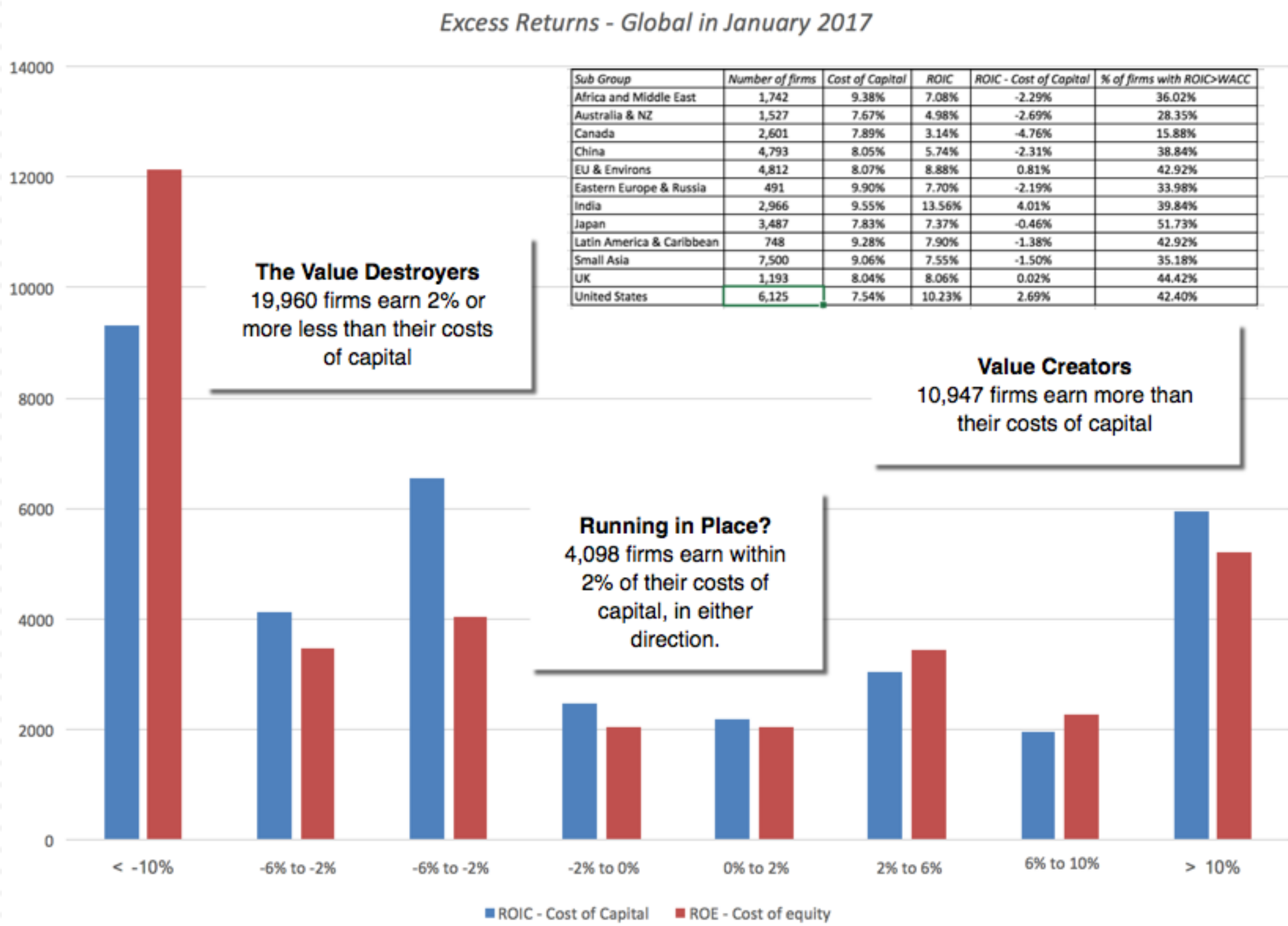
GOOD COMPANIES, GOOD MANAGERS, GOOD INVESTMENTS?

