

Steps to Investing in Enterprise Value

This article discusses the steps one can take to invest in value in an enterprise. The steps begin with understanding the value creation process. Then, specific action steps are suggested to invest in value. The steps include the simple process of thinking about and brainstorming the main value drivers in the enterprise. The steps also use more sophisticated and complex management tools to identify value drivers and strategies to create value.

Once one has gained an understanding of the value creation process, as outlined below, it is a fairly simple matter to apply this knowledge and understanding to analyzing the value that has been created in enterprises for those considering making an investment in such enterprises.

The remainder of this article discusses the steps to investing in enterprise value. Note that many of the steps here are the same as in the *Steps To Value Creation*, which was written for the managers of enterprises to create value in their organizations.

Learn About Enterprise Value Creation and Investing in Enterprise Value

1. Study this workbook to gain an understanding of how value is created; in particular, study the following workbook articles:
 - Preface
 - Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study*
 - Value Creation Chart
 - Intrinsic Value and the Intrinsic Value Line™
 - Management Tools
 - Chief Value Officer (CVO)

Investing in Enterprise Value – Public Companies

2. Remember: Business is always about the creation of enterprise value! In the case of companies in which you have an interest to invest, you want to ensure that they have and will continue to create value.
3. Refer to the chart labeled, *Investment Research and Management Framework*.
4. Using the *Cassandra Stock Selection Model*TM or other approaches, review and select a candidate list of stocks for further extensive analysis.
 - a. The *Cassandra Stock Selection Model*TM is a proprietary model of Paul M. Wendee & Associates, LLC. It is designed to screen and pre-qualify stock candidates from a large universe of publicly traded stocks. The model is a quantitative model that was designed as a standalone model for stock screening and selection. While it was designed and has been shown to be quite effective as a standalone model, it is always paired with the *6 Factor Model*TM to provide more extensive analysis and confirmation of the results generated by the *Cassandra Stock Selection Model*TM.
 - b. In lieu of the *Cassandra Stock Selection Model*TM, you can use other sources to generate a candidate list of stocks. Examples include:
 - i. *Value Line Investment Survey* – you can find this source at most libraries and stock brokerage firms.
 - ii. *Standard & Poor's* – you can find this source at some libraries and stock brokerage firms.
 - iii. *Morningstar* - you can find this source at some libraries and stock brokerage firms.

- iv. *American Association of Individual Investors (AII)* – you can subscribe to their service at <http://www.aaii.com/>. AII has a lot of very good free information on their website as well.
5. Use the 6 Factor Model™ to conduct further extensive analysis on your candidate stocks.

The six factors and an explanation of each follows:

- a. **Analyst Recommendations** – while analysts are not always perfect, or not even very good in many cases, in their analysis and recommendations, they do provide some value to the investment process. Remember, they are human just like you! But, they have spent some time looking at and thinking about the companies under their review. And they should have some familiarity with the industries of the companies that they follow. Try to find a few analysts that you like and respect, and most importantly, that make good recommendations over time. Also, if you consider the opinions of many analysts, the results will tend to average out. For the 6 Factor Model™, averaging out is what we are trying to accomplish. If you keep these points in mind, then using analyst input in conjunction with the other five factors in the 6 Factor Model™ should be useful. You can find relatively good analyst recommendations from the Value Line Investment Survey, Morningstar, and Standard & Poor's.
- b. **Fundamental Analysis** – there is no substitute for taking the time to go through a company's financial statements. There are many good books on financial statement analysis, ratio analysis, financial forecasting, etc. The American Association of Individual Investors (AII) has a stock database with screening and analysis tools which can aid greatly in the fundamental analysis process.

AAII also has a lot of good educational information for reviewing financial statements.

While we emphasize the use of the discounted cash flow approach for determining the intrinsic value of an enterprise; in practice, the intrinsic value is often estimated using other techniques and methodologies in addition to the discounted cash flow approach. These techniques and methodologies include well-known historical *relative valuation measures* such as price-to-earnings ratios (P/E), price-to-book ratios (P/B) and price-to-sales ratios (P/S); as well as prospective, or forward-looking, relative valuation ratios such as the price-to-earnings-to-growth ratios (PEG). You can find information on the relative valuation approach on the AAI website. It is our recommendation to use both the discounted cash flow and relative valuation approaches in your estimation of intrinsic value. This is all part of the fundamental analysis that is conducted in the second step of the 6 Factor Model™.

- c. **Relative Strength** – the approach discussed here is what is called a *value approach* to stock investing. Often times you will find a company that has great fundamentals and is undervalued relative to its intrinsic value. The problem that value investors sometimes face is the *value trap*. The value trap is where a good company that has good fundamentals and a low valuation remains undervalued for a variety of reasons (e.g., it remains undiscovered or the market continues to mis-price the security). Relative strength is a measure of how well a stock's price has performed relative to a benchmark such as the S&P 500. You can get relative strength data from AAI or *Investor's Business Daily*, a financial newspaper.

