GOOD COMPANIES, GOOD MANAGERS, GOOD INVESTMENTS?

Aswath Damodaran
Good companies, managers and investments

- Investment advice often blurs the line between good companies, good management and good investments, using the argument that for a company to be a "good" company, it has to have good management, and if a company has good management, it should be a good investment.

- That is not true, but to see why, we have to be explicit about what makes for a good company, how we determine that it has good management and finally, the ingredients for a good investment.
Good versus Bad Companies

Excess Returns - Global in January 2017

The Value Destroyers
19,960 firms earn 2% or more less than their costs of capital

Value Creators
10,947 firms earn more than their costs of capital

Running in Place?
4,086 firms earn within 2% of their costs of capital, in either direction.
Good and Bad Management

Status Quo Value: With existing management in place
- Investment Decisions
- Financing Decisions
- Dividend Decisions
  - ROIC and Reinvestment
  - Debt ratio & cost of capital
  - Dividends, Buybacks & Cash Balance

Value of the company

Optimal Value: With "optimal" management in place
- Investment Decisions
- Financing Decisions
- Dividend Decisions
  - ROIC and Reinvestment
  - Debt ratio & cost of capital
  - Dividends, Buybacks & Cash Balance

Value of the company

Management Quality is inversely related to this number

Value of Control = Optimal Value - Status Quo Value
Good and Bad Investments

The **value of a company** reflects how good its business model really is and how well it is managed.

The **price of a company** reflects what the market thinks about its business model & quality of management.

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**The Mismatch Test**

Is the market’s view of the company at odds with the reality about the company?

<table>
<thead>
<tr>
<th>Company is</th>
<th>Market perceives it as</th>
<th>Investment Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>Good</td>
<td>Indifferent</td>
</tr>
<tr>
<td>Good</td>
<td>Bad</td>
<td>Buy</td>
</tr>
<tr>
<td>Bad</td>
<td>Good</td>
<td>Sell</td>
</tr>
<tr>
<td>Bad</td>
<td>Bad</td>
<td>Indifferent</td>
</tr>
</tbody>
</table>

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Cash flows, growth & risk ➞ Value ➞ Demand & Supply
The Price/Value Divide

- **Pricing Myopia**: If your investment strategy is to buy low PE stocks, you may end up with stocks that look cheap but are not good investments, if these are companies that deserve to be cheap (because they have made awful investments, borrowed too much money or adopted cash return policies that destroy value).

- **Value Myopia**: Conversely, if your investment strategy is focused on finding good companies (strong moats, low risk), you can easily end up with bad investments, if the price already more than reflects these good qualities.
PE Ratio and Fundamentals

Start with a simple dividend discount model

Value of Equity per share = \frac{\text{Expected Dividends Per Share next year}}{\text{(Cost of Equity-g)}}

Divide both sides of the equation by earnings per share

\frac{\text{Value of Equity per share}}{\text{Earnings per share}} = \text{PE} = \frac{\text{Payout ratio}}{\text{(Cost of Equity-g)}}

\text{Payout Ratio} = \frac{\text{Dividends per share}}{\text{Earnings per share}}

PE ratio = f(\text{Payout ratio, Cost of equity, Expected growth rate})

Higher growth \rightarrow Higher PE

Higher risk (cost of equity) \rightarrow Lower PE

Higher ROE (payout ratio) \rightarrow Higher PE
Finding good investments with PE

- Companies that have low growth, high risk and abysmally low returns on equity should trade at low PE ratios and those with higher growth, lower risk and sold returns on equity, should trade at high PE ratios.

