Seeking Alpha

Is That Stock Attractively Valued? Your Beloved Multiples May Fool You

Apr. 8, 2020 1:41 PM ET9 comments | 26 Likes

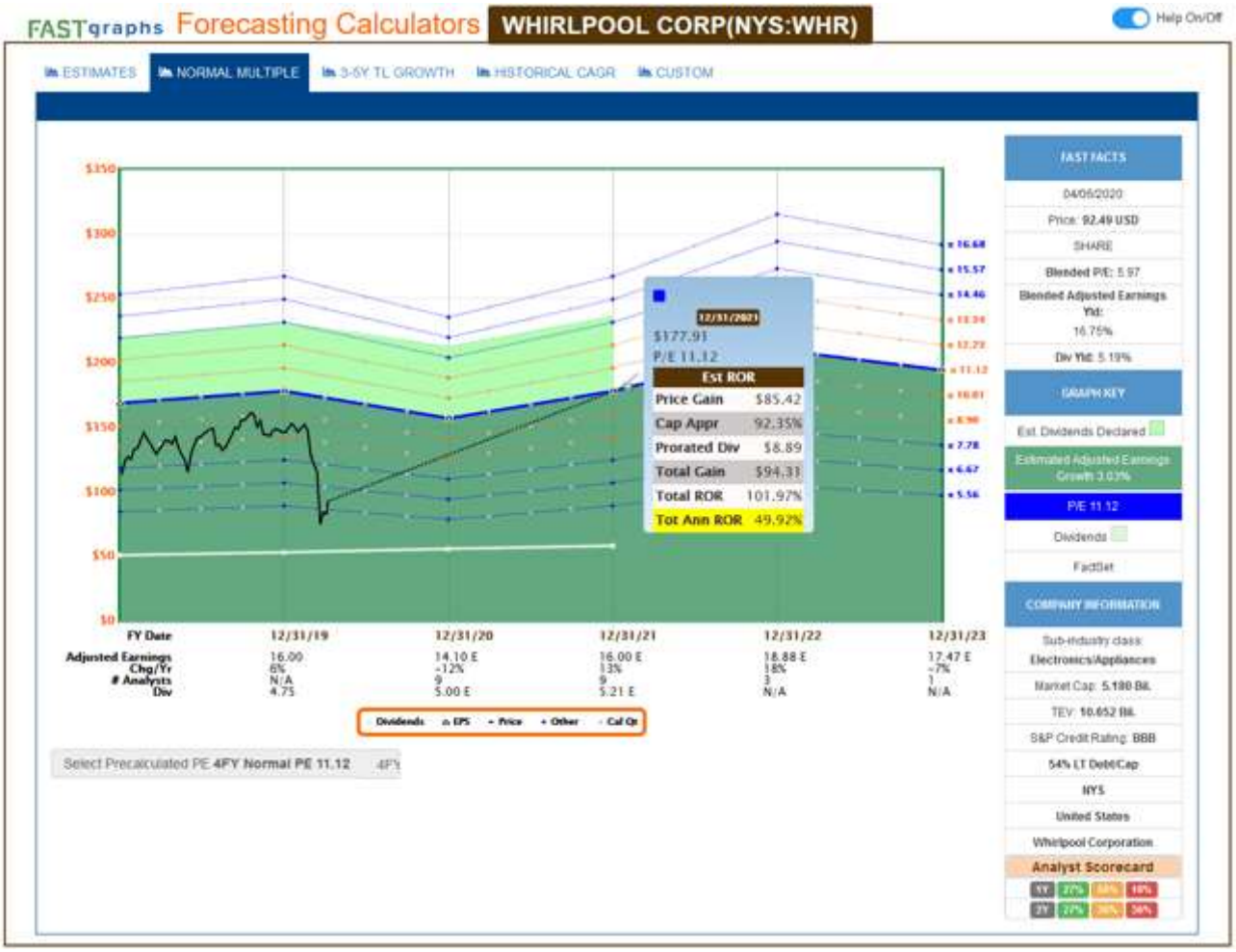
by: The FALCON Method

Summary

- What's the problem with the widely-used valuation multiples?
- The "money's-not-free approach"
- A classic example of where EVA (Economic Value Added) and EPS differ and EVA wins the argument.
- Future Growth Reliance: our sentiment indicator of choice.

