



# Tilting the Odds In Your Favor

---

## A Layman's Guide to Due Diligence

BMW Conference 3.0  
Raleigh, NC  
October 12, 2007



## The Spirit-Crushing Agenda

---

- Personal Background
- Due Diligence = An Underappreciated Artform?
- Ponch's Irreverent Investing Precepts
- Finance 101 and the Primacy of Free Cash Flow
- Intrinsic Value and Backing Into Market Expectations
- The Earnings and P/E Mirage
- Financial Modeling
- Qualitative Due Diligence
- Hands-On Case Study



## Personal Background

---

- Ponch73
- 6+ years as a bulge bracket institutional investor
- Recovering Aggressive Growth Investor
- Former lives as a Disney strategist and mgmt consultant
- Around the World in 221 days
- Always unflappable and impeccably poised
- Prominent weaknesses include poker, Boston Red Sox



## Due Diligence = An Underappreciated Artform?

---

- BMW Method board's incredible generosity of spirit
- BMW Method = stockcharting + **due diligence**
- Compound the odds-tilting in one's favor
- Increase the underlying confidence with which to double down
- Shortfall of due diligence posts = opportunity?
- Inform qualitative discussion with financial history / analysis
- Common goal of becoming better evaluators of opportunities
- BMW Due Diligence Board?

## Ponch's Irreverent Investing Precepts

---

- Patience arbitrage
- Beware of false prophets
- Conventional wisdom is insidious
- Unconventional wisdom is inconspicuous
- Doing your own homework pays intangible dividends
- Optimize risk/reward by estimating the floor and ceiling price
- Buy into panic, sell into euphoria
- The most money can be made on the 2<sup>nd</sup> and 3<sup>rd</sup> trade
- “Diversification is a hedge against ignorance”

# Finance 101

---

- Worth = present value of future stream of **free** cash flows
- Future stream is discounted by the **discount rate**
  - **Discount rate** = risk free rate + equity risk premium
  - **Risk free rate** ~ 10 year Treasury yield
  - **Equity risk premium** ~ 5-6 percentage points (500-600 basis points)
- A shorthand approach to valuation is a free cash flow multiple
  - **FCF multiple** =  $1 / (k-g)$
  - **k** = discount rate
  - **g** = long-term growth rate
- A no growth company is worth ~10x free cash flow. Why?
- What is the market's opinion of a firm at 8x free cash flow?

# The Primacy of Free Cash Flow

---

- **Long-term stock values** correlate closest to free cash flows
- Earnings are a shorthand proxy for free cash flows. However:
  - Earnings can be manipulated or goosed (Enron)
  - Earnings can embed considerable or complex assumptions (Doral, Bear Stearns)
  - Earnings can represent a departure from observable reality (Computer Associates)
- Earnings are for **accountants**. Free cash flows are for **investors**.
  - Free cash flows are a **real** operational by-product
  - Much more difficult to manipulate a **stream** of free cash flows
  - Free cash flows can be **more easily audited** by a layman investor
- **Do not** accept Wall Street's lazy conventions for free cash flow!
  - EBITDA, operating cash flow and cash earnings are **not** free cash flows
- At least **three** industries do not lend themselves well to free cash flow analysis. Here, **tangible book value** may be a better metric to determine floor valuations.
  - Financial services (banks, insurance, specialty finance)
  - Retail (clothing, food)
  - Biotech

# Intrinsic Value Calculations and Market Expectations

---

- A stock's intrinsic value is the stream of expected future free cash flows. For simplicity's sake, the inputs are as follows:
  - Discount rate (usually 10% or 11%)
  - This year's free cash flow
  - Expected free cash flow growth for next 5 years
  - Expected free cash flow growth for 5 years thereafter
  - Expected inflationary free cash flow growth rate thereafter (usually 3%)
- By determining a stock's current free cash flow multiple, you can infer the market's expectations for future cash flow growth
  - 10x = 0%
  - 14.3x = 3%
  - 16.4x = 5% for 10 years, then 3%
  - 23.3x = 10% for 10 years, then 3%
- Most free cash flow multiples will fall in the range of 10x to 40x