- If you are looking to screen for good investments, you therefore need to find stocks with low PE, high growth, a low cost of equity and a high return on equity.
## The Other Multiples

<table>
<thead>
<tr>
<th>Multiple</th>
<th>Mismatch for cheap</th>
<th>Mismatch for expensive</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PE</strong></td>
<td>Low PE, High growth, Low Equity Risk, High Payout</td>
<td>High PE, Low growth, High Equity Risk, Low Payout</td>
</tr>
<tr>
<td><strong>PEG</strong></td>
<td>Low PEG, Low Growth, Low Equity Risk, High Payout</td>
<td>High PEG, High Growth, High Equity Risk, Low Payout</td>
</tr>
<tr>
<td><strong>PBV</strong></td>
<td>Low PBV, High Growth, Low Equity Risk, High ROE</td>
<td>High PBV, Low Growth, High Equity Risk, Low ROE</td>
</tr>
<tr>
<td><strong>EV/Invested Capital</strong></td>
<td>Low EV/IC, High Growth, Low Operating Risk, High ROIC</td>
<td>High EV/IC, Low Growth, High Operating Risk, Low ROIC</td>
</tr>
<tr>
<td><strong>EV/Sales</strong></td>
<td>Low EV/Sales, High Growth, Low Operating Risk, High Operating Margin</td>
<td>High EV/Sales, Low Growth, High Operating Risk, High Operating Margin</td>
</tr>
<tr>
<td><strong>EV/EBITDA</strong></td>
<td>Low EV/EBITDA, High Growth, Low Operating Risk, Low Tax Rate</td>
<td>High EV/EBITDA, Low Growth, High Operating Risk, High Tax Rate</td>
</tr>
</tbody>
</table>
The Bottom Line

- Good companies bring strong competitive advantages to a growing market and their results (high margins, high returns on capital) reflect these advantages.

- In well managed companies, the investing, financing and dividend decisions reflect what will maximize value for the company, thus allowing for the possibility that you can have good companies that are sub-optimally managed and bad companies that are well managed.

- Good investments require that you be able to buy at a price that is less than the value of the company, given its business and management.
# An Investing Hierarchy

<table>
<thead>
<tr>
<th>Company's Business</th>
<th>Company's Managers</th>
<th>Company Pricing</th>
<th>Investment Decision</th>
</tr>
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<tbody>
<tr>
<td>Good (Strong competitive advantages, Growing market)</td>
<td>Good (Optimize investment, financing, dividend decisions)</td>
<td>Good (Price &lt; Value)</td>
<td>Emphatic Buy</td>
</tr>
<tr>
<td>Good (Strong competitive advantages, Growing market)</td>
<td>Bad (Sub-optimal investment, financing, dividend decisions)</td>
<td></td>
<td>Buy &amp; hope for management change</td>
</tr>
<tr>
<td>Bad (No competitive advantages, Stagnant or shrinking market)</td>
<td>Good (Optimize investment, financing, dividend decisions)</td>
<td>Good (Price &lt; Value)</td>
<td>Buy &amp; hope that management does not change</td>
</tr>
<tr>
<td>Bad (No competitive advantages, Stagnant or shrinking market)</td>
<td>Bad (Sub-optimal investment, financing, dividend decisions)</td>
<td>Good (Price &lt; Value)</td>
<td>Buy &amp; hope for management change &amp; pray company survives</td>
</tr>
<tr>
<td>Good (Strong competitive advantages, Growing market)</td>
<td>Good (Optimize investment, financing, dividend decisions)</td>
<td>Bad (Price &gt; Value)</td>
<td>Admire, but don't buy</td>
</tr>
<tr>
<td>Good (Strong competitive advantages, Growing market)</td>
<td>Bad (Sub-optimal investment, financing, dividend decisions)</td>
<td>Bad (Price &gt; Value)</td>
<td>Wait for management change</td>
</tr>
<tr>
<td>Bad (No competitive advantages, Stagnant or shrinking market)</td>
<td>Good (Optimize investment, financing, dividend decisions)</td>
<td>Bad (Price &gt; Value)</td>
<td>Sell</td>
</tr>
<tr>
<td>Bad (No competitive advantages, Stagnant or shrinking market)</td>
<td>Bad (Sub-optimal investment, financing, dividend decisions)</td>
<td>Bad (Price &gt; Value)</td>
<td>Emphatic Sell</td>
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