Aswath Damodaran

Good companies, managers and investments

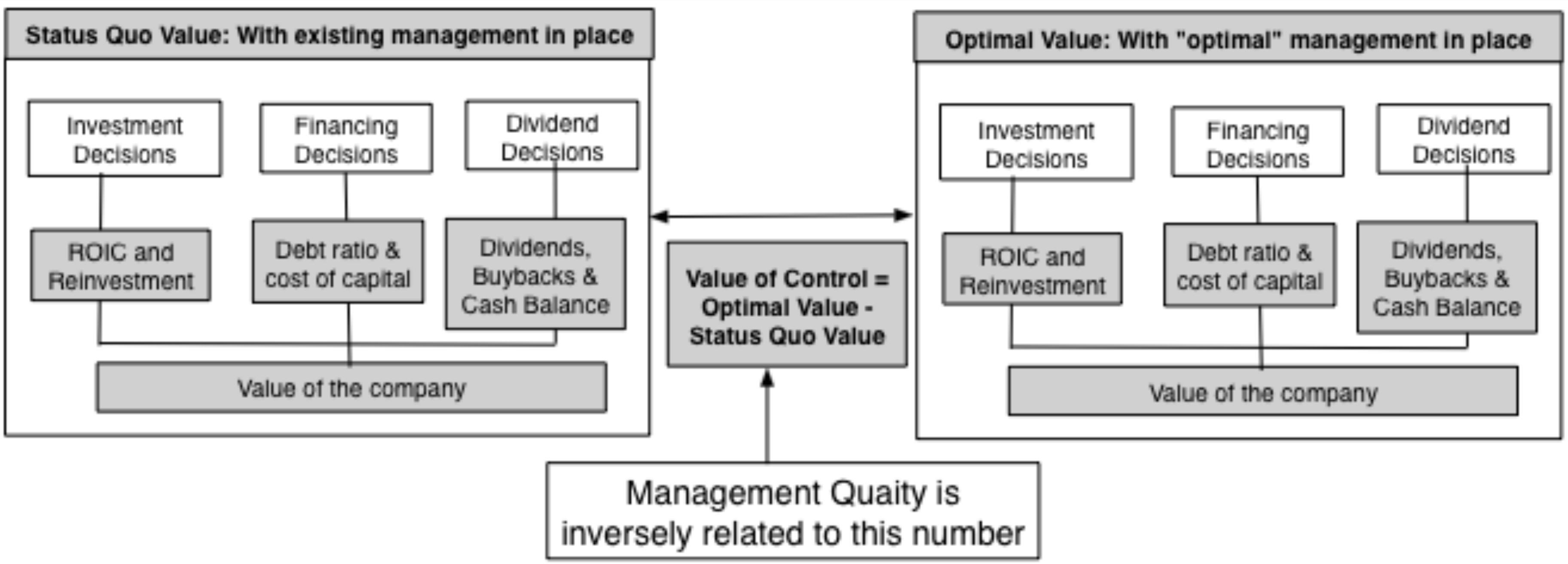
- Investment advice often blurs the line between good companies, good management and good investments, using the argument that for a company to be a "good" company, it has to have good management, and if a company has good management, it should be a good investment.
- That is not true, but to see why, 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



Sub Group	Number of firms	Cost of Capital	ROIC	ROIC - Cost of Capital	% of firms with ROIC>WACC
Africa and Middle East	1,742	9.38%	7.08%	-2.29%	36.02%
Australia & NZ	1,527	7.67%	4.98%	-2.69%	28.35%
Canada	2,601	7.89%	3.14%	-4.76%	15.88%
China	4,793	8.05%	5.74%	-2.31%	38.84%
EU & Environs	4,812	8.07%	8.88%	0.81%	42.92%
Eastern Europe & Russia	491	9.90%	7.70%	-2.19%	33.98%
India	2,966	9.55%	13.56%	4.01%	39.84%
Japan	3,487	7.83%	7.37%	-0.46%	51.73%
Latin America & Caribbean	748	9.28%	7.90%	-1.38%	42.92%
Small Asia	7,500	9.06%	7.55%	-1.50%	35.18%
UK	1,193	8.04%	8.06%	0.02%	44.42%
United States	6,125	7.54%	10.23%	2.69%	42.40%

Good and Bad Management



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

Company is	*Market perceives it as*	*Investment Decision*
Good	Good	Indifferent
Good	Bad	Buy
Bad	Good	Sell
Bad	Bad	Indifferent

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

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

Divide both sides of the equation by earnings per share

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

Payout Ratio = Dividends per share/ Earnings per share

PE ratio = f(Payout ratio, Cost of equity, Expected growth rate)
Higher growth -> Higher PE
Higher risk (cost of equity) -> Lower PE
Higher ROE (payout ratio) -> 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 <u>low PE, high growth, a low cost of equity and a high return on equity</u>.

The Other Multiples

Multiple	*Mismatch for cheap*	*Mismatch for expensive*
PE	Low PE, High growth, Low Equity Risk, High Payout	High PE, Low growth, High Equity Risk, Low Payout
PEG	Low PEG, Low Growth, Low Equity Risk, High Payout	High PEG, High Growth, High Equity Risk, Low Payout
PBV	Low PBV, High Growth, Low Equity Risk, High ROE	High PBV, Low Growth, High Equity Risk, Low ROE
EV/Invested Capital	Low EV/IC, High Growth, Low Operating Risk, High ROIC	High EV/IC, Low Growth, High Operating Risk, Low ROIC
EV/Sales	Low EV/Sales, High Growth, Low Operating Risk, High Operating Margin	High EV/Sales, Low Growth, High Operating Risk, High Operating Margin
EV/EBITDA	Low EV/EBITDA, High Growth, Low Operating Risk, Low Tax Rate	High EV/EBITDA, Low Growth, High Operating Risk, High Tax Rate

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

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