# The Earnings and P/E Mirage

---

- Which is the cheaper stock?
  - A: \$40 bil market cap and \$3 bil in net earnings (P/E = 13.3)
  - B: \$20 bil market cap and \$1 bil in net earnings (P/E = 20)
- Now, which is the cheaper stock?
  - A: \$40 bil market cap, \$20 bil in net debt and \$3 bil in net earnings
  - B: \$20 bil market cap, \$5 bil in net cash and \$1 bil in a/t earnings
- Now, which is the cheaper stock?
  - A: \$40 bil market cap, \$20 bil in net debt and \$2 bil in unlevered free cash flow
  - B: \$20 bil market cap, \$5 bil in net cash and \$1.5 bil in unlevered free cash flow
- P/E ratios or earnings yields ignore balance sheet effects or cash intensity
- A far better metric is to compare the ratio of enterprise value (market cap + net debt or market value – net cash) to unlevered free cash flow (free cash flow excluding the effect of interest expense or interest income)
- Remember that it is **entirely inappropriate** to compare price to cash flow (apples to oranges)

# Financial Modeling

---

- Build a thorough long-term financial model with at least 10 years of history
- Such a financial model might include the following four key sections
  - Price, volume, revenues, gross, operating, net income / margins, diluted shares
  - Operating and free cash flows, capex, and nonrecurring / non-operational items
  - Uses and sources of cash (acquisitions, stock repurchases)
  - Assets (including cash and non-interest-bearing current liabilities)
- Your financial model will tell you a story in numbers
  - Margin trends denote pricing power, competitive dynamics and barriers to entry
  - Free cash flows point to a company's true level of profitability
  - Share count and dividend trends speak to management's regard for shareholders
  - Cash-adjusted Return on Invested Capital (CROIC) indicates management's effectiveness at earning a return on its capital allocations
- How quickly and effectively could a motivated community of likeminded Fools working together build such a financial model?



# Broadbrush Due Diligence Checklist – The Business

---

- How does the company make money? What is an average selling price? How predictable and repeatable are unit sales? Are unit sales and revenues seasonal or especially lumpy?
- What are the two or three most important drivers of this company's end customer demand?
- How are revenues logically segmented (by different lines of business and/or by price and volume)?
- How large is the industry? What is the company's market share? How has this trended over time?
- Is the company's business cyclical? If so, where are we in the business cycle?
- What is the company's durable competitive advantage (cost leadership in a scale business, dominant market share and associated network effects, high switching costs, barriers to entry like patents, regulatory benefits, or proprietary technology)?
- Does the company have any structural competitive disadvantages like an operating cost disadvantage, stagnant or declining market share, inferior core product, etc.
- Who are the company's competitors? How intense is the competition in this industry? How is competition expected to change over time? What are the relative market shares of competitors? Are new competitors expected to enter the industry? Is it easy or difficult for them to do so?
- Do the company's customers or suppliers have disproportionate power or influence over the company? Does the company enjoy pricing power over its customers or suppliers?

# Broadbrush Due Diligence Checklist -- Stewardship

---

- How long is the tenure of current senior management? How significant is senior management turnover? What is its track record here and at prior employers?
- What is the compensation of senior management? Is manager compensation aligned with the interests of shareholders?
- What is the composition of the board? Is management overrepresented?
- What are the stock holdings of insiders? Have any insiders been recently buying or selling stock in an unusual fashion?
- Does any one shareholder have disproportionate influence over the company's operation?
- How significant is institutional ownership of the company's stock? Who are the largest non-insider shareholders of the company? Is the list of the large holders dominated by a particular investment style – momentum/aggressive growth or long-term value?
- How significant is the short interest in this stock?
- What are the current factors weighing on or propelling the stock? Are these short-lived or more structural in nature?

# Hands-On Case Study: Hermes Interactive (part I)

---

You are the painfully good-looking but totally-unappreciated junior software analyst at Marlborough Management, a large and successful northeastern investment management firm. Your most recent performance evaluation was surprisingly mediocre, and you are feeling a little bit under the gun.

