Intrinsic Value and Value Investing

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- Value Investing involves making a judgement about a business but it also is based soundly on Intrinsic Valuation foundations

Intrinsic Value and Value Investing

- The first of these is Return on Equity (ROE)
- Has the company consistently made strong equity returns for its investors?
- Buffet normally looks back 5 to 10 years
- He also compares these returns to the company's main competitors to get a comparison yard stick on the performance

- Return on Equity (ROE) = Net Income/Shareholder Equity

Intrinsic Value and Value Investing

- The next step is to consider the Debt to Equity ratio
- Buffet prefers free cash to be available to stock holders rather than being used to service debt
- He is also cautious if the company's growth has been driven by adding leverage to the balance sheet

Intrinsic Value and Value Investing

- Buffer prefers the company to be generating earnings from its shareholder equity
- This is also known as the Balance Sheet Equation
- A company with positive shareholder equity is generating sufficient cash to cover its liabilities and not relying on debt finance to continue to operate

- Shareholders' Equity = Total Assets - Total Liabilities

Intrinsic Value and Value Investing

- Profit Margins are the next step in the Buffet Equation
- He likes to see strong profit margins, ideally which are growing
- This suggests that the management are good at controlling costs

Intrinsic Value and Value Investing

- You will recall that Intrinsic Value is not just about the quantitative but also about the qualitative
- These include:
  - Business Model
  - Management
  - Markets
  - Products
  - Sustainable Competitive Advantage

Intrinsic Value and Value Investing

- Competitive Advantage is a critical element for Buffet
- How unique are a company's products?
- How easily can they be substituted?
- This echoes the work of Michael Porter

Intrinsic Value and Value Investing

- You can break down Competitive Advantage into
  - Comparative Advantage - products produced more efficiently leading to higher profit margins
  - Differential Advantage - products seen as unique or of higher quality
  - Michael Porter's Generic Strategies of Differentiation or Cost Leadership

Intrinsic Value and Value Investing

- Of course Buffet also looks closely at the intrinsic value compared to the market value as we have seen.
- He sets his investment criteria and sticks to it.
- He says he never invests unless he can write down why he will pay a specific price per share for a particular company

Intrinsic Value and Value Investing

- The final point to add is that Buffet holds his investments for the long term - he does not trade in and out of them

Intrinsic Value and Value Investing