OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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"On April 29, we moved our Best Ideas Newsletter portfolio to "fully invested" as US equities continue to benefit from the Fed/Treasury "put" which supports our bullish outlook on stocks in general, particularly high quality names included in our newsletter portfolios."

- Callum Turcan

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The Best Ideas Newsletter Portfolio (see page 8): BRK-B, CSCO, DG, DIS, FB, GOOG, INTC, JNJ, PYPL, SDY, XLV, VNQ, V, XAR

Recently Removed: BKNG (February 24, 2020)

Recent Changes: *NEW* Went "fully invested" in our Best Ideas Newsletter portfolio on April 29, 2020

Best Idea PayPal Soars on Very Promising Outlook

Image Shown: *Best Ideas Newsletter portfolio idea PayPal is surging after a strong outlook that speaks to underlying strength of the "new" consumer in a post COVID-19 world.*

By Callum Turcan

Please note a version of this article was emailed out to members on May 7.

On May 6, one of our favorite companies PayPal Holdings Inc (PYPL) reported first quarter 2020 earnings. While PayPal missed consensus estimates on both the top- and bottom-line, investors looked towards the future and shares of PYPL rose sharply after the report on May 7. We continue to like PayPal as a near top-weighted holding in our Best Ideas Newsletter portfolio. Please note we increased the weighting of PYPL shares in our Best Ideas Newsletter portfolio back on January 13, 2020 and further increased PayPal's weighting in our Best Ideas Newsletter portfolio **after going "fully invested" in April 29, 2020.** Please note that we have increased the weightings in the newsletter portfolio holdings across the board, which can be viewed on Page 8 of this edition of the Best Ideas Newsletter.

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Goal of the Best Ideas Newsletter

The goal of the Best Ideas Newsletter is to highlight ideas with strong capital appreciation potential and to update readers about new developments in the market. A simulated portfolio of capital appreciation ideas is presented on page 8 of each edition.

Best Idea PayPal...continued on next page

***Best Idea PayPal...*from previous page**

The top end of our fair value estimate range sits at $150 per share, and in our view, shares of PYPL have room to run further from current levels as of this writing (even after their strong performance of late). **PayPal is very well-positioned to ride out the storm created by the ongoing coronavirus ('COVID-19') pandemic as the world continues to transition towards an era heavily reliant on digital payments.**

Earnings Overview

PayPal's total payment volumes ('TPV') rose 18% year-over-year (19% on a constant-currency basis), driving 12% year-over-year GAAP revenue growth (13% on a constant-currency basis) last quarter. An increase in its credit loss reserves, a product of the ongoing COVID-19 pandemic and the negative impact that is having on employment rates and consumer incomes, held down PayPal's bottom-line (transaction and credit losses on a GAAP basis rose by 73% year-over-year last quarter, hitting $0.6 billion) as its GAAP diluted EPS came in at $0.07 in the first quarter (down 88% year-over-year). Share repurchases reduced PayPal's diluted outstanding share count marginally last quarter versus the same period a year-ago.

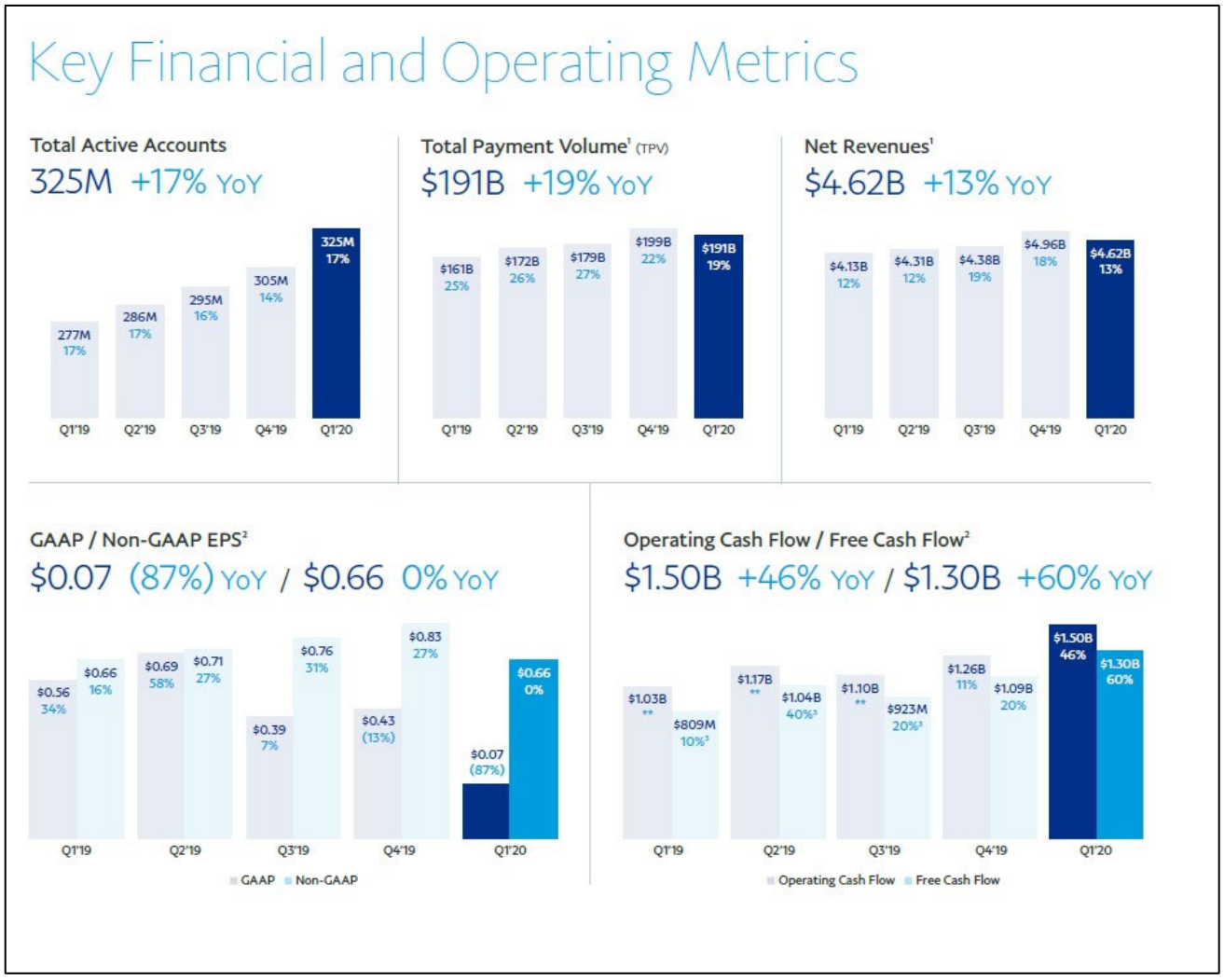


***Image Shown**: PayPal posted solid performance during the first three months of 2020, save for the large but expected increase in its credit loss reserves relating to its modestly-sized lending operations. **Image Source**: PayPal - First Quarter 2020 Earnings Press Release*

***Best Idea PayPal...*continued on next page**

*Best Idea PayPal...*from previous page

PayPal remains a free cash flow cow, generating $1.5 billion in net operating cash flow and spending $0.2 billion on capital expenditures in the first quarter of 2020 which allowed for $1.3 billion in free cash flows. That fully covered $0.8 billion in share repurchases last quarter, and PayPal does not have a common dividend policy at this time as management prefers to reinvest cash flow back into the business. PayPal completed its ~$4.0 billion cash-and-stock purchase of Honey Science Corporation last quarter (a deal we really like), which resulted in its long-term debt load growing from $5.0 billion at the end of 2019 to $8.0 billion at the end of the first quarter of 2020 (the firm did not have any short-term debt at the end of either periods).

Honey is a very popular browser extension that aims to build up a loyal fan base by scouring the web for any available online coupons, automatically applying those coupons when the user is purchasing a relevant product through e-commerce or digital channels, and then offering loyalty points to those users that can be redeemed for gift cards. The company makes money off commissions based on user transactions from retailers Honey has partnered up with.

Please note that even after this deal, **PayPal retained its net cash position and exited March 2020** with $7.9 billion in cash and cash equivalents, $2.3 billion in short-term investments, and $2.4 billion in long-term investments on hand. PayPal paid $3.6 billion in cash along with $0.4 billion in assumed restricted stock, restricted stock units, and options to acquire Honey (the deal was completed in January 2020). Here's what the firm had to say about the transaction in its 10-Q filing covering the first quarter of 2020:

> *We believe our acquisition of Honey will enhance our value proposition by allowing us to further simplify and personalize shopping experiences for consumers while driving conversion and increasing consumer engagement and sales for merchants.*

Part of PayPal's success came from a 17% year-over-year increase in its total active accounts last quarter, assisted by Honey adding 10.2 million accounts to its user base (a one-time event before factoring in organic growth, which remained strong and we'll cover that in a moment) along with another 10 million net from its existing operations which includes the very popular peer-to-peer ('P2P') money transfer app Venmo. As it relates to Venmo, management noted during PayPal's first quarter conference call that Venmo's TPV was up 48% last quarter which apparently was on a year-over-year basis (including "well over 50%" growth in January and February before apparently slowing down modestly in March).