You own a small position in a Silicon Valley-based software company called Hermes Interactive and have a positive rating on the stock in your firm's official system. In fact, you recently sent a firmwide e-mail suggesting that portfolio managers begin accumulating shares of Hermes stock. You yourself own the stock at an average price of \$35.

Hermes has its R&D operations overseas in Ireland, and enjoys favorable corporate tax treatment. The company dominates the market for software testing tools (80% of its total business) and is seen as the de facto choice for most Global 2000 companies. Its forays into other side businesses have been both underwhelming and a management distraction.

Over the past two or three years, Hermes has been a standout growth company in a maturing and consolidating sector and has typically posted revenue growth of 15-20% (the industry, in comparison, has typically posted revenue growth of 5-8%). After a nice run, however, the stock has recently shed a third of its stock price because Hermes' highly-promotional senior management had forecast bookings growth in excess of 20% and not delivered on its guidance. In addition, the company has been delinquent in filing its quarterly financial statements and there is a pending SEC investigation relating to options issuance practices. Adding insult to injury, Hermes' CFO has a contentious relationship with Wall Street, and is perceived as combative, untrustworthy and arrogant. There has been some recent rumors circulating that the company entered into talks with a large computer company to be acquired, but that price and control became a stumbling block.

After arriving into the office on a cold, gray day, you find out that Hermes has scheduled an emergency conference call for 8 AM EST. Minutes before the call begins, the company issues a press release that the CEO, CFO and General Counsel have been terminated for 40 instances of stock options misdating between 1995 and 2002 that personally benefited the CEO in each case. On your computer screen, you immediately see that the stock is trading down 30% to \$22-25 per share. Much to your chagrin, several prominent sell-side analysts are downgrading Hermes from Strong Buy to Strong Sell on the news, citing concerns about the veracity of Hermes' books.

## Hands-On Case Study: Hermes Interactive (part II)

---

The press release goes on to say that Hermes is conducting an internal investigation into its options accounting and will not be able to issue audited financial statements in the near future. The company anticipates significant material changes to its earnings. It does not anticipate any impact on previously-reported pro forma financial measures or cash flows. The company has appointed a new CEO, whose name with which you are not familiar.

With a huge pit forming in your stomach, you do some quick calculations. By comparing the balance sheets of the last ten quarters, you determine that Hermes has generated \$500 million of cash over that time period (\$60 mil of cash accrued on the balance sheet while \$440 mil was spent on net stock repurchases and acquisitions. By treating the convertible debt on the balance sheet as debt (the conversion prices are more than 100% higher than the current share price), you determine that Hermes has roughly 91 mil shares outstanding and \$5 per share of net cash on its balance sheet.

Just as you finish your arithmetic, the phone rings. One of your colleagues on the sell side has some additional information for you. Hermes' new CEO has apparently been in turnaround situations before. In the late 1990's, he turned around a laggard software company and ended up selling it to a large telecom company. In so doing, he generated a 300% return for shareholders. Your sell side contact also tells you that Hermes' new CEO has received a compensation package that includes a very large options grant (over 1 million shares with a strike price set at today's closing price).

Upon getting off the phone, one of your Marlborough colleagues tells you that he carools with a technology buyer for one of Hermes' largest customers, a financial firm. The technology buyer mentioned that Hermes has the best products on the market and that he couldn't rip them out even if he wanted to. Your colleague also tells you that, in his experience, there is a very good chance that Hermes will be delisted from the Nasdaq if it can not refile audited financial statements by the end of the year.

With your head spinning, your boss comes into your office and tells you that you need to issue an e-mail indicating your current thinking on the stock. You have three choices: downgrade and sell the stock, sit tight, or take the opportunity to add to your position (a move that strikes your boss as foolhardy). He tells you in no uncertain terms that buying more Hermes stock isn't a very smart career decision. By his way of thinking, a delisted stock could take a very, very long time to recapture its lost value.

What do you do?