2011 Lessons

As we approach the end of 2011, we had a time to reflect on the development during the past year. It was a very productive year and we are very grateful for the opportunities God has allowed us to have. The SNV automated model generated valuation reports, which has been developed into a portfolio, which is still in the early stages. Also, LBO models have been run to evaluate potential future takeover/PE deals. The site has been cleaned up for a more polished look. Overall, I would give a 95% grading for the work finished in 2011, relative to the goals set in 2010.

I took a stroll in the afternoon and was thinking about purpose. I was hesitant to post the summer 2012 internship in Craigslist. Not only was our valuation model not completed, as far as accuracy, but the 2010 internship failure left a bad image for the website and the firm.

What is SN Valuation for? What purpose does it serve, not only for myself, but for those visiting and eventually contributing to the site? I couldn't find an answer, which is why I was hesitant to post on Craigslist.

Without answering this fundamental question, there was no urgency to post on Craigslist, and other websites for that matter. Sure, a lot of work may be produced, which gives us a sense of accomplishment, but it must be reciprocated with the added value, utility to the readers and investors.

At the onset, we set out to help average investors, who had no access to Bloomberg or premium subscription services. We wanted to equip and educate average investors on investing, to look at financial statements and learn to forecast growth. Also, we wanted to build a healthy sense of skepticism when they read reports generated by sell side research firms.

While surfing the web over the past 2 years, since SN Valuation's inception, we realized so many great, qualified resources are already available on the web. As a result, we felt both challenged to develop better models and reports, and questioned the site and firm's function in the investment world.

We also set out to provide internship opportunities for college students who didn't attend top tier schools, or didn't have the GPA to land a summer internship. 2007 was a tough year for graduates in the job market, and even more so for business undergrads who had zero internship experiences. Unfortunately, we anticipate 2012 to be the same.

If there are a couple people out there who stumbled upon this website and want to learn something of value, then the following page shows the main learning point for SN Valuation in 2011. Hopefully, you will get a greater sense of what function you will serve as an analyst, investor, business owner in the future by grasping this fundamental concept.

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		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
5 Year Bond (no options)	Coupon	0	50	50	50	50	50
	Principal	-1000	0	0	0	0	1000
	Net Flow	-1000	50	50	50	50	1050
	Return	5.00%					
5 Year Zero Coupon Bond	Coupon	0	0	0	0	0	0
	Principal	-783	0	0	0	0	1000
	Net Flow	-783	0	0	0	0	1000
	Return	5.01%					
		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
5 Year Equity with Dividend	Dividend	0	50	50	50	50	50
	Investment	-1000	0	0	0	0	1000
	Net Flow	-1000	50	50	50	50	1050
	Return	5.00%					
5 Year Equity without Dividend	Coupon	0	0	0	0	0	0
	Principal	-783	0	0	0	0	1000
	Net Flow	-783	0	0	0	0	1000
	Return	5.01%					

I love fixed income because it is very methodical, although I am a newbie. Oftentimes, I reference bond concepts when I am stumped with equities.

The most important point I have been making in 2011 is the importance of 1) terminal value and 2) not using FCFF, but rather dividends when valuing the firm. Also, when using dividends, that cash flow needs to be deducted from the ending cash balance, when the equity piece is backed into from the enterprise value, 3) Cashflow valuations fail to consider net asset value. Although I have the following disagreements/questions, I still apply them in the valuations.

1) Terminal Value
   - A. I hate EV/EBITDA. It is a great market, comp multiple, but tells me nothing of intrinsic value. 5 x EV/EBITDA, what does that mean? It takes 5 years to pay for the firm with the EBITDA? So, what?
   - B. Bonds have a definite TV- $1000, or par value. Equities on the other hand, is the disposition price, when conducting a LBO. But how does one calculate the disposition price, 5 years in advance?
2) Cashflow – FCFF or dividends?
   - A. FCFF, is not dividend. It is the cashflow generated, but it is not paid out to investors. To use FCFF, we need to consider that as cash outflows, so it should not show up in the cash balance in Year 5.
3) Asset Value
   - A. If the net book asset value (tangible assets- all liabilities) is $1 Billion, but EBITDA is $1 Million, and we apply a EV/EBITDA of 6x multiple, then EV is only $6 Million. How about the net assets?

The following example confirms my understanding of #2 for cashflow.

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
FCFF		-	100	100	100	100	100
Cash Balance without FCFF=dividend		0	100	200	300	400	500
Cash balance with FCFF=dividend		0	0	0	0	0	0

	No Dividend	Dividend=FCFF
Enterprise Value	500	500
Cash	500	0
Debt	0	0
Equity Value	**1000**	**500**
Paid out Dividend	**0**	**500**
Total Payout to Investor	**1000**	**1000**

Let's assume equity is 0 at year 0. Then FCFF grows to 100 for the next 5 years. In scenario A, we don't pay out the dividend and we grow the cash balance to 500 in Year 5. In scenario B, we do pay out the FCFF as dividend and we have a zero cash balance in Year 5. We apply a 5x EV/FCFF TV multiple.

For scenario A, we don't pay out any dividend, equity value is 1000.

However, in Scenario B, we do pay out dividends and equity value is 500.