Furthermore, management highlighted that this success carried on into April, with PayPal adding 7.4 million net accounts last month. That helped boost PayPal's revenues in the month of April up by roughly 17% (20% on a constant-currency basis) versus April 2019 levels. For the second quarter of 2020, PayPal is guiding for its revenues to climb higher by ~15% on a constant-currency basis versus the same period the prior year. Here's some key management commentary from PayPal's latest quarterly conference call (emphasis added):

> *"Our net new actives hit record highs in April, surging over a 140% from January and February levels, averaging approximately 250,000 net new active accounts per day. For the month of April, we added an all-time record of 7.4 million net new customers. I don't want to lose sight of the fact that we also had a record Q1 adding 10 million net new accounts,* ***but that will pale in comparison to the 15 million to 20 million net new active accounts we anticipate adding in Q2.*** *And last but certainly not least, in April, our revenues grew by 20% on an FX-neutral basis, including record revenue growth of 35% in our PayPal checkout experiences…*
>
> *The opportunities for Honey and PayPal to help consumers find the items they need at prices they can afford have never been more important for both merchants and consumers.* ***To put that in perspective, in April, Honey's net new actives grew nearly 180% from pre-COVID levels. And for the month of April, revenues for Honey were up over 40% from January and February.*** *" --- Dan Schulman, CEO of PayPal*

*Best Idea PayPal...*continued on next page

*Best Idea PayPal...*from previous page

A growing active user base should work wonders in extending and enlarging PayPal's long-term growth runway. In the upcoming graphic down below, PayPal provides an overview of its strong April 2020 performance which in our view is management's way of highlighting PayPal's optimistic outlook.

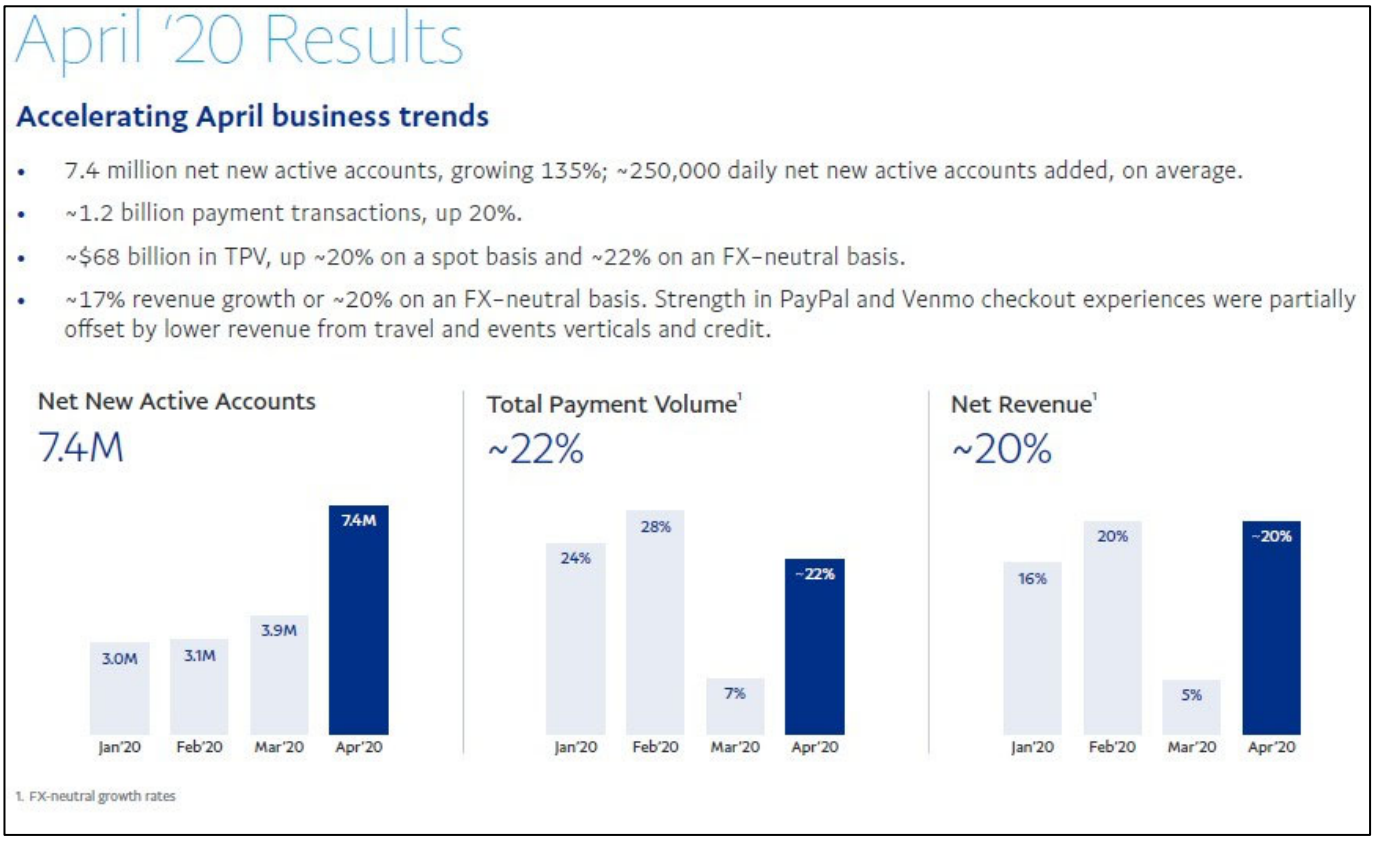


Image Shown: *PayPal's strong operational performance carried on into the month of April 2020 from the first quarter of this year.* ***Image Source:*** *PayPal - First Quarter 2020 Earnings Press Release*

PayPal has also had success in winning over new users from demographic cohorts it previously hasn't had as much (relatively speaking) success in engaging with until more recently. Management had this to say in response to a question from an analyst asking about PayPal's active user growth (and the dynamics concerning that growth trend) during PayPal's latest quarterly conference call:

> *"We're also seeing new segments of customers come in. We're seeing like older cohorts come in, calling it, silver tech, let's just say, those who are older or haven't used PayPal before and now are using it as their kids and family members are explaining to them how to use the service. When we look at engagement and this is a really important question you asked about cohorts in here.*
>
> *What we really look at and our best indicator of lifetime value as well as propensity to stay with us and not to churn is what we call our 10-day adoption rate, and that is within the first 10 days of somebody signing on that they do three or more transactions with PayPal, three or more. And so when we find when they do that, they're just a lifelong PayPal customer." --- CEO of PayPal*

We appreciate PayPal's solid financial and operational performance in the first quarter and in April, credit loss provisions aside.

*Best Idea PayPal...*continued on next page

***Best Idea PayPal...*from previous page**

Looking Ahead

While PayPal provided guidance for the second quarter of 2020, the firm withdrew its full-year guidance due to uncertainties created by COVID-19. The acquisition of Honey reinforces PayPal's relationships with its merchant client base as PayPal now has access to greater amounts of consumer purchasing habits and trends, which in theory could be used in the future to help merchants grow their sales and thus grow PayPal's TPV over time. That upside is entirely incremental to our current fair value estimate and fair value estimate range and highlights why we like PayPal as a long-term capital appreciation opportunity.

This year, PayPal is losing its exclusive payment processing deal with eBay Inc (EBAY), and we would like to stress that PayPal is very well positioned to keep growing its TPV even after eBay pivots to another payment processing provider (which will likely see PayPal's revenues and TPV from customers using eBay's marketplace platform decrease significantly). Please note that eBay has increasingly become a smaller part of PayPal's overall business and TPV in just the past few years alone. In 2019, revenue from customers using eBay's marketplace platform accounted for 14% of PayPal's revenues, down from 20% in 2017 and 29% in 2014. Additionally, please note that throughout 2019, PayPal's exposure to eBay continued to decrease materially and that the operating agreement between PayPal and eBay expires in July 2020.

During PayPal's fourth quarter of 2019 conference call, management noted that eBay was expected to represent ~6% of PayPal's TPV by the middle of 2020. PayPal will experience some short-term headwinds from the eBay operating agreement coming to an end, along with potential headwinds posed by foreign currency movements and COVID-19, but the firm's long-term growth trajectory continues to shine bright. **Investors, in our view, are looking past the noise and focusing on the kinds of long-term free cash flow growth PayPal could potentially generate. That trajectory is assisted by its pristine balance sheet.**

PayPal has successfully leveraged its financial tech operations and money transfer infrastructure to help get funds to small- and medium-sized businesses through the Payroll Protection Program ('PPP'), created through the Coronavirus Aid, Relief, and Economic Security Act ('CARES Act') that was recently passed by the US Congress to combat the negative economic effects of COVID-19. Here's some management commentary on the issue, from PayPal's latest quarterly conference call:

> *"It was an important and proud moment when we became one of the very first non-bank lenders approved to distribute the Paycheck Protection Program funds to the small businesses we serve. We have already funded tens of thousands of loans, distributed well over $1 billion with an average loan size of $35,000, and PayPal and Venmo customers in the US are eligible to receive their economic stimulus payment directly into their digital wallet." --- CEO of PayPal*

While a small part of its company-wide operations, incremental moves such as these are crucial for PayPal as it seeks to prove it can offer all kinds of financial services to its clients and potential clients.

Concluding Thoughts

The jump in shares of PayPal after it reported its first quarter earnings report is a welcome sign but didn't surprise us given how impressed we have been with the payment processing and financial tech company's operations, financials, and growth trajectory. We continue to really like PayPal as a holding in our Best Ideas Newsletter portfolio and see room for additional capital appreciation upside going forward. PayPal's lending business took a hit last quarter due to expectations that some of its loans won't get repaid, but as that remains a small part of its overall operations, PayPal remains a solid way to play secular growth tailwinds within the financial services, payment processing, and financial tech space.

Disclosure: *Callum Turcan does not own shares in any of the securities mentioned above.*

Facebook Is Roaring Higher!