Most investors use multiples when it comes to assessing a stock's valuation. The classic line of thought goes something like this: "Whirlpool (WHR) is trading at a PE of 6 while the typical range for this stock has been between 11 and 14 in the last five years, so the stock looks cheap."

"If the sentiment turns, and the PE multiple climbs back to 11, I could get a very attractive annualized rate of return."



While I believe that widely-used multiples like PE are rather sentiment indicators than valuation tools, I have to admit that as long as you focus on quality stocks (see the first part of this series on our wide-moat filter), you should do very well if you buy them when they seem to be attractively valued in historical comparison. So what could go wrong?

First, which multiple would you pick? PE?

Is the most popular price-to-earnings (PE) your multiple of choice with EPS in the denominator? If so, you must be rooting for an increase in the company's earnings-per-share so that this higher EPS, multiplied by your target PE ratio (that you wish the stock would climb back to) would give a higher share price, thus a higher return on your investment. The problem is that EPS is the earnings that accountants calculate, and accounting has serious flaws. In fact, EPS can increase if all earnings are retained and simply invested at a non-zero rate. Does this make the company more valuable? **Are you really satisfied with any non-zero return on that retained money that belongs to you?**

To take this further, any investment financed with debt, such as a major acquisition, will contribute to accounting net income, increase earnings per share (EPS), and elevate the firm's reported return on equity (ROE) so long as it generates a rate of return that is anything over the after-tax cost of the borrowed funds, that is near zero these days. Even Warren Buffett made this point in his 2017 letter to Berkshire shareholders:

> The ample availability of extraordinarily cheap debt in 2017 further fueled purchase activity. After all, **even a high-priced deal will usually boost per-share earnings if it is debt-financed.** At Berkshire, in contrast, we evaluate acquisitions on an all-equity basis."

Any firm can show positive net income and EPS along with EPS growth as long as it is covering the after-tax cost of the money it borrows. **In accounting, stockholders' equity is considered free. As long as you have any return expectation when you invest in stocks, you must disagree** with the Generally Accepted Accounting Principles (GAAP), and you most certainly need to address this issue when making investment decisions. Using the PE, as I did for illustration purposes in "the classic line of thought" example above, ignores this huge shortcoming. EPS says nothing about the true value creation of companies, thus any multiple based on EPS should be used very carefully, if at all.

That said, the price (P) part of the ratio has its flaws as well. See Joel Greenblatt's example below (from his book The Little Book That Still Beats the Market):

	Company A	Company B
Sales	100$	100$
EBIT	10$	10$
Share price	60$	10$
Debt	0$	50$
Interest Expense	0$	5$
Pretax income	10$	5$
Tax (40%)	4$	2$
Net income	6$	3$
PE	10 (60/6)	3.33 (10/3)

EV	60$	60$ (10+50)
EBIT / EV	10/60	10/60
EV/EBIT	6	6

While A and B are the exact same companies, **the difference in their capital structures distorts the PE (and all capitalization-based multiples, for that matter)**. Have you ever thought about this when mechanically applying your PE targets in a tool like FAST Graphs? Sure, multiples using Enterprise Value (EV) instead of price address this problem, but as soon as you pick EBIT, EBITDA, or Free Cash Flow as the second part of your EV-based ratio, you may be in for some trouble.

Cash is king, isn't it? What about Free Cash Flow as part of a multiple?

Free Cash Flow (FCF) can be calculated by deducting capital expenditures from the operating cash flow. Basically, FCF is the amount of cash that remains after everything has been paid, all new investments have been made, and is available for distribution to the shareholders. The key question goes: **Is more free cash flow always better? Not really!**

A large amount of free cash flow may indicate that the company can't find sufficient opportunities for new investments, which can limit future growth prospects. Negative free cash flow, on the other hand, could indicate that the company has an abundance of investment opportunities but not enough internal cash flow to pursue all of them. In fact, FCF in any one year, or even over longer intervals, is not a reliable measure of performance. The key question is whether the company is investing in positive NPV (Net Present Value) projects that have attractive returns above the cost of capital. If yes, the more investments it makes, and the lower or more negative its free cash flow goes, the greater value is created (that will be reflected in the stock price). It is simply not possible to tell whether a firm is more or less valuable by generating more or less free cash over a period of time, so there go your P/FCF and EV/FCF multiples.

