A QUICK INFORMATIVE GUIDE ON

How to calculate fair value

By Jacob B

Free Preview

Contents

Hi, I'm Jacob.

I'm a Canadian investor focused on using knowledge to enrich people's minds about money. I achieve this in three ways:

- Writing a free email newsletter for over 150 subscribers (thank you to everyone who signed up).
- Creating educational guides, such as this one.
- Sharing the valuation of over 70 stocks for free, every Monday.

Even though I don't have a university degree at the moment, I have spent years of learning, and sharing information in this topic. Starting in 2021, I dove deep into a rabbit hole surrounding finance. Eventually, I discovered investing, and my knowledge in this area has only grown since then.

The years I spent absorbing this knowledge were finally tested in April of 2023 when I bought my first-ever stock. In short, I finished the year with a 10.6% gain. A few months after the purchase of my first stock, I came across an app called Blossom.

This app was basically Twitter mixed in with Instagram that allowed you to share insights on investing with other Canadians (recently Americans as well).

(It also allowed users to connect their brokerage accounts and display their holdings on a public profile.)

I not only learned a lot from this app, but I also shared the knowledge I gained over the years with others.

During this time, I also discovered the concept of fair value and began writing posts about it on Blossom.

While no one can ever know everything, you can always strive to learn as much you can. That is exactly my goal: to learn as much as I can while teaching others along the way.

"By teaching others you will learn yourself." - G.I. Gurdjieff

In just two simple chapters...

Preparation

Find

Do you have a stock/business in mind? Great. This marks the beginning of the calculation process. Just as a farmer tills the soil or a cook preps before a meal, as an investor, you must gather all the necessary information about a stock before calculating its fair value. Cash flow statement, balance sheets, etc.

Chapter I

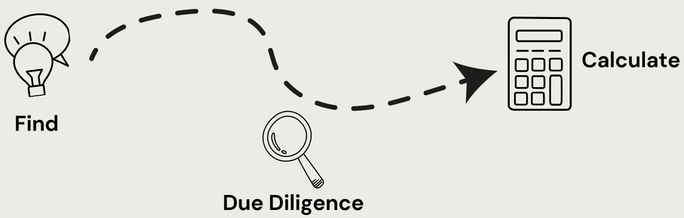
Due Diligence

In this chapter, you will learn about the different ways a company can have a competitive advantage over rivals (with examples provided). This will help build a habit of due diligence before calculating, and before investing. You will also learn about the concept of Economic Moats and find out how to research these metrics using Google.

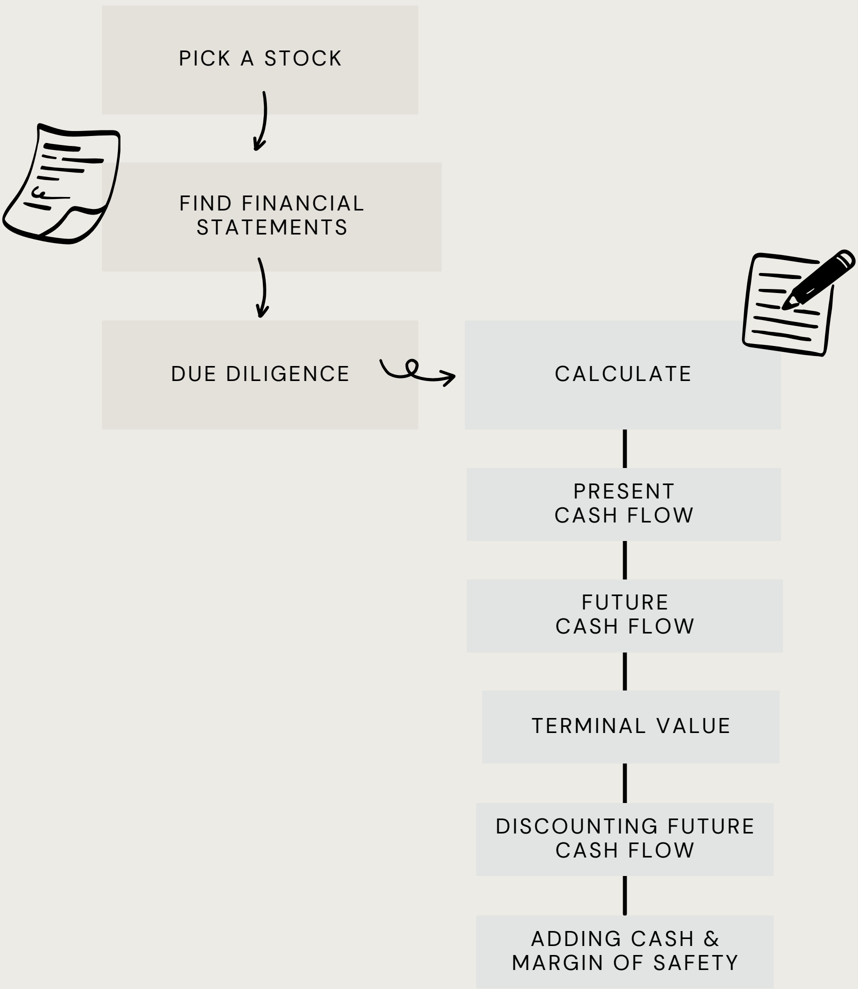
Chapter II

Caclulate

Finally, this is where you get into calculating fair value. You will learn, in five steps, how to calculate intrinsic value using the Discounted Cash Flow Analysis. This chapter is the longer of the two, and it uses an historical Apple example to guide you through the process.