Image Shown: *Shares of Facebook Inc have roared higher since reaching their March 2020 lows, far outpacing the rebound in the S&P 500 (SPY). We continue to like shares of FB as a top-weighted holding in our Best Ideas Newsletter portfolio.*

By Callum Turcan

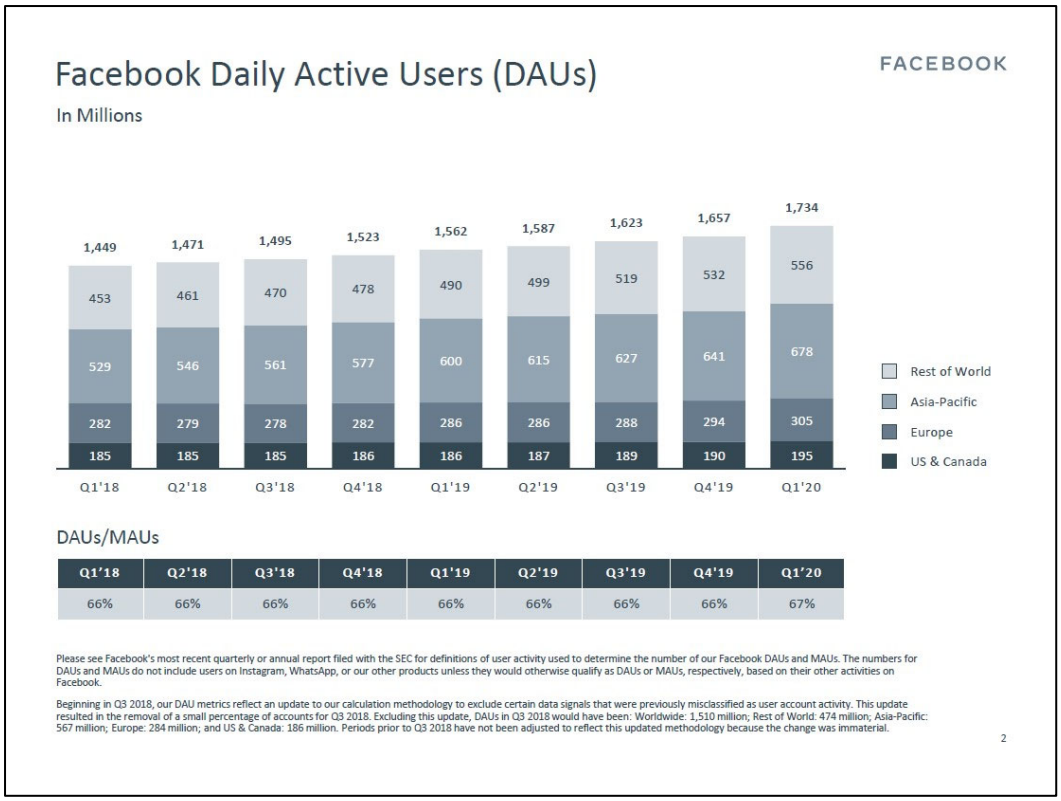
Top-weighted Best Ideas Newsletter portfolio holding Facebook Inc (FB) posted first quarter 2020 earnings on April 29 that saw its GAAP revenues jump 18% year-over-year to $17.3 billion while its GAAP diluted EPS grew by 101% year-over-year, hitting $1.71. Please note that Facebook's bottom-line comparison was made easier due to the firm recording a $3.0 billion legal settlement with the US Federal Trade Commission ('FTC') during the first quarter of 2019. While digital advertising spending levels are expected to get crushed in 2020 due to the ongoing coronavirus ('COVID-19') pandemic, **Facebook communicated to investors that its long-term growth trajectory remained very promising during the firm's latest quarterly conference call.** In our view, digital advertising spending levels will quickly bounce back once economies around the world start to reopen in earnest, though we caution that efforts to reopen the economy and resume "normal" daily activities need to keep in mind the risk another wave of infections imposes.

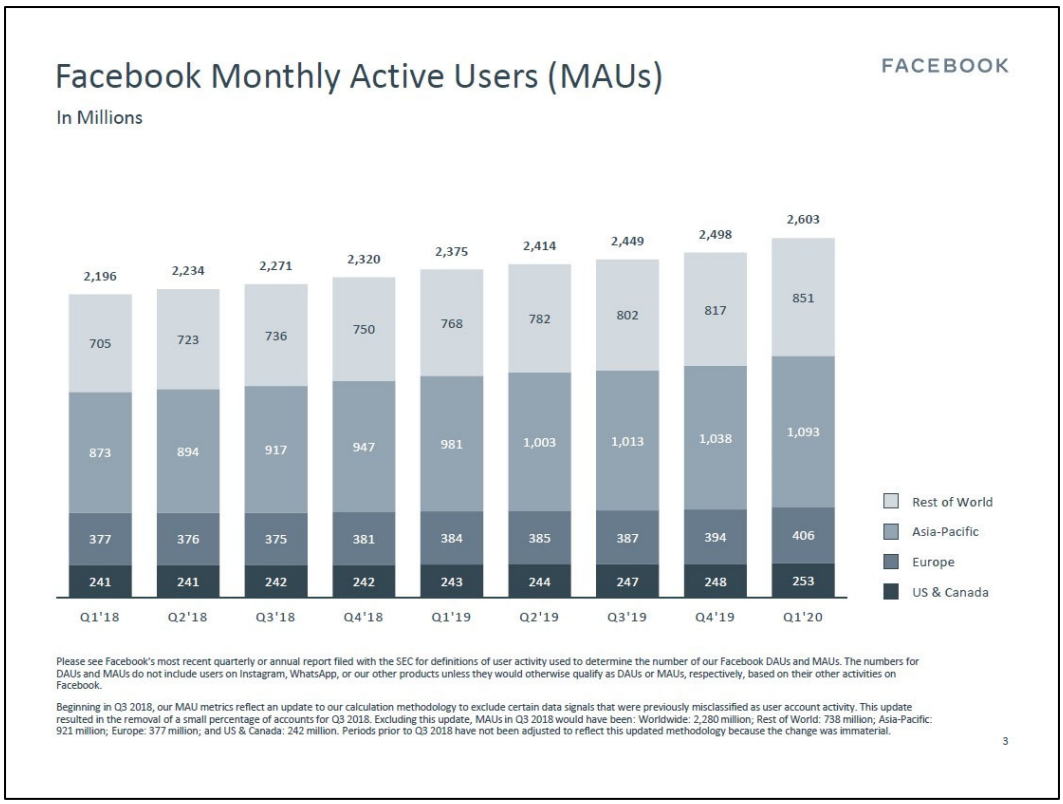
Operational Update

In the two upcoming graphics on the next page (Page 7), note that stay-at-home orders and other containment measures led to both Facebook's Daily Active Users ('DAUs') and Monthly Active Users ('MAUs') posting very strong sequential and year-over-year growth last quarter. That's one of the reasons why Facebook's share price has performed well of late, in our view, **as strong user growth should better allow for Facebook to rebound when the global economy starts to reopen.** Facebook experienced MAUs and DAUs growth in every major geographical region last quarter. Please note that Facebook's 'US & Canada' geographical segment remains its most lucrative as the digital advertising market in this region is very mature and connects businesses with households that have relatively high levels of disposable incomes.

*Facebook is Roaring...*continued on next page

***Facebook is Roaring...*from previous page**





***Images Shown:** Facebook's user base growth rate jumped up last quarter, with growth experienced in every geographical region. **Images Source:** Facebook – First Quarter of 2020 Earnings IR Presentation*

***Facebook is Roaring...*continued on page 9**

Valuentum's Best Ideas Portfolio

By Valuentum Analysts

Recently Removed: BKNG (February 24, 2020)

Recent Changes: *NEW* Went "fully invested" in our Best Ideas Newsletter portfolio on April 29, 2020

Valuentum's BEST IDEAS -- as of May 15, 2020

Portfolio Holdings	Symbol	Div Yield %	Fair Value	Economic Castle	VBI Rating	P/FV	Last Close	% of Portfolio
Berkshire Hathaway	BRK-B	0.00%	$229.00	NA	5	0.74	169.25	8%-13%
Facebook	FB	0.00%	$231.00	Attractive	6	0.91	210.88	8%-13%
Alphabet - Class C	GOOG	0.00%	$1436.00	Attractive	6	0.96	1373.19	8%-13%
Visa	V	0.69%	$178.00	Very Attractive	6	1.03	183.49	8%-13%
PayPal	PYPL	0.00%	$140.00	Attractive	6	1.04	145.51	6.5%-8%
SPDR S&P Dividend ETF	SDY	3.48%	NA	NA	UR	NA	82.49	6.5%-8%
Health Care ETF	XLV	2.54%	NA	NA	UR	NA	100.42	6.5%-8%
Cisco	CSCO	3.37%	$54.00	Very Attractive	3	0.82	44.27	5%-6.75%
Intel	INTC	2.18%	$51.00	Attractive	3	1.14	58.28	5%-6.75%
Johnson & Johnson	JNJ	2.77%	$148.00	Attractive	7	1.02	150.44	5%-6.75%
S&P Aero & Defense	XAR	1.43%	NA	NA	UR	NA	74.97	5%-6.75%
Dollar General	DG	0.81%	$143.00	Attractive	6	1.27	182.02	3.5%-5%
Disney	DIS	1.66%	$111.00	Attractive	4	0.98	109.05	3.5%-5%
Vanguard REIT ETF	VNQ	4.54%	NA	NA	UR	NA	68.80	3.5%-5%
Cash consideration	-	-	-	-	-	-	-	0.0%

UR = Under Review

This portfolio is not a real money portfolio. Data as of May 15, 2020.

The cash weighting in the Best Ideas Newsletter portfolio is now 0% at the midpoint. The midpoints of our respective weighting ranges sum to 100% to reflect the range of possible combinations that may result in this allocation.

Goal: The Best Ideas Newsletter portfolio seeks to find stocks that have both good value and good momentum characteristics and typically includes in the portfolio each idea from a Valuentum Buying Index rating of a 9 or 10 (consider buying) to a rating of a 1 or 2 (consider selling). Just like a value manager may not include every single undervalued company in the market in his/her portfolio, not all highly-rated companies on the Valuentum Buying Index are included in the portfolio.

We may tactically add to or trim existing positions in the portfolio on the basis of sector or broader market considerations, but we seek to capture a stock's entire pricing cycle (from being underpriced with strong momentum to being overpriced with poor momentum). The Best Ideas Newsletter portfolio puts the Valuentum Buying Index into practice.

Every person has different goals and different risk tolerances, so where before in the newsletter portfolios, we would outline the specific percentage weighting, we think providing ranges make much more sense. For example, depending on someone's risk tolerances, a larger cash position in an overheated market may be prudent. On the other hand, the longer one's time horizon, perhaps a smaller cash position may make more sense.