If you wish to devote some time to killing all the popular multiples containing EBIT, EBITDA, or book value, you may want to read the book Best-Practice EVA by Bennett Stewart. Not an easy read, but you can find examples there that illustrate how continuing growth in sales, EPS, EBIT, and EBITDA can be produced without any increase in shareholder wealth. Here's a quotation from the book that summarizes the problem with the most popular valuation multiples:

> If you believe stock prices result from the market applying a multiple, then you believe the best way to increase your stock price is to increase the denominator of whatever multiple you like the most. And if you do that, odds are you will end up killing your EVA [Economic Value Added] and your stock price. If you cotton to P/E, you aim to increase the E, the earnings per share, and you move mountains to avoid diluting EPS. If enterprise multiple is what you fancy, then you go on a warpath for more EBITDA. You are willing to spend any amount on capital so long as you improve cash profit. And if price-to-book is your cup of tea, you grow the book value. You retain earnings and add assets that increase your capital charge and reduce your EVA. In each case, you are literally aiming at measures that will almost guarantee you will kill your firm's EVA and end up trading for a much lower multiple of whatever denominator measure you used as your performance goal."

On to real value creation

Although Warren Buffett has never used the trademarked term EVA (Economic Value Added) in his letters, he keeps emphasizing the importance of the "money's-not-free approach". (In fact, he uses this "money's-not-free approach" term in his 1994 letter when he writes about the compensation plan at Scott Fetzer. Under the plan, the CEO's bonus increases when earnings on additional capital exceed a meaningful hurdle charge, and decreases if incremental investment yields sub-standard returns. Equity is not free money. Retained earnings must earn their keep!)

> Indeed, in both 2015 and 2016 Berkshire ranked first among American businesses in the dollar volume of earnings retained, in each year reinvesting many billions of dollars more than did the runner-up. **Those reinvested dollars must earn their keep.**" (Warren Buffett in his 2016 letter to Berkshire shareholders)
>
> Unrestricted earnings should be retained only when there is a reasonable prospect - backed preferably by historical evidence or, when appropriate, by a thoughtful analysis of the future - that for every dollar retained by the corporation, at least one dollar of market value will be created for owners. This will happen **only if the capital retained produces incremental earnings equal to, or above, those generally available to investors**." (Warren Buffett in his 1984 letter to Berkshire shareholders)

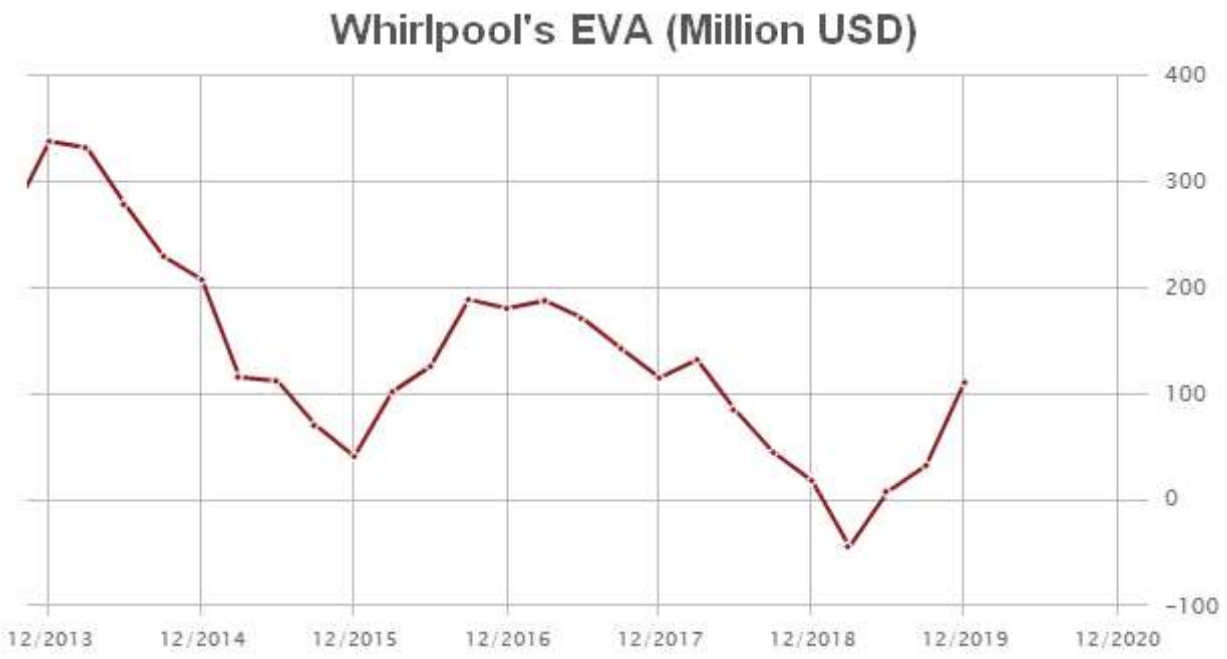
As you can see, one of the greatest investors of all time does think that the accounting distortion of "free equity" must be addressed. Here is where EVA (Economic Value Added) enters the field. In simple terms, EVA is sales less operating costs less the full cost of financing business assets, as if the assets had been rented.