Intrinsic Value Calculation Process – Flowchart Diagram



INTRODUCTION

What is fair value?

In order to truly grasp this concept, consider the stock you wish to buy—or the business it represents—as a cash printer, a sort of robot money machine if you will. This machine has the ability to generate a certain amount of money per year, and each machine varies.

Some machines may be rusty, printing less money, while others may be old and deteriorating, losing money year over year.

Nonetheless, the amount of money these machines make doesn't matter; what matters is how much you're willing to pay for them. I've noticed some people commenting on my posts, claiming that fair value is merely a guess and an unreliable source for investing. However, that couldn't be further from the truth.

After all, the philosophy of long-term investing is based on the consistent investment into businesses you understand at a discounted price. Fair value is what helps decide this discount. Apple's machine, for example, is currently worth almost $3 trillion. Would you pay that price if the machine was only generating $1 million a year? Probably (obviously) not. But what if Apple’s machine was generating around $120 billion? Would you buy it at that price?

This is where fair value comes into play. Also known as intrinsic value, fair value essentially tells you what a business is worth at a particular time based on present and future cash flows. In other words, it helps predict how much money the business will ‘print’ (make for you) in the future.

So, how exactly do you calculate future cash flows? Well, that's what I'll be discussing today, and by the time you finish reading this, you'll feel like the next Warren Buffett.

Without further ado, let's dive into it.

Due Diligence

Okay, so before we get into calculating, you need to conduct proper due diligence to consider which stocks or businesses to invest in for the long term. Researching into these includes many things. Sustainable competitive advantages and the potential to thrive for decades to come are just some of them.

But one thing to remember is something called an Economic Moat.

The concept of an economic moat, (created by Warren Buffett), refers to a company's ability to maintain a competitive advantage over its competitors and keep profitability over the long term. Moats come in a variety of ways, but here are some examples:

- **Brand Power:** strong brand recognition and customer loyalty can provide a nice competitive advantage, making it difficult for competitors to penetrate the market.

- **Cost Leadership**: companies that can produce goods or services at a lower cost than their competitors (and often) have a competitive advantage, boosting higher profit margins.

- **Network Effects**: businesses that benefit from network effects, where the value of their product or service increases as more people use it, tend to have strong competitive advantages. (Think of Meta.)

- **Switching Costs**: high switching costs for customers make it challenging for them to switch to competitors' products or services. (This is not always a monetary cost. Look at Apple's ecosystem for example. It's very hard to escape once you're in.)

- **Financial Health**: a company's financial health is an important factor of its ability to withstand recessions and market downturns. Key metrics to consider include:

- **Revenue Growth**: consistent revenue growth signals a company's ability to control market share and expand its operations over time.

- **Profitability**: sustainable profitability, demonstrated by healthy profit margins and return on investment, is essential for long-term growth.

- **Debt Levels**: companies with good levels of debt are better positioned to survive recessions and market downturns (and invest in future growth).

Finally, management and decision-making are another important factor for a company's long-term success. Researching management quality involves evaluating things such as:

Track Record: a management's track record of carrying out growth strategies, managing risk, and creating shareholder value.

Alignment with Shareholders: management teams that prioritise shareholder interests and have transparency and accountability are more likely to have larger long-term value.

By taking these points into account when deciding on a company to invest in, it not only builds great habits, but it will also help you with the process of determining the valuation of said business.

Tip: to find any of these metrics for a company, simply Google: [COMPANY NAME] [METRIC] (e.g., Amazon historical revenue growth).

CHAPTER II

Calculate

"The intrinsic value of any stock, Bond, or business, today is determined by the cash inflows and outflows discounted at an appropriate interest rate that can be expected to occur during the remaining life of the asset." - John Burr Williams.

What John is explaining here is a valuation process called the Discounted Cash Flow Analysis, and it is what you will be learning about in this writing.

What this quote is saying is that the present value of a business is all its future cash flows added together. Essentially, John is telling us that as an investor, you need to answer two questions:

- How much cash will this business make us in the future?
- What are those future cash flows worth for us right now?

These are the starting points of the calculation process, which leads us to step one:

Step 1: Finding A Business's Free Cash Flow

The first step is finding out how much cash the business is making for shareholders right now. This is called owner's earnings.

Owner's earnings is a valuation method released by Warren Buffett in Berkshire Hathaway's annual report in 1986, where he said that the value of a company is just the total net cash flows minus any reinvestment of earnings.

Owner's earnings formula:
Operating cash flow (-) maintenance capital expenditure.

However, the problem with this formula is that not all companies disclose maintenace capital expenditure. Coincidentally, there is a method to calculate this called free cash flow, (which is what I will be using in this writing) that does not use maintenance capital expenditure.

Free cash flow formula:
Operating cash flow (-) total capital expenditure.

You're probably wondering: "But what are these terms? Operating cash flow? Total capital expenditure? What are you going on about?" Well, let me explain.

Operating cash flow is the last line of a company's cash flow statement. What it will look like on a cash flow statement is this: **"Cash generated by operating activities"...**

That’s the end of the preview! To finish reading the remaining content, press here.