Ideas may not add up to 100% on either the low % or high % due to rounding and/or other combinations / permutations.

Standard Disclaimer: The simulated Best Ideas Newsletter portfolio is for information purposes only and should not be considered a solicitation to buy or sell any security. Valuentum is not responsible for any errors or omissions or for results obtained from the use of the simulated Best Ideas Newsletter portfolio and accepts no liability for how readers may choose to utilize the content.

*Facebook is Roaring...*from page 7

Facebook's 'Worldwide' Average Revenue Per User ('ARPU') grew year-over-year in the first quarter but was down sequentially. That's largely to be expected given that digital advertising spending levels tend to be strongest in the fourth quarter due to seasonal shopping trends (i.e. Christmas shopping) in key Western markets. In the upcoming graphic down below, Facebook provides a visual breakdown of the trajectory of its ARPU over the past several quarters.

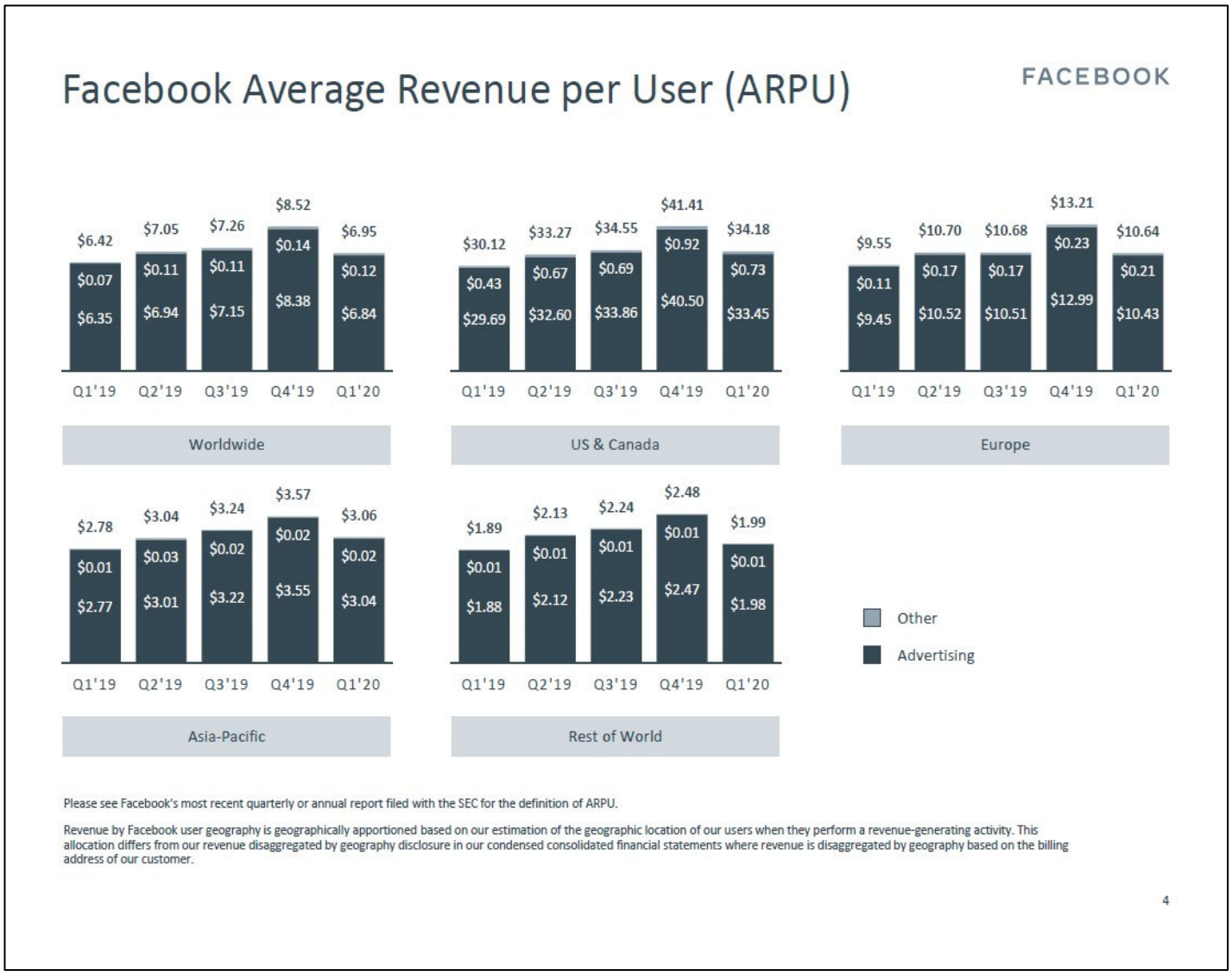


Image Shown: *Facebook's ARPU continued to grow year-over-year last quarter, though that metric will likely shift lower over the coming quarters due to the pandemic, before rebounding later on.* ***Image Source:*** *Facebook - First Quarter of 2020 Earnings IR Presentation*

In the short-term, Facebook's ARPU will likely drop due to the negative dynamic impact the ongoing pandemic is having on consumer spending levels and digital advertising budgets worldwide. However, the giant in this space Alphabet Inc (GOOG) (GOOGL) sees digital advertising spending levels rebounding quickly when the global economy begins to reopen due to the high return on investment this method of advertising offers clients. As an aside, Alphabet Class C shares (ticker: GOOG) are included as a top-weighted holding in our Best Ideas Newsletter portfolio.

*Facebook is Roaring...*continued on next page

*Facebook is Roaring...*from previous page

Balance Sheet Strength and Indian Growth Ambitions

Facebook exited the first quarter with $60.3 billion in cash & cash equivalents and marketable securities combined and continued to carry no debt on the books. Last quarter, Facebook generated ~$7.65 billion in free cash flow and spent ~$1.25 billion on share repurchases (Facebook does not have a common dividend program at this time).

We strongly appreciate Facebook's pristine balance sheet, high quality cash flow profile, and large net cash position as that allows for the company to capitalize on prime opportunities when they arise. For instance, Facebook is buying a ~10% equity stake in Jio Platforms for USD$5.7 billion (Jio Platforms is a subsidiary of Reliance Industries, a massive conglomerate run by India's richest individual, Mukesh Ambani). Here's what Facebook had to say about the deal during its latest quarterly conference call:

> *"One aspect of online commerce I want to mention is the partnership we just announced with Jio Platforms in India. The largest Facebook and WhatsApp communities in the world are in India, and we think there's an especially important opportunity to serve small businesses and enable commerce there over the long term. By bringing together JioMart, which is Jio's small business initiative to connect millions of shops across India, with WhatsApp, we think that we're going to be able to create a much better shopping experience. There's a lot more we can do here and I'm looking forward to making progress with the team at Jio." --- Mark Zuckerberg, CEO of Facebook*

Facebook is excited about the opportunities India's emerging digital landscape will create, and that includes plenty of e-commerce opportunities. Market research group Forrester forecasts strong double-digit growth in India's annual e-commerce sales over the coming years, assisted by the large telecommunications investments Jio Platform has made over the past decade (Jio Platform built out India's 4G telecommunications infrastructure and caters to over 370 million subscribers in the country). Mobile e-commerce sales are expected to represent a large driver of this growth trajectory. WhatsApp and Jio Platforms combined are expected to allow the partnership to better capitalize on that upside.

The goal is to leverage WhatsApp to connect India's ~1.35 billion strong populace with the millions of small businesses (including many mom-and-pop grocery stores) out there, most of which are unlikely to have a meaningful (or any) online presence. WhatsApp has been investing in product catalog infrastructure (a necessary part of any e-commerce marketplace) and Facebook has been allocating resources to develop payment processing technology. Jio Platform's owns JioMart, an online grocery shopping service, and tying JioMart in with WhatsApp could drive meaningful sales growth at the marketplace.

Ultimately, the goal is to create a large comprehensive platform where Indian consumers can go online (using Jio Platform's telecommunication infrastructure), locate stores within logistical range (in terms of shipping/transportation options) on JioMart, connect and communicate with those stores via WhatsApp, and buy groceries from the millions of small businesses out there all on one integrated platform (with WhatsApp handling the payment processing side of things).

According to *YaleEnvironment 360*, by 2050, India is forecasted to see the size of its population grow by another 230 million people. By 2027, the size of India's population will exceed that of China's, which stood at approximately 1.4 billion people as of the end of the last decade. There will be a lot more hungry mouths to feed in the years to come in India and the partnership between Facebook and Jio Platform will help streamline the last stage of the nation's food supply chain. Demographic trends support India's long-term economic growth trajectory, particularly if major investments are made in infrastructure (a major part of Indian Prime Minister Narendra Modi's economic policy platform) and education.

*Facebook is Roaring...*continued on next page

***Facebook is Roaring...*from previous page**

We like the Jio Platform-Facebook partnership's strategy and please note Facebook's Indian growth ambitions represent a key reason why our models include very strong mid-cycle growth expectations as it relates to Facebook's future forecasted free cash flows as you can see below.

Valuation Analysis

Valuation Assumptions

In Millions of USD (except for per share items)	5-year Projections	
Revenue CAGR %	18.5%	
Avg. EBIT Margin %	36.2%	
Avg. Cash Tax Rate %	15.0%	
Earnings Before Interest CAGR %	11.4%	
Earnings Per Share CAGR %	13.4%	
Free Cash Flow to the Firm CAGR %	11.2%	
Earnings before interest = Net operating profits less adjusted taxes	Long-term Projections	
Phase II --> III FCFF CAGR %	9.8% (II)	3% (III)
Cost of Equity %	9.8%	
After-tax Cost of Debt %	NA	
Discount Rate (WACC) %	9.8%	
Synthetic credit spread = 0.46%	Results	
Phase I Present Value	65,969	
Phase II Present Value	313,871	
Phase III Present Value	262,275	
Total Firm Value	642,116	
Net Balance Sheet Impact	41,114	
Total Equity Value	683,230	
Diluted Shares Outstanding	2,921.0	
Fair Value per Share	$234.00	

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Facebook and the break down to the firm's total equity value, which we estimate to be about 683.23USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $234 per share fair value estimate.

