environment is critical to its long-term success.

The firm's growth strategy is also influenced by its financial structure. The firm may need to raise capital through equity or debt financing to fund its growth. The choice of financing method affects the firm's cost of capital and its ability to retain control over its operations. The firm's financial structure should be aligned with its growth strategy to maximize shareholder value.
Each of the elements of valuation—assets, earnings power, and growth—is useful in its own right, but the best insights into a firm’s value come from comparisons among them, especially the direct comparison between the asset value and the EPV. Consider the case in which the asset value of a company—the reproduction costs of the assets—is greater than its EPV, properly calculated. There are only two conditions in which we are likely to find these results. In the first, the firm’s management is doing a poor job by failing to earn as much on the assets as it should. In the second, the industry is operating with more than normal excess capacity. Either it has expanded too rapidly ahead of an anticipated increase in demand or it has not shrunk quickly enough to adjust to a permanent decline.

Careful investigation can determine which of these conditions, poor management or excess capacity, is responsible. If it is poor management, then potential value may be unlocked by a catalyst, such as a takeover or even the threat of one, that will either bring in new faces or concentrate the attention of the incumbents. If the problem is overcapacity, the firm’s value will increase no faster than the rate at which the excess capacity is absorbed by new demand or eliminated as assets decay and are not replaced. In both situations, the true value investor will ignore the higher asset value and use the lower earnings power figure as his or her measure of the firm’s intrinsic value. He or she will also look to purchase shares when the market prices them far enough below this intrinsic value to provide a sufficient margin of safety. Discrepancies between asset value and EPV suggest both an opportunity and a caution. If the gap can be closed because of better management, then the intrinsic value of the firm will increase, which should be quickly reflected in its market price because the earnings will grow (i.e., return to normal). On the other hand, the fact that the assets are not producing the earnings they should indicate that the firm is operating at a competitive disadvantage. If the firm raises additional capital to invest for growth, that investment will tend to destroy rather than add to value.

When separate valuations of the assets and of the earnings power produce figures that are approximately the same, we have confirmation of the accuracy of the intrinsic value estimate. The agreement between the two approaches suggests that the quality of the management is average and that
the firm enjoys the competitive advantages over its rivals. These conditions translate to higher profitability, greater market share, and more than its competitors. Consequently, the firm acquires more capital, which it can invest for higher returns. Thus, investors who purchase shares in the firm benefit from this competitive advantage, as well as the market rate, and will assign a higher value to any future growth in the firm's value.

Finally, the EPI is substantially greater than the firm's value, that attribute being an estimate of the future growth of the firm. Consequently, the EPI can be interpreted as a measure of the firm's competitive advantage over its rivals. The higher the EPI, the greater the competitive advantage, and the higher the value of the firm.

Therefore, the value of a firm cannot be assessed simply by looking at its current economic performance. One must also take into account its competitive advantage and its potential for future growth. This is why the EPI is so important in assessing the value of a firm. It provides a measure of the firm's competitive advantage and its potential for future growth.

The more competitive advantage a firm has, the higher its EPI, and the higher its value. In other words, the EPI is a measure of the firm's competitive advantage and its potential for future growth.

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