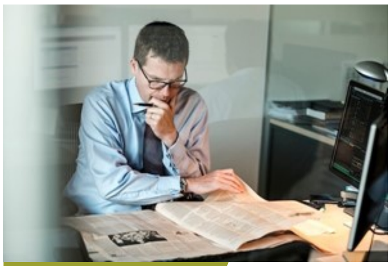

Friday Morning Coffee

Nr. 118 — What are punters expecting?

"**People calculate too much and think too little**"- Charlie Munger (Vice Chair at Berkshire Hathaway).

Our confession - When we look at a stock trading at 182x current year's normalised earnings, our imagination hits its limits and we end up doing lots of calculations.

In order to understand the exuberance around certain IT names, we thought of revisiting the concept of "Expectation Investing". In a book published by Rappaport and Mauboussin in 2003, the authors suggest that investors should estimate the expectations baked into a company's stock price, instead of forecasting. Something that James Montier would call "Reverse DCF".

The idea of expectation investing germinated from the work of Miller & Modgliani on valuation (1961). **Economic theory suggest that competitive forces will drive down returns of the company below to its cost of capital overtime as higher returns of the company would attract competitors that will accept lower returns, consequently, driving down the returns of the industry**. The time period during which the company is expected to earn returns higher than its cost of capital is termed as "Competitive advantage period" or CAP. The CAP is rarely static for a company and changes in line with the underlying dynamics of the industry as well as competitive position of the company and competency of its management.

Rappaport and Mauboussin observed that in the valuation of a company most analysts have a forecast period, or CAP, that is too short and much of the value is attributed to terminal value, consequently, making valuations sensitive to implicit growth in the terminal years. In contrast, **expectation investing involves a much longer CAP period and assigns a modest value to the terminal period. Moreover, the authors also assume that the company does not create value beyond the CAP period as the returns come down in line with the cost of capital of the company and thereafter they determine terminal value of a company as an annuity**. In the end, authors stretch the length of the forecast period as many years as necessary to achieve current stock price. Once the CAP is determined, authors believe that it can be a key analytic process wherein one can compare the CAP of a company against its own history or peers or industry.

It may sounds too simplistic and theoretical, but as a volatility trader would argue "**a simple model with known limitations is way more superior to a sophisticated model with unknown limitations**". After all when it comes to option valuations, the good old Black-Scholes model developed in the seventies continues to rule the roost even though the underlying assumptions of the model are far away from reality. Anyway.

Having brushed up all the nitty-gritty of the concept, we fired up excel and got going with the exercise. We chose to stay on this side of the pond instead of going to the frothy side; into US names. We made it a point that we have zero input from our side and relied on Bloomberg consensus estimates for earnings and took cost of capital from it as well. Now, remember earlier we talked about a company trading at 182x current year normalised earning? Yes, it is Adyen, a Dutch technology company that facilitates electronic payments. Founded in 2007, Adyen was listed on the stock exchange in 2018. For a comparison, we looked at Worldline, a French peer of Adyen.

European Capital Partners

Friday Morning Coffee

Nr. 118 — What are punters expecting?

All we had to do was plug and chug and get to the results. We were quite amused by the findings. At the current market price, market players estimate that Adyen would grow its Free cash flow at 26% CAGR for the next 9 years before it stops creating any value i.e. CAP of 9 years. Whereas the French peer, Worldline, has a CAP of 6 years with Free cash flow growth and is estimated to be 17% CAGR. To put things in perspective, at current valuations market participants are expecting that FCF of Adyen would increase by the factor of 8 before it goes off the value accretive CAP period. And the humble Worldline would be able to increase FCF by the factor of 2.5 only. Interesting.

With that said, neither are we suggesting, nor do we prefer one company over the other as this was purely a number crunching exercise with zero qualitative inputs. Even if Adyen and Wordline operate in the same sector and offer similar services, their product offerings, target clients and geographic scale is not comparable. For example, the infrastructure that Adyen offers is built from scratch and has the ability to offer end to end services on a global scale, whereas the product of Wordline is more of patch work due to numerous M&A that it had to do to remain relevant for the clients thereby affecting its scalability.

The aim of the exercise was to look at valuation from an alternative lens. We may not have conformed to the advice of Charlie Munger against Physics envy in investing as mentioned earlier, but we are firm believers of his other wisdom – "To the man with only a hammer, every problem looks like a nail".

We wish you a nice weekend,

The ECP Team

September 4 th, 2020