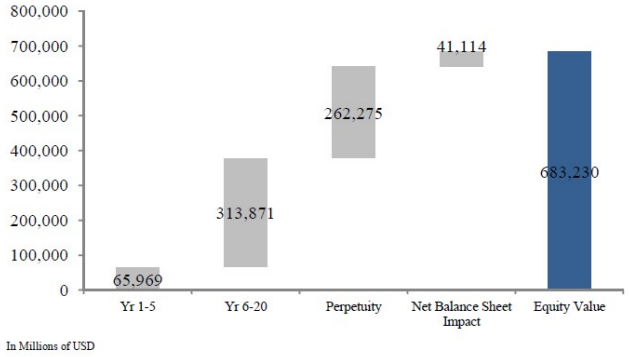


Image Shown: *Under our base case scenario, our discounted free cash flow models give shares of FB a fair value estimate of $234 per share.*

Additionally, please note that recently, Vista Equity Partners announced it would invest USD$1.5 billion in Jio Platforms and Silver Lake Investments announced it would invest USD$0.75 billion in Jio Platforms. **There's a lot of apparent interest in Facebook's and Jio Platform's vision that aims to fundamentally reshape India's digital landscape.**

Walmart Inc (WMT) purchased a 77% equity stake in India's e-commerce giant Flipkart for approximately USD$16.0 billion back in 2018 and Amazon Inc (AMZN) pledged to invest roughly USD$1.0 billion in India with an eye towards digitizing the operations of small- and medium-sized businesses at the start of 2020 (on top of the investment commitments Amazon has already made). Facebook is now pushing its way into the space, aided by Jio Platform's largess and existing telecommunications/digital infrastructure.

Concluding Thoughts

We continue to like both Alphabet and Facebook as top-weighted holdings in our Best Ideas Newsletter portfolio and in our view, **the digital advertising market will rebound strongly once the pandemic is contained.** The discovery of a COVID-19 vaccine (or an effective therapeutic for treating the virus after infection occurs) combined with unprecedented fiscal and monetary stimulus measures seen around the world would go a long way in supporting both Alphabet's and Facebook's growth trajectory. As the world waits for a potential vaccine/treatment to get discovered (with clinical trials currently underway), Facebook continues to witness extremely strong user base growth and the firm is making major investments in emerging digital markets (like India) to further extend its already impressive growth trajectory.

Disclosure: *Callum Turcan does not own shares in any of the securities mentioned above.*

Alphabet Surges Higher!

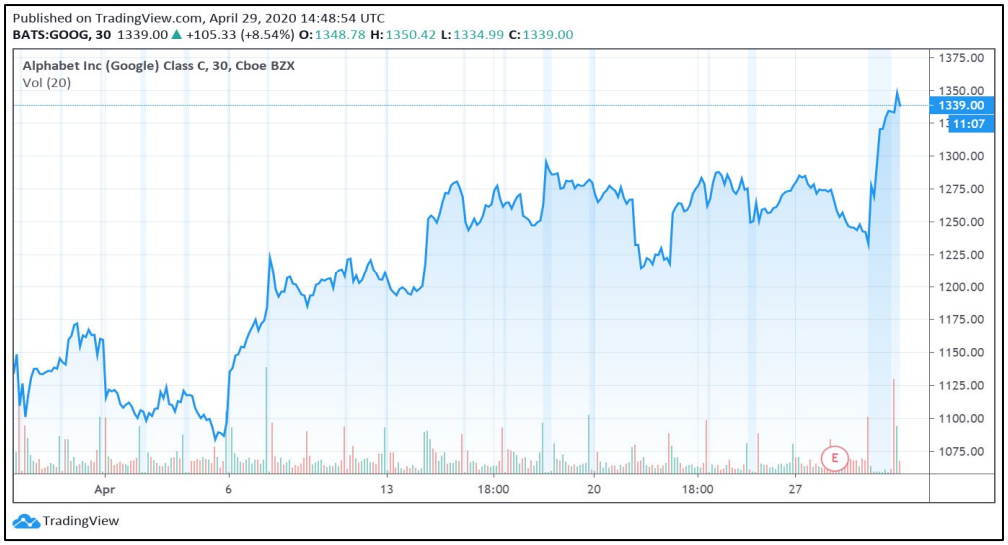


Image Shown: *Shares of Alphabet Inc surged higher on April 29 after reporting a stellar earnings report, and we continue to like Alphabet Class C shares as a top-weighted holding in our Best Ideas Newsletter portfolio.*

By Callum Turcan

After the market close on April 28, Alphabet Inc (GOOG) (GOOGL) reported first-quarter earnings for 2020 that beat top-line consensus estimates and missed bottom-line consensus estimates, with sales supported by the strength of its digital advertising business and its growing Google Cloud business. Alphabet's advertising revenue (comprised of revenue from its Google Search, YouTube, and Google Network Members' properties operations) was up 10% year-over-year to $33.8 billion while Google Cloud reported 52% revenue growth year-over-year, reaching $2.8 billion last quarter. All-in-all, Alphabet's GAAP revenues climbed higher by 13% year-over-year in the first quarter, hitting $41.2 billion.

Shares of Alphabet moved significantly higher on April 29 as the firm's outlook was better than expected, aided by management communicating that Alphabet was prepared to utilize its fortress-like balance sheet to repurchase stock at a meaningful discount to their intrinsic value (we'll cover that later on in this article). Our fair value estimate for shares of GOOG sits at $1,436 per share as you can see in the upcoming graphic down below.

Valuation Analysis

Valuation Assumptions	
In Millions of USD (except for per share items)	5-year Projections
Revenue CAGR %	14.1%
Avg. EBIT Margin %	22.7%
Avg. Cash Tax Rate %	12.0%
Earnings Before Interest CAGR %	14.2%
Earnings Per Share CAGR %	13.1%
Free Cash Flow to the Firm CAGR %	17.0%
Earnings before interest = Net operating profits less adjusted taxes	Long-term Projections
Phase II --> III FCFF CAGR %	8.6% (II) 3% (III)
Cost of Equity %	9.8%
After-tax Cost of Debt %	4.2%
Discount Rate (WACC) %	9.8%
Synthetic credit spread = 0.46%	Results
Phase I Present Value	98,347
Phase II Present Value	447,390
Phase III Present Value	359,229
Total Firm Value	904,966
Net Balance Sheet Impact	105,128
Total Equity Value	1,010,094
Diluted Shares Outstanding	703.3
Fair Value per Share	$1,436.00

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Alphabet and the break down to the firm's total equity value, which we estimate to be about 1010.09USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $1436 per share fair value estimate.

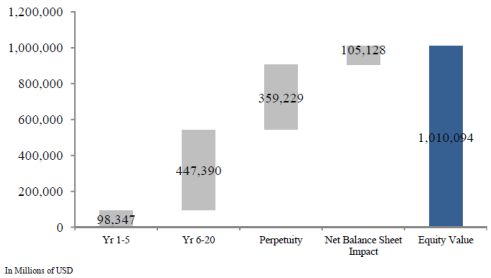


Image Shown: *Shares of GOOG have room to run higher, in our view.*

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Quarterly Overview

The negative blow the ongoing coronavirus ('COVID-19') had on digital advertising spending in the first quarter was less than feared though still meaningful given that Alphabet's growth rate slowed materially in March according to management's commentary. While the second and third quarters will likely be brutal given sharp pullbacks in digital advertising budgets, **the company is confident digital advertising spending will bounce back once the storm begins to clear.** Here's what Alphabet's CEO, Sundar Picahi, had to say during the firm's latest conference call:

> *"Turning to our business, let me touch on our performance this quarter. Q1 was in many ways the tale of 2 quarters. For our advertising business, the first 2 months of the quarter were strong. In March, we experienced a significant and sudden slowdown in ad revenues. The timing of the slowdown correlated to the locations and sectors impacted by the virus and related shutdown orders…*
>
> *Overall, recovery in ad spend will depend on a return to economic activity. There are 2 key aspects of our business that give us confidence about the future. First, as we saw after 2008, one of the strongest features of Search is that it can be adjusted quickly, so it's relatively easier to turn off and then back on, and marketers see it as highly cost effective and ROI based."*

Management seemed to indicate that the decline in Alphabet's digital advertising business could be quickly reversed as the economy reopens, **which speaks favorably towards its medium-term trajectory**, relatively speaking, as investors were expecting a much worse outlook.

Alphabet's Google Cloud segment continued to show promise (which offers cloud computing services in a lucrative but highly competitive market), and while a small part of its company-wide revenues, Google Cloud offers Alphabet one of its best way to diversify into a non-digital advertising business (a process that will take time).

When it comes to YouTube's non-advertising revenues, management noted that the video sharing and streaming service continued to experience subscriber growth last quarter. Alphabet's 'Google other' revenues climbed higher by almost 23% year-over-year in the first quarter, hitting $4.4 billion, and those sales include YouTube subscription revenues. Digital advertising remains Alphabet's core business, but we appreciate the firm expanding into other realms.

Rising traffic acquisition costs ('TAC') and operating expenses weighed on Alphabet's operating income, keeping in mind that as a percent of advertising revenues, TAC costs shifted lower according to management. The operating income from Alphabet's Google segment only climbed marginally higher year-over-year (up almost 1%) as it reached $9.3 billion last quarter.

However, please note Alphabet's 'Other Bets' operating loss widened by 29%, reaching $1.1 billion last quarter (while that segment's revenues actually declined year-over-year as these are long-term bets with no meaningful near-term commercial opportunities) which also weighed on Alphabet's GAAP operating income. However, the lack of a major European Commission fine still saw Alphabet's GAAP operating income rise by 21% year-over-year to reach $8.0 billion in the first quarter.