> The cost of capital, in other words, is not a cash cost you can see and touch. It is not a cost that accountants actually deduct or ever will. It is an opportunity cost— the cost to the lenders and shareholders of giving up the returns they could otherwise expect to earn from investing their money in a stock and bond portfolio that has a risk profile the same as the company in question." (Best-Practice EVA by Bennett Stewart)

In the EVA framework, the company is earning a positive economic profit only after covering all resource costs, something that is true of only about half of the public companies in the economy at any time. (Read it again: **it is not at all evident that companies are earning adequate returns on the capital they employ**. More companies are profitable in the accounting sense than those who can outearn their true cost of capital, with the equity portion included.)

Take a look at Whirlpool between 2013 and 2019!

Earnings per share shows a nice increase almost every year, yet the stock price is moving sideways. See the explanation below.



Source: evaexpress.com

WHR - EVA Income Statement	Consumer Durables & Apparel | Mkt Cap: $ 5.8B |						
Fiscal Period:	2013TFQ4	2014TFQ4	2015TFQ4	2016TFQ4	2017TFQ4	2018TFQ4	2019TFQ4
Period Ending:	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19
Sales	$18,769	$19,872	$20,891	$20,718	$21,288	$21,037	$20,419
Sales Growth Rate (y-o-y)	*3.5%*	*5.9%*	*5.1%*	*-0.8%*	*2.8%*	*-1.2%*	*-2.9%*
COGS (Adjusted)	14,743	15,736	16,511	16,227	16,811	16,609	16,130
SG&A (Adjusted)	918	990	1,188	1,086	1,209	1,242	1,256
EBITDAR	3,108	3,146	3,192	3,405	3,268	3,186	3,033
Working Capital Charge	139	154	179	182	179	166	128
PP&E Charge	1,057	1,084	1,255	1,216	1,212	1,224	1,073
EVA From Operations	1,913	1,909	1,758	2,007	1,877	1,796	1,832
Intangible Capital Charge	1,083	1,145	1,257	1,283	1,322	1,323	1,288
R&D Charge	*609*	*641*	*651*	*658*	*668*	*669*	*662*
Ad&Promo Charge	*299*	*305*	*308*	*330*	*354*	*371*	*369*
Book Intangibles Charge	*175*	*199*	*298*	*295*	*300*	*284*	*258*
EVA Before Tax	830	764	500	724	555	473	544
EVA Effective Tax	268	230	155	184	145	111	134
EVA After Tax	561	534	345	540	410	362	410
Other EVA	-42	-109	-24	-64	18	24	54
EVA Excluding Goodwill & Special Items	519	425	321	476	427	386	463
Goodwill & Cum Unusual Items Charge	182	219	281	296	313	369	353
EVA	$337	$207	$40	$180	$114	$18	$110
ΔEVA	$305	-$130	-$166	$139	-$65	-$97	$92

Source: evaexpress.com

While EPS showed growth, the increase in EVA (real value creation) was not that clear, to say the least. This is a classic example of where EVA and EPS differ, and EVA wins the argument. In fact, a stock is worth more only if

1. the underlying company is creating more value, meaning that the current EVA increases,
2. or investors' expectations about the firm's future EVA creation increase.