Relative strength can help you stay out of the value trap by picking stocks where the price of the stock has started moving.

- d. **Risk/Return Model** – one of the foundational principles in finance is that there is a relationship between risk and return. The greater the risk, the greater return you should expect to get from an investment. But the market is not completely efficient in pricing this relationship. That means that you can find “deals” by the market’s mis-pricing of securities. In other words, you can find situations where there is greater return potential than what is justified by the risk involved. In this step of the 6 Factor ModelTM, you want to rank stocks by their risk/return profile and concentrate on the stocks that have higher return potential with less risk. Here is the process (an example will be given at the end of the description that follows):

- i. Obtain an estimate of the five year growth rate in earnings. You can get this estimate in a couple of different ways:

a) See what analysts are estimating for the five year growth in earnings. These estimates can be obtained from AAI, Standard & Poor’s, Morningstar, and Yahoo Finance.

b) Use the following formula in lieu of or in addition to analyst estimates:

$$g = \text{ROE} \times (1 - \text{Payout Ratio}) \text{ where,}$$

g = growth rate in earnings

ROE = return on equity

Payout Ratio = dividends/earnings

Note: For ROE and the Payout Ratio, you can use historical averages to estimate the future ROE and Payout Ratios; or, you can use any other reasonable method or technique to estimate future values for these variables.

- ii. Obtain an estimate of the Price to Earnings Ratio, *P/E ratio*, in the fifth year of the forecast. One way to estimate this is by calculating average P/E ratios for the company and its industry over various time periods.
- iii. Obtain the *beta* for the stock. The beta can be found in AAI, Morningstar, and Yahoo Finance.
- iv. Find the estimated earnings in the fifth year by taking the current earnings per share and compounding it for five years by the estimated growth rate in earnings.
- v. Find the total dividend payments over the next five years by taking the current dividend and compounding it for years 1 through 5; then summing the five years of dividends.
- vi. Find the projected price at the end of year 5 by taking the fifth year estimated earnings number and multiplying it by your estimate of the P/E ratio in the fifth year.
- vii. Add the total dividends over the five year period to the fifth year price to obtain the total gain at the end of the fifth year.
- viii. Compute the total annual rate of return on this gain by doing a present value calculation and solving for the rate (see the example that follows).

- ix. Divide the annual rate of return by the beta of the stock to obtain the *Return-to-Risk Ranking Score*TM.
- x. This is the score that will be used as one of the ways to rank your candidate list of stocks. The higher the score, the higher the expected return per unit of risk. Therefore, the best candidates have the higher scores.
- xi. Example:

Inputs

Earnings per share (EPS - trailing 12 months) - \$4.12

Dividend (DPS - current) – \$0.35

Price (current) - \$30.25

P/E ratio (5th year estimate as 5 yr. average) – 10.3

Beta – 0.75

EPS 5 year estimated growth rate (g) – 13.1

Calculations

<u>EPS</u>	<u>g</u>	<u>Compounded Value (est. 5th yr EPS)</u>
\$4.12	13.1	\$7.62

<u>DPS</u>	<u>g</u>	<u>Compound Value Yr 1</u>	<u>Compound Value Yr 2</u>	<u>Compound Value Yr 3</u>	<u>Compound Value Yr 4</u>	<u>Compound Value Yr 5</u>
\$0.35	13.1	\$0.40	\$0.45	\$0.51	\$0.57	\$0.65

Sum = \$2.58

<u>EPS (5th yr est.)</u>		<u>P/E Ratio (5th yr. est.)</u>		<u>Price (5th yr. est.)</u>
\$7.62	X	10.3	=	\$78.49

<u>Total Dividends</u>	+	<u>Price (5th yr. est.)</u>	=	<u>Total Gain</u>
\$2.58		\$78.49		\$81.07

Projected Annual Return (computed by finding the rate at which \$30.25 grows to \$81.07 in 5 years) = 21.79%

$$\text{Return-to-Risk Ranking Score}^{\text{TM}} = 21.79\% / 0.75 = 29.05$$

- e. **Value Driver Analysis** – the fifth step in the 6 Factor ModelTM is value driver analysis. Value driver analysis is discussed extensively in this workbook. There are some specific steps which also apply to value driver analysis when investing in enterprise value which can be found at the end of this article.
- f. **The Big Picture** – In this, the final step of the 6 Factor ModelTM, you should step back and look at the enterprise you are evaluating from a “big picture” perspective. This is where you separate the forest from the trees. Up to this point, you have done a lot of very detailed analysis, much of it quantitative in nature. A lot of what you have looked at is historical information. Looking at things from a “big picture” perspective helps you spot things which might have slipped through the cracks on your detailed analysis or is not relevant because the historical analysis might not reflect the business environment going forward. As this is your final step, it serves as a final check on your analysis.

Investing in Enterprise Value – Private Companies

- 6. Remember: Business is always about the creation of enterprise value! In the case of companies in which you have an interest to invest, you want to ensure that they have and will continue to create value.