Pressures from TAC and operating losses from its Other Bets segment need to be monitored going forward, though Alphabet remained a juggernaut in the first quarter and that spoke favorably towards its outlook as the firm gets ready to ride out the storm. A growing headcount also weighed on the firm's operating margins.

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Here's what Alphabet's CFO Ruth Porat had to say during the firm's latest quarterly conference call:

> *"Regarding our key expense lines, on a consolidated basis, total cost of revenues including TAC, was $19 billion, up 19% year-on-year. Other cost of revenues on a consolidated basis was $11.5 billion, up 26% year-over-year primarily driven by Google-related expenses. The biggest factors here again this quarter were costs associated with our data centers and other operations, including depreciation, and then content acquisition costs, primarily for YouTube's advertising supported content followed by content costs for YouTube TV and our paid YouTube music and premium subscription services.*
>
> *Operating expenses were $14.2 billion with headcount growth being the largest driver of year-on-year growth for R&D and sales and marketing expenses. For G&A, the biggest driver of expense growth was attributable to a reserve for estimated credit deterioration as a result of COVID-19…*
>
> *Total Traffic Acquisition Costs were $7.5 billion or 22% of total advertising revenue and up 9% year-over-year. Total TAC as a percentage of total advertising revenues was down slightly year-over-year, reflecting once again of favorable revenue mix shift from network to Google properties."*

Cash Flow and Balance Sheet Update

Alphabet continued to generate an enormous amount of free cash flow in the first quarter, though that will likely become a tougher task during the remainder of the year given the sharp slowdown in digital advertising spend of late. Last quarter, it generated a tad less than $11.5 billion in net operating cash flow and spent $6.0 billion on capital expenditures, allowing for ~$5.55 billion in free cash flow. The company does not pay out a common dividend at this time and spent $8.5 billion repurchasing its stock in the first quarter.

Some of its share repurchases were clearly funded by Alphabet's pristine balance sheet, which remained pristine after the fact. As of the end of March 2020, Alphabet's total cash, cash equivalents, and marketable securities line-item stood at $117.2 billion (down $2.4 billion from the end of 2019) while its long-term debt load stood at a just $5.0 billion (up $0.5 billion from the end of 2019). Additionally, the firm carried $12.4 billion in non-marketable securities on the books at the end of March 2020. The digital advertising giant's GAAP diluted EPS climbed higher by 4% year-over-year in the first quarter, reaching $9.87, as its outstanding diluted share count fell by over 1% due to its ongoing share buyback program.

Management indicated during the firm's latest quarterly conference call that Alphabet's share repurchasing program would continue as planned, aided by the strength of the firm's fortress-like balance sheet and high quality cash flow profile. Here's what Alphabet's CFO had to say during the firm's latest quarterly conference call in response to an analyst question (emphasis added):

> *"…**[W]e believe a share purchase program for us appropriately sized is responsible [in] the current environment based on our capital allocation framework and our cash balance**. So in the beginning of the year, I indicated that we expected to repurchase shares at a pace at least consistent with the fourth quarter on the remaining authorization and that remains our view for the second quarter."*

Alphabet intends on utilizing its pristine balance sheet to continue buying back its stock, which we can appreciate given that shares of GOOG are trading meaingful below our fair value estimate as of this writing. The company's strong balance sheet allows for the firm to take advantage of the recent decline in its share price to buy back stock at prices that represent a significant discount to their fair value estimate or intrinsic value. In many instances, we prefer that companies hoard cash during harrowing times such as these, but Alphabet and a select few other large tech companies are in a completely different position than most publicly traded firms out there. At the top end of our fair value estimate range, shares of GOOG carry a fair value estimate of $1,795 per share.

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Key Considerations Going Forward

Looking ahead, the second quarter won't look as rosy as the first with Alphabet's major clients aggressively scaling back their digital advertising budgets. While that spending will likely return once the pandemic starts to subside, we caution that Alphabet's near-term performance will be lumpy.

With that being said, for the first time in a while, Alphabet is now focused on controlling costs to better position itself to ride out the storm. That includes slowing down its hiring rate (Alphabet's headcount rose by 19% year-over-year last quarter, reaching over 123,000 employees) and cutting marketing spend, among other things (such as potentially paring back its investment in data centers, keeping in mind Alphabet wants to make Google Cloud a bigger part of its revenue mix).

Management is not just sitting around; the company is making the decisions required to ride out a storm like COVID-19. During the firm's latest quarterly conference call, management noted that significant changes to Alphabet's spending and investing plans would begin to appear by the third quarter (if not sooner). Alphabet still intends on making the necessary long-term investments to keep the company competitive, but in "non-essential areas" the firm is showing a willingness to scale back which we appreciate. We'll see how or if Alphabet rationalizes some of its 'Other Bets' spending levels given the lack of revenues those segments are generating.

Concluding Thoughts

We continue to like Alphabet, particularly Alphabet Class C shares (ticker GOOG), as a top-weighted holding in our Best Ideas Newsletter portfolio. Digital advertising spending will recover as the economy restarts as it is much easier to start, stop, and restart digital advertising investments compared to other forms of advertising. Furthermore, Alphabet is well-positioned to ride out the storm and emerge on the other side of the COVID-19 pandemic with a reduced outstanding share count and a stronger cloud computing segment. Cloud computing is a hypercompetitive and lucrative space, one that requires a lot of investment to stay ahead of the curve.

Alphabet continued to make material investments in its Google Cloud operations last quarter, which included aggressively increasing its headcount in the segment's engineering and sales departments. Those investments have panned out nicely so far and management remains committed to making Google Cloud a core part of Alphabet's operations. Over the long-term, the company's autonomous driving unit Waymo offers the company a way to further diversify its business, which we appreciate.

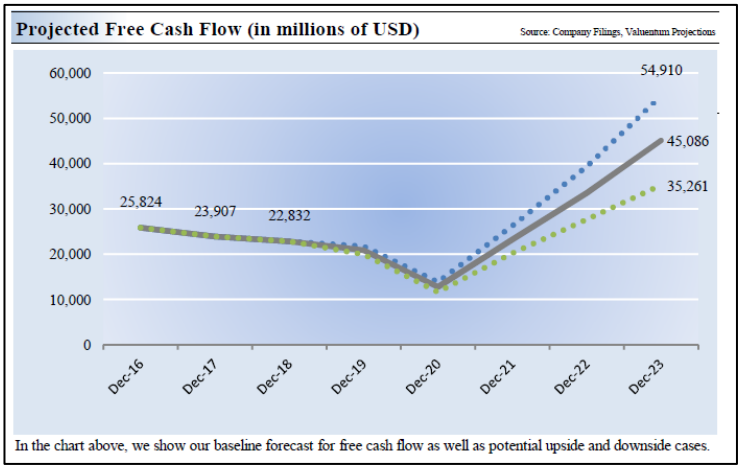

Image Shown: *We forecast that Alphabet will generate strong free cash flow growth over the coming years.*

Disclosure: *Callum Turcan does not own shares in any of the securities mentioned above.*

Detroit Automakers on the Ropes, Tesla Continues to Dominate

Image Source: GM

We're not sure the Detroit automakers will ever be the same after COVID-19. The global pandemic might be the knock-out blow that keeps them on the canvas for a long time, as the group continues to face changing consumer preferences and the rise and dominance of Tesla. Cash preservation is the name of the game at the moment, as they await a restart to some of their U.S. operations May 18.

By Callum Turcan and Brian Nelson, CFA

The legacy automakers continue to be in a world of hurt as environmentally conscious consumers begin to dominate the landscape. It is an irreversible trend that General Motors (GM), Ford (F) and Fiat Chrysler (FCAU) once had in their hands to capitalize on, but they let it slip away. Tesla (TSLA) is now the company to beat.

The share-price performance across the group couldn't tell the story better. Tesla's equity is up over 80% so far during 2020, while shares of General Motors, Ford, and Fiat Chrysler have been largely halved. We maintain that removing General Motors from the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio January 13 was the right move.

General Motors is against the ropes as competitive pressures from Tesla and the outbreak of COVID-19 around the globe has all but revealed the risks of a cyclical, operationally leveraged entity tied to waning consumer demand for combustible engines. **On April 27, General Motors announced that it has suspended its quarterly cash dividend as it put an axe to its share repurchase program.**

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General Motors noted that it remains committed to reinvesting in its business at pretax returns at 20%+, and remaining an investment-grade balance sheet, but the recent health crisis has shown that generating strong returns through the course of the economy cycle may be elusive for the auto giant. Its recent steps to fortify its balance sheet are the right moves during this time, but investors don't have to own a struggling automaker.

The same may be true for Ford. Shares of Ford have collapsed from $10 as recently as July 2019 to the mid-$5 range, as of this writing, and the company's first-quarter results, released April 28, showed a company mired in losses. During the first quarter of 2020, Ford posted a net loss of $2 billion, blaming COVID-19 for the weakness, as expected. The company is also aggressively working to shore up its balance sheet, drawing more than $15 billion from its existing credit lines and issuing $8 billion in unsecured debt.

As with General Motors, Ford previously suspended its dividend and what it describes as "antidilutive" share repurchases. There's not much to say about its outlook either, as Ford's CFO Tim Stone noted "today's economic environment remains too ambiguous to provide full-year 2020 financial guidance," with expectations for "second-quarter EBIT to be a loss of more than $5 billion, as year-over-year industry volumes decline significantly in every region."

The next couple quarters will be rough for the group, and cash preservation will be among the top priorities. Fiat Chrysler is also shoring up cash at the moment. The company noted April 21 that it drew down its €6.25 billion revolving credit facility. Fiat Chrysler also announced earlier in April that it negotiated another €3.5 billion credit facility, which has yet to be drawn upon. The Detroit automakers are looking for a May 18 U.S. restart date for some of their operations.