As an investor, you are only served well by a company if it earns a better return on your money than you could earn with an investment of the same risk profile. With that said, it's time to accept that the PE multiple is just a plug: it's the arithmetic relationship between the earnings that accountants calculate and the share price that true value creation determines. **The PE is the result of the valuation, not the source of it!**

So where does this take us? Introducing the Future Growth Reliance

To repeat: the true drivers of shareholder returns are earning and increasing EVA and increasing expectations for earning even more EVA. If you don't like the term EVA, you can call it however you wish, the point is that you must focus on real value creation and not the widely-used accounting categories of profit and cash flow.

As expectations about future value creation are a driver of the stock's valuation, it's time to dissect the components of value in the EVA framework so that we can see what expectations are reflected in the current stock prices. After all, **as long as we limit**

ourselves to the very best companies (wide-moat stocks as written in the previous part of this series), **the odds are heavily stacked in our favor if we only buy these quality names when expectations are at or near all-time lows**. Even so, aiming for a diversified portfolio of stocks is recommended as anything can go wrong with a single company, but it's very hard to imagine a scenario where we would earn subpar returns with a portfolio of such stocks in the long run.

For quantifying the expectations for future growth in EVA, we can use the so-called Future Growth Reliance ratio. I deliberately simplify here, just to get the point through as easily as possible. (If you want all the details, read the Best-Practice EVA book.)

A firm's market value consists of the following components:

- Capital (that includes all capital invested in the business, including working capital, net PP&E, the present value of rents, and intangible capital, and several capital adjustments)
- Current Value Added (CVA): The value derived from capitalizing current level EVA at the cost of capital in perpetuity. In practice, this is trailing 4-quarter EVA divided by the cost of capital (i.e., a zero-growth EVA perpetuity). This comes from assuming that the firm's EVA remains constant forever.
- Future Value Added (FVA): The present value of the expected growth or decline in EVA. When a stock has negative FVA, investors expect EVA to decline from its current level, and vice versa.

There is a way to derive FVA from share prices. This implied FVA measures the total present value of the growth in EVA that investors are implicitly forecasting. Future Growth Reliance (FGR) is the ratio of FVA to market value. It is the percent proportion of the firm's market value that is derived from, and depends on, growth in EVA. **In short, FGR describes the level of confidence that the market is placing on the company's ability to rebound from a cyclical downturn or strategically drive EVA expansion.** E.g.: the FGR ratio of 20 percent says that the firm's market value would tumble 20 percent if investors became convinced that it would never be able to increase EVA above its current level. A negative FGR ratio signals that the market is discounting the stock's current level of EVA, indicating an expectation for future headwinds.

To sum up, a higher FGR ratio indicates higher valuation. We want to buy our wide-moat targets when this sentiment indicator is low. As complicated as the above paragraphs may sound, in practice we are looking at charts like this and have formulas to compare the stock's current FGR-based valuation to its long-term mean and median.

Source: evaexpress.com

To make it clear, the FGR ratio is still a sentiment indicator and not a valuation tool. The ratio can be compared to peers, industry benchmarks and the stock's own history. (We mostly do the latter in our stock selection process.) I believe that the FGR is exactly what we needed in the second step of our stock selection process as this is **the best-of-breed sentiment indicator that addresses accounting distortions, thus gives us a true picture of which wide-moat companies seem attractively valued in historical terms**. We want to buy our top-quality targets when the baked-in expectations are low, since that is when surprising on the upside has the highest probability. As investment is a game of probabilities, all we can do is stack the odds in our favor as much as possible.

That said, no indicator is perfect and the FGR may have its flaws, this is why we base our decisions on multiple sources. Remember that we already had a DCF-based valuation filter in our first step before implementing our EVA-based historical sentiment filter. We are still not ready to print our shortlist of stocks for thorough qualitative analysis but our shortlist is getting shorter and much more manageable. There's more to follow, so stay tuned!

If you liked this article and do not want to miss any of these in the future, please scroll up and click "Follow" next to my name.

Disclosure: I am/we are long WHR, TROW, BRK.B. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.