7. Refer to the chart labeled, *Investment Research and Management Framework*. The first part of this chart, the *Cassandra Stock Selection Model*TM, refers to public companies. The last three parts of this chart, the *6 Factor Model*TM, *Portfolio Management* and *Feedback Loop*, refer to both public and private companies.
8. Use the 6 Factor ModelTM as a starting point in your review of private companies. The relative strength part of the 6 Factor ModelTM won't apply to your analysis of private companies. And there may or may not be an analyst report on the company (although there may be an appraisal or audit report on the company). If there is an analyst report of some sort, you should study it carefully. You can use the Risk/Return part of the 6 Factor ModelTM, using the private market price and estimates of the other non-public variables (use public market variables to help in your estimates of the non-public variables).
9. Refer to the article, *The 5 Minute Review*TM. The 5 Minute ReviewTM was written as a checklist for angel investors and others that invest in private companies. Using The 5 Minute ReviewTM in conjunction with the 6 Factor ModelTM will allow you to conduct a very comprehensive review of the private companies in which you have an interest to invest.

Analysis of Value Drivers and Value Creation

10. Think about the organization under study and try to determine what the three or four main value drivers are in that organization (you can have more than three or four – just try to figure out a few of the main value drivers that are driving value in the organization).

11. Brainstorm with others to try to determine what the three or four main value drivers are in the organization. Often times, more heads are better than one at figuring out complex problems.
12. Refer to the *Value Creation Process Chart* and its description to help you think through the value creation process and identify areas for creating value.
13. Has the organization appointed a Chief Value Officer (CVO) to oversee the value creation process. In any event, in order to ensure that value creation receives the proper attention it deserves, one or more people in the organization should take responsibility for the value creation process. Has the organization taken this important step?
14. Next, start using more formal management tools to identify the value drivers that exist in the organization, and which ones might lead to better value creation. A good management tool to start with is *SWOT analysis*.
15. Use other management tools, as appropriate. See the article in this workbook entitled, *Management Tools*, to get ideas. Remember that management tools fall into three general categories (as described in the article on management tools): (1) exploratory management tools; (2) strategic management tools; and (3) management tools that address a specific issue or solve a specific problem. Use of the management tools in keeping with these three categories and their functions will lead you to the identification of the important value drivers operating in the organization and effective ways to use these value drivers to create value.
16. Spend some time thinking about and brainstorming the organization's competitive, industry, and economic environment. As you advance in your knowledge of value driver theory, you may want to refer to *Porter's Five Forces Analysis* of industry competitiveness

to gain an understanding of the competitive nature of the industry in which the organization operates¹. See the article in this workbook entitled, *A Simple and Effective Economic Forecasting Model*, to learn how to gain an understanding of the economic environment that confronts the organization.

17. Study and read the other articles in the four parts of this workbook on understanding, creating, sustaining, analyzing, and investing in value. If financing for the organization is needed, review the articles related to financing business enterprises.
18. Establish a valuation benchmark by computing the organization's intrinsic value. If you would like to gain an understanding of and learn how to calculate the intrinsic value, which is always a good idea, Damodaran's book on valuation, *The Little Book of Valuation*², is an excellent reference. It would also be helpful to construct the Intrinsic Value LineTM for the organization, as described in the article in this workbook, *Intrinsic Value and the Intrinsic Value LineTM*.
19. Based on your analysis of the organization, and using your knowledge and understanding of value driver theory and management tools, design and construct value creating strategies for the organization. Do this as an exercise to see if the organization is doing the same things you would do if you were running the organization.
20. Use the *Problem Solving Framework* to address specific problems or challenges facing the enterprise. The Problem Solving Framework can also be used as a general model and framework to form organizational teams to create value in the enterprise. Again, do this

¹ Porter, M. E. (1980). *Competitive strategy: Techniques for analyzing industries and competitors*. New York, NY: The Free Press.

² Damodaran, A. (2011). *The little book of valuation: How to value a company, pick a stock and profit*. Hoboken, NJ: John Wiley & Sons.

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21. Re-calculate the organization's intrinsic value on a continuous basis to check the progress of creating value in the organization.
22. As part of a feedback loop, repeat all of the preceding steps, and make adjustments as necessary, on a continuous basis to see if the organization is on track for creating value.

Buy Discipline

23. The final step to investing in enterprise value, after all of the preceding analyses have been completed, is to estimate the intrinsic value of the company (as discussed in the sections above). Compare your estimate of the intrinsic value to the current market price for the company's stock to see if there is sufficient potential for an increase in the price of the stock. This is the stage where you determine if the company is, in your estimation, selling for a reasonable price.

Portfolio Management

24. See the discussion on portfolio management in the article entitled, *Investment Research and Management White Paper*.

Feedback Loop – Monitoring, Sell Discipline, and Rebalance

25. See the discussion on portfolio management in the article entitled, *Investment Research and Management White Paper*.
26. The Feedback Loop should lead to ever increasing levels of value. If it doesn't, it serves as an early warning indicator that problems are developing and provides a roadmap for possible solutions.