Tesla, and in particular Tesla's CEO Elon Musk, has reportedly grown impatient and is already pushing forward with restarting production at the company's domestic auto plant in Fremont, California, initially in defiance of Alameda County officials (the city of Fremont is located in Alameda County). The county has since agreed to let Tesla restart operations at the plant sometime in mid-to-late May, as long as certain safety conditions are met. California's governor, Gavin Newsom, announced on May 7 guidance for how the state could restart manufacturing activities however, the governor also noted local governments could impose different restrictions if necessary. We'll see how this saga unfolds.

In neighboring Nevada, Tesla has restarted operations at its battery production facility dubbed the 'Gigafactory' and is ramping up production capabilities at the site. That plant is located in Storey County and is situated near Reno, Nevada. We caution that very serious safety precautions need to be taken in order to ensure the safety of workers at both facilities. Nevada's governor, Stephen Sisolak, began taking steps to reopen the state's economy that went into effect May 9 which helped set the stage of Tesla to restart operations.

Concluding Thoughts

The Detroit automakers may never be the same. While some bounce back is to be expected, memories of the bailouts of the Great Financial Crisis and now the Great Crash of 2020 will leave a sour taste in investors' mouths. They also dropped the ball yet again with respect to innovation and will likely cede tremendous share to Tesla, as the forward-leaning electric automaker literally changes the game with consumer excitement surrounding the build of its Cybertruck.

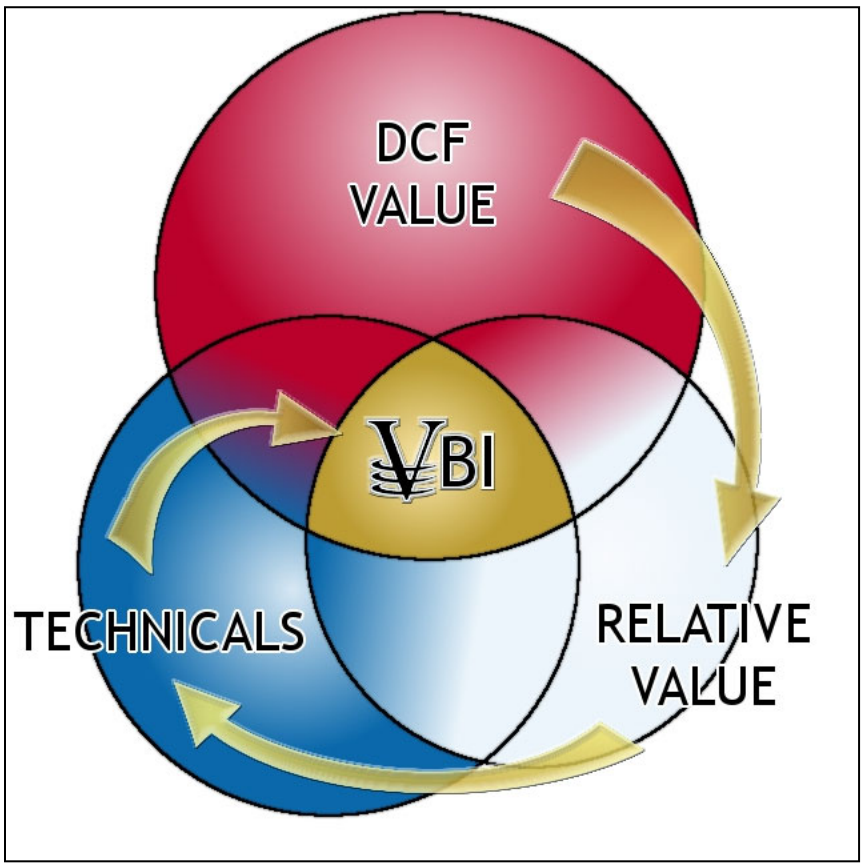
***Disclosure**: Callum Turcan and Brian Nelson do not own shares in any of the securities mentioned above.*

Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

At Valuentum, we think some of the best opportunities arise from an understanding of a variety of investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value through momentum investing. We think companies that are attractive from a number of investment perspectives--whether it be growth, value, income, momentum, etc.--have the greatest probability of capital appreciation and relative outperformance. The more deep-pocketed institutional investors that are interested in the stock for reasons based on their respective investment mandates, we posit the more likely it will be bought and the more likely the price will move higher to converge to its "true" intrinsic value (buying a stock pushes its price higher). On the other hand, we think the worst stocks will be shunned by most investment disciplines and display expensive valuations, poor technicals and deteriorating momentum indicators.

We think stocks that meet our demanding criteria fall in the center of the Venn diagram below, displaying attractive characteristics from a discounted cash-flow basis, a relative value basis, and with respect to a technical and momentum assessment. The size of the circles generally reveals the relative emphasis we place on each investment consideration, while the arrows display the order of our process -- value first then technicals and momentum last. We may like firms that are undervalued both on a discounted cash flow (DCF) basis and relative value basis, but we won't like firms just because they're currently exhibiting attractive technical or momentum indicators. We're not traders or speculators. We target the long term, and we want to have a strong process to support the ideas we deliver to our subscribers.



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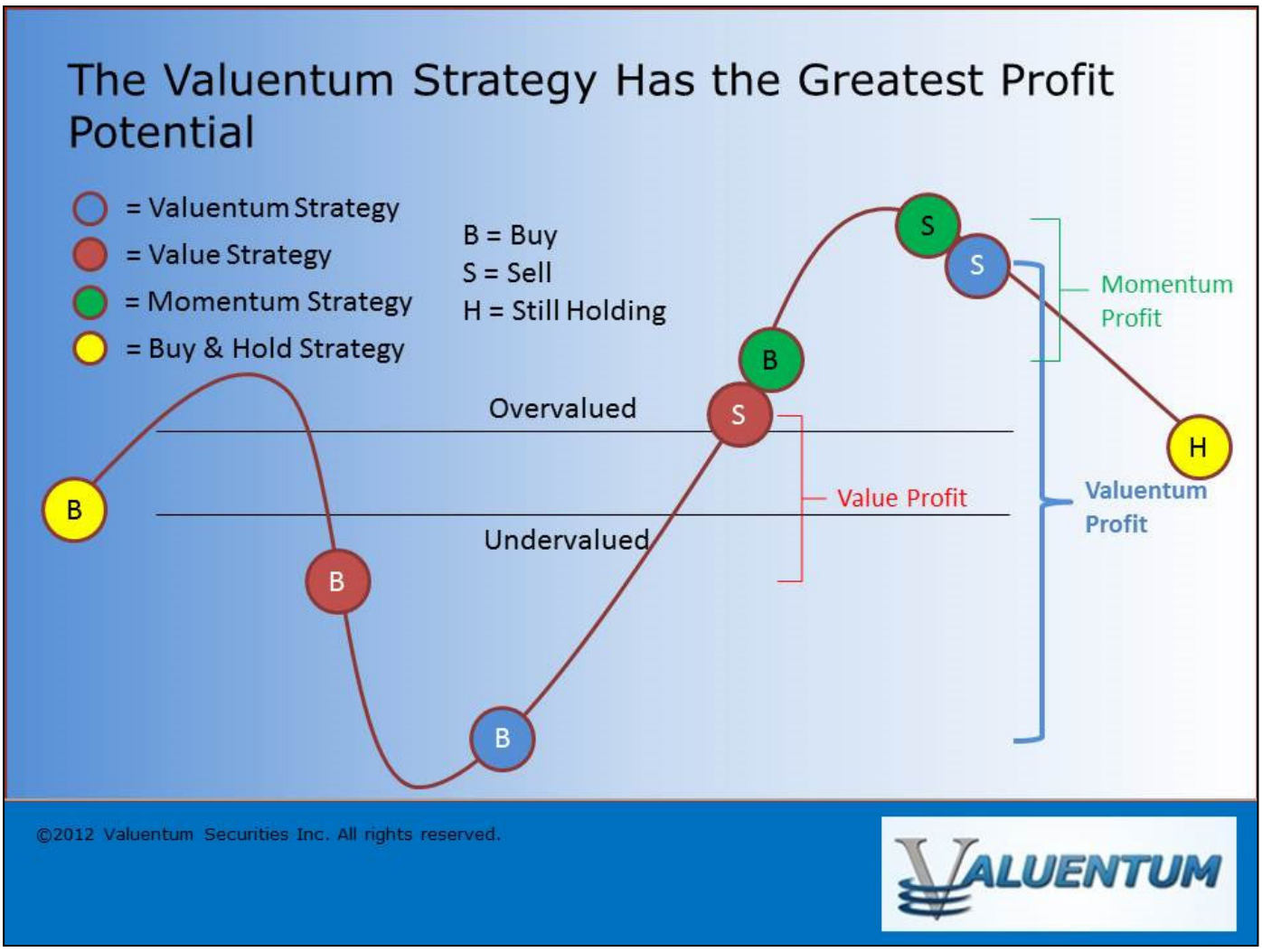
The center of the Venn diagram above, the Valuentum Buying Index (VBI) combines rigorous financial and valuation analysis with an evaluation of a firm's technicals and momentum indicators to derive a rating between 1 and 10 for each company (10=best). Because the process factors in a technical and momentum assessment after evaluating a firm's investment merits via a rigorous DCF and relative-value process, the VBI attempts to identify entry and exit points on what we consider to be the most undervalued stocks.

We think research firms that just focus on valuation may expose readers to a stock on its way down (a falling knife), while those that just use technical and momentum indicators may expose portfolios to significantly overpriced stocks at their peaks. It is our view that only when both sides of the investment spectrum are combined can investors find undervalued stocks at potentially timely prices for consideration.

Let's examine the chart below, which showcases how the Valuentum process, by definition, may have the greatest profit potential of any common investing strategy. The Valuentum process targets adding stocks to actively-managed portfolios when both value and momentum characteristics are "good" and removing them when both value and momentum characteristics are "bad" (blue circles: Buy --> Sell). We define the Valuentum strategy as capturing the entire equity pricing cycle, while the value and momentum strategies individually truncate profits, as illustrated in the image below.



