CIO INBOX

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INN8 INVEST

FACTS VS FICTION...AND HOW TO THINK ABOUT THE VALUE OF COMPANIES

"You don't need eyes to see, you need vision." ... Maxwell Frazer

KEY TAKEAWAYS

- We emphasize that the value of a company is based solely on its future deliverables and not on its past accomplishments.
- We critique the reliance on financial statement analysis for company valuation, highlighting its inherent focus on the past and the approximate nature of the "facts" used.
- We promote the use of imaginative storytelling – assigning different probabilities to potential future scenarios – as a valuable method for assessing a company's worth.

INTRODUCTION

Having researched asset managers over many years, and studied markets, I have a good appreciation for the many different approaches that investors take when valuing companies. Although it would be simplistic to conclude that there are essentially only two approaches to this task (there are many), I think it is fair to talk about two contrasting approaches.

In this short article, I will explore one approach that focuses on "facts" – more on why this is in quotes later – and another that focuses on stories (narratives). I will compare and contrast these approaches and argue for why and when storytelling ("fiction") is so important.

VALUING COMPANIES

Before getting into the detail, I need to make an important point up front. It may cause me to lose the reader but is critical when thinking about what a company is worth i.e. its value. If you do not understand or agree with this point, do not bother with the rest of the article as this is an important premise to the arguments I will be making.

What a company is worth today is purely a function of the future and not based on its past. Superficially, some of you may agree with this but may find a level of discomfort when you think about the history of the company, how it came to be where it is today and as such, struggle with the idea of how this does not impact what the company is worth today. It is therefore important to tease apart that the future may in fact depend on the past in many ways, without changing the fact that a company's value is purely a function of the future.

Let us explore this is in a little more detail and with two examples, to ensure that you understand the point and its importance.

The value of a company is intrinsically tied to its future potential, primarily because it reflects the anticipated earnings and growth, which are inherently forward-looking. For instance, a technology firm might be in the development phase of a ground-breaking product or service – such as a cutting-edge AI software or a next-generation semiconductor –

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which is predicted to revolutionise its industry. Though this product's potential revenue would not be reflected in the company's historical accounts, its future launch could significantly boost the company's value due to expected surges in revenue and market share.

Conversely, consider a pharmaceutical company that has been heavily reliant on a single blockbuster drug for its revenue. If the patent for this drug is about to expire, leading to the potential for an influx of generic competitors, or if the drug is discontinued due to unforeseen side effects, the company's past performance would no longer be indicative of its future earnings. In such cases, despite robust past results, the company's value may plummet due to the anticipated decrease in future revenue. Both these examples illustrate why a company's value is fundamentally a function of the future and not merely a reflection of its past.

FACTS UBER (ABOVE) EVERYTHING

Some investors believe that financial statement analysis – balance sheets, income statements and cash flow statements – is not only the most important exercise in deriving the value of a company but rather the only exercise needed. There are unfortunately two fatal flaws to this approach.

The first is that the value of a company derives from what it achieves in the future, not what it achieved in the past. Therefore only analysing the past could yield the wrong result unless the future happens to look exactly like the past, which is very unlikely. Also, making assumptions about the future unfortunately never qualifies as fact-based so there should at least be some recognition that it cannot only be fact-based.

The second is that financial statements are a far cry from facts, and believing otherwise is rather naïve. We need analysts to change their mentality around this as they put more weight on these things as if they were facts. I am not arguing that there are no facts in financial statements, just that 99% of the numbers should not be relied on as being facts, as they are at best, approximations of the truth, and at worst, flat-out hallucinations (fraud etc.)

Even where you recognise the flaws in these numbers – such as when and how revenue is recognised and / or how certain costs are expensed – but choose to use them anyway in your analysis, you still need to make assumptions about the future, whether explicit or implicit. Many investors think that if they do not make explicit assumptions, they are not making any assumptions at all, or at least not forecasting. But this is equally naïve. Even where you think the future looks exactly like the past, you have made that assumption implicitly.

So what sorts of issues arise from using "facts" derived from financial statements? One issue is that your assumptions about the future could be wrong if your understanding of the past is wrong, although technically you could get to the "right" answer purely by luck. Making predictions is difficult, especially when the predictions are about the future. Thus good information should be better than bad information, although by no means is it guaranteed to be so.

STORYTELLING (FICTION)

One way to think about the future is to imagine what is possible. Facts can very often get in the way of a good story, especially when they are informed by a long history. The reality is that the world is forever changing, and the rate of change appears to be accelerating. Trying to predict the future by looking in the rear-view mirror is often futile. There are countless examples of predictions made with confidence and conviction, only to be proven wrong within short periods of time – for example, the New York Times predicted that it would take 1 to 10 million years before "man" would fly, merely 2 months before the Wright brothers flew.

Some will argue that blue-sky thinking is worthless because many of these predictions or stories may never come to pass, but this misses the point of why the exercise is important. You can imagine a future without having to get bogged down on the likelihood of that future coming to pass. You have the freedom to imagine the world and how a company would do in that world, from which you could derive the value of the company under that story. You could then separately arrive at a probability as to how likely you think that future may be, to derive a value for the company that incorporates that story.

It is important to understand that if you are not doing this, you are essentially putting zero probabilities on each and every one of these possible stories. Again, not making an assumption explicitly does not imply that you have not made one implicitly. If you then imagine the many possible stories for a company, all with different and perhaps low probabilities, you may find that they add up to some substantial numbers and value for a company.

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I see this with managers that are so focused on "value" investing – deriving the value of a company mainly from backward-looking numbers pulled from financial statements, although some may include one-year forward consensus numbers. They fail to understand how other managers could be buying these companies, which they believed are over-valued/expensive. This is a failure of imagination, not valuation.

Exponential growth is notoriously difficult for humans to understand and predict accurately. This is primarily because our brains are wired to think in linear terms and struggle with the concept of accelerating growth that characterises exponential trends. For instance, the rapid advancement of technology in recent decades, often described by Moore's Law, is a prominent example of exponential growth that has consistently defied linear projections. When it comes to business valuation, this human limitation can lead to underestimating a company's future potential, especially for firms in fast-growing sectors. Therefore, it is vital to use imagination to envision scenarios of exponential growth while assessing a company's future worth. This imaginative approach can provide a broader range of possibilities and help better prepare for potential future outcomes, potentially offering a more accurate approximation of a company's value in a rapidly evolving business landscape.

CONCLUSION

This article presented a critique of traditional company valuation methods and an endorsement of forward-thinking, imaginative evaluation. We emphasize that the future, not the past, determines a company's worth and therefore the most accurate assessments of a company's value will take into account future possibilities and probabilities rather than relying solely on historical data. The importance of being able to imagine potential future narratives for a company, even those with lower probabilities, is highlighted as a key tool for evaluating a company's true worth and potential.

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