Investment Process

If a PM gives you a new stock, what are the steps in preparing a pitch?

1. **Business Level Analysis**
    a. Read the "Business" section of the company's 10-K and ask yourself:
        i. What is the business model?
        ii. Who are their customers?
        iii. Who's on the management team?

Micro

Good Company Qualities:

- *High Return on Capital*
- *Barriers to Entry*
- *Growing Industry*
- *High Margins*
- *A competitive advantage*
- *Market leadership*

Good Management:

- *High insider ownership*
- *Well respected*
- *Not constantly restating earnings*
- *Not overly promotional*
- *Clean accounting*

All these qualities above are obvious and won't differentiate a pitch but still important to understand.

2. **Sector/Industry Analysis**
    a. What are the industry tailwinds and headwinds?
    b. Who are their main competitors?
    c. What market share do they have?

Macro

Subsector level: What is going on with the immediate competitors? Are they growing, taking share, is the pie growing or is it being split? Who is winning and who is losing? Substitute products? Competitive products?
Sector level: What is going on in the industry? i.e. Industrials as a whole doing well because of restocking?
National level: What is going on nationally? i.e. How has the rise in interest rates going to affect banks and real estate investments?

3. **Market View Analysis**
    a. What is the opinion of the "street"?
        i. What do analysts say about the company in equity reports?

    ii. What is the consensus estimate on the stock price? What is the rationale behind those estimates? (eg. Multiple expansion? Greater revenue growth? Margin expansion?)
    iii. Short Interest?
    iv. Are there a lot of institutional buyers?

__Setup__
The most often overlooked part of a trade. **How has the stock performed heading into the catalyst, or before you put the trade on.** If it has already gone up 10% into the catalyst, it is much harder to outperform on the catalyst. Determine the crowdedness of the trade. The easiest way is the look at the sell-side rating and talk to the sell-side to see if they get a lot of calls on the name. **Are people bullish or bearish?** If it is a short, checking short interest is an easy way (ticker equity SI). If it is a long you can look at the **holders list (ticker equity HDS) if the top holders are a bunch of hedge funds, than it is likely the stock is very crowded.** When the market sells off, the crowded names underperform the most.

Ideally you want a stock that has underperformed its peers, under owned by hedge funds, and heading into a catalyst that you think will have a positive surprise. Conversely, if it is a crowded name that has already outperformed into a catalyst that everyone is expecting to be positive, you are unlikely to get much of a reaction out of the stock

4. **Thesis/Variant View Development**

Based on research so far, do I think the company will **overperform or underperform expectations?**

- Is that due to certain facts being **overlooked** by other analysts?
- Is there a problem that is being **overblown**?
- What has to happen for my thesis to be true? Revenue growth?

5. **How Do We Make Money?**
    a. Value the company (find possible target price) using:
        i. Comparable Companies
        ii. DCF
        iii. Remember, **target price = Your Earnings Estimate x Multiple**
    b. If I'm selling, who will be buying and vice-versa?
    c. What are possible catalysts? (eg. earnings, legal wins, R&D developments, etc)

Target Price = Earnings Estimate x Multiple

Company Earnings:
Will they be beating earnings in the next quarter or in the next year? Why will they beat earnings? i.e. Higher revenue, higher margins, lower interest expense, share buybacks, etc.

Paint the story on how and then explain why there will be higher revenue growth. You can't just say there will be higher revenue growth without explaining the drivers and how you get to a beat. What's your confidence they will beat earnings? What's the probability? What's your margin of safety? What can go wrong?

Multiple:
Are you modeling multiple expansions? Why? **Where is it trading relative to its historical multiple?** Should the multiple trade at a **premium or discount** given how the Company has changed over the years and where we are in the cycle now.

Where is the Company **trading relative to its peer group** (called GICS)? If the entire market has seen multiple expansion, then it's fair this company should too. i.e. is it expensive vs. itself and vs. its peers? What's your confidence in multiple expansion? What catalyst or even is going to cause this multiple to start expanding?

***Reminder*: What makes a stock price appreciate?**
A stock price is simply an **earnings metric multiplied** by a **multiple metric**
- EG. Stock Price = **EPS * P/E**

Therefore, if a stock price is **increasing,** it is either driven by **higher earnings,** or **multiple expansion.**
- For example, if XYZ stock is trading at $10, and does $1 per share in EPS, it is trading at 10x earnings. If you think the stock is worth $12, you are arguing that either the earnings are too low, or the multiple is too low, or likely a combination of the two.

The **highest quality ideas** are driven from **earnings upside** and **LESS** from **multiple expansion***
- Key is to understand why earnings are increasing and why you have a different opinion from the consensus – What are the **drivers** for higher than expected earnings? Is it coming from **higher revenue, higher margins, lower interest, lower taxes?**

- Higher quality ideas will show earnings growth coming for items **above** the **Operating Income line** (eg. higher revenue and higher margins due to lower costs)
    - *Exception:* Earnings growth coming from **share buybacks**

*This is because multiple expansion is a lot riskier. Multiples are largely driven by macro factors and the overall market.

Multiple Metrics:
a) P/E (price / earnings)
b) EV/EBITDA (Enterprise value / EBITDA)
c) FCF yield (free cash flow yield)

Return on Equity (ROE) measures the effectiveness of a Company's management to turn a profit on invested capital
- ROE = Net Income / Shareholder's Equity
- It is also important to examine a Company's historical ROE to evaluate the stability and consistency.

Task: Assign every analyst to three (or a multiple of three) breakout rooms. Each breakout room is responsible for answering one of the first three steps for the company Walmart (NYSE: WMT)