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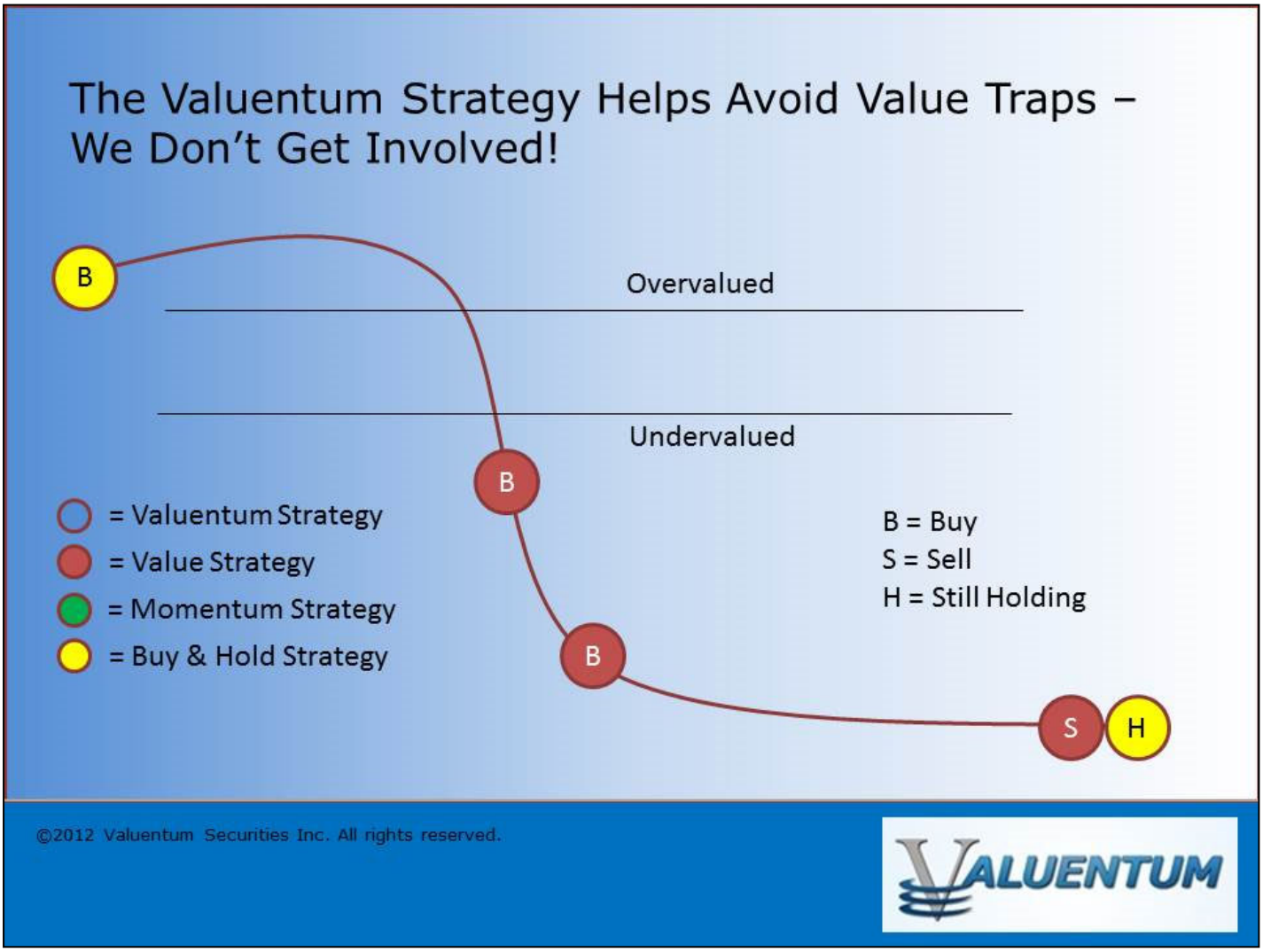
Furthermore, we think Valuentum subscribers are less likely to be involved in so-called value traps because we demand material revenue and earnings growth for firms to earn a 10 on the Valuentum Buying Index. Value traps often occur as a result of secular declines in a firm's products or services, resulting in deteriorating revenue and earnings trends (and often a falling stock price). We also think Valuentum subscribers are less likely to be exposed to these "falling knives" since the process requires firms to not only be undervalued, in our opinion, but also be exhibiting bullish technical and momentum indicators before we would consider adding them to the newsletter portfolios.

Since the stock market is a forward-looking mechanism, price usually leads fundamentals. Without a turnaround in price, the risk that the fundamentals of an undervalued stock have not turned for the positive is higher. Where value strategies may encourage the buying of a stock all the way down regardless of whether fundamentals ever turn (red circles: Buy --> Sell), the Valuentum strategy attempts to steer clear of these situations. The Valuentum Buying Index is designed to wait for technical improvement in the equity, which often precedes fundamental changes at the company.



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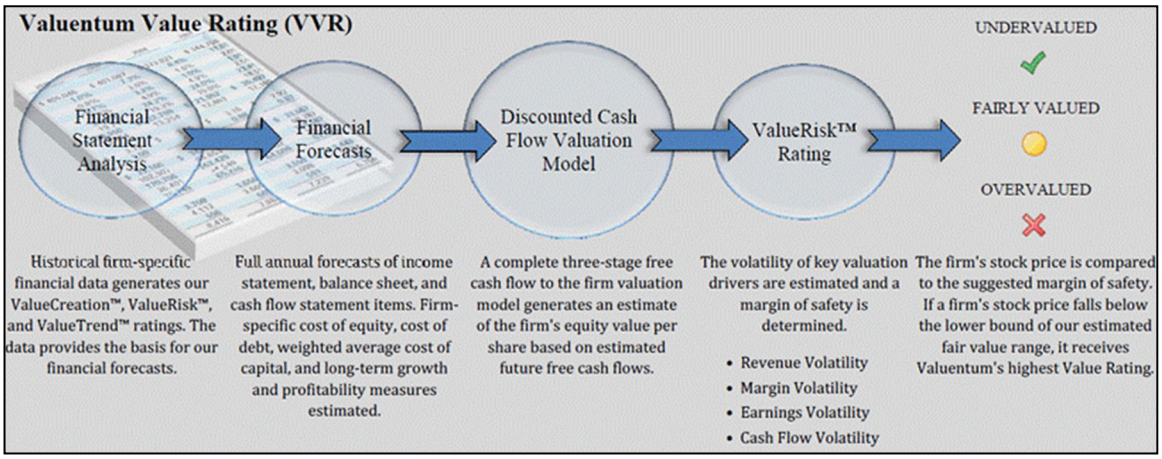
Let's walk through the three investment pillars of our stock-selection methodology.

I. The Valuentum Buying Index Applies A Rigorous Discounted Cash Flow Valuation Process

The Valuentum Buying Index methodology starts with in-depth financial statement analysis, where we derive our ValueCreation, ValueRisk, and ValueTrend ratings, which together provide a quantitative assessment of the strength of a firm's competitive advantages. We compare a company's return on invested capital (ROIC) to our estimate of its weighted average cost of capital (WACC) to assess whether it is creating economic profit for shareholders (ROIC less WACC equals economic profit). Firms that have improving economic profit spreads over their respective cost of capital score high on our ValueCreation and ValueTrend measures, while firms that have relatively stable returns score well with respect to our ValueRisk evaluation, which impacts our margin-of-safety assessment.



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After evaluating historical trends, we then make full annual forecasts for each item on a company's income statement and balance sheet to arrive at a firm's future free cash flows. We derive a company-specific cost of equity (using a fundamental beta based on the expected uncertainty of key valuation drivers) and a cost of debt (considering the firm's capital structure and synthetic credit spread over the risk-free rate), culminating in our estimate of a company's weighted average cost of capital (WACC). We don't use a market price-derived beta, as we embrace market volatility, which may provide investors with opportunities to buy attractive stocks at bargain-basement levels, in our view. A forward-looking Economic Castle rating is then derived.

We then assess each company within our three-stage free cash flow to the firm (enterprise cash flow) valuation model, which generates an estimate of a company's equity value per share based on its discounted future free cash flows and the company's net balance sheet impact, including other adjustments to equity value (namely pension and OPEB adjustments). Our ValueRisk rating, which considers the underlying uncertainty of the capacity of the firm to continue to generate value for shareholders, sets the margin of safety bands around this fair value estimate. For firms that are trading below the lower bound of our margin of safety band, we consider these companies undervalued based on our DCF process. For firms that are trading above the higher bound of our margin of safety band, we consider these companies overvalued based on our DCF process.

We think a focus on discounted cash-flow (DCF) valuation helps to prevent investors from exposing their portfolios to significantly overpriced stocks at their peaks. The image below reveals how pure momentum investors may expose their portfolios to pricing extremes and dramatic falls (green circles: Buy --> Sell). The Valuentum Buying Index attempts to steer clear from these situations.

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II. The Valuentum Buying Index Incorporates A Forward-Looking Relative Value Assessment

Our discounted cash-flow process allows us to arrive at an absolute view of the firm's intrinsic value. However, we also understand the critical importance of assessing firms on a relative value basis, versus both their industry and peers. Many institutional money-managers--those that drive stock prices--pay attention to a company's price-to-earnings (PE) ratio and price-earning-to-growth (PEG) ratio in making buy/sell decisions. With this in mind, we have included a forward-looking relative value assessment in our process to further augment our rigorous discounted cash-flow process. If a company is undervalued on both a price-to-earnings ratio and a price-earnings-to-growth (PEG) ratio versus industry peers, we would consider the firm to be attractive from a relative value standpoint.

III. The Valuentum Buying Index Seeks to Avoid Value Traps, Falling Knives and Opportunity Cost

Once we have estimated a firm's intrinsic value on the basis of our discounted cash-flow process, determined if it is undervalued according to its firm-specific margin of safety bands, and assessed whether it has relative value versus industry peers, we then evaluate the company's technical and momentum indicators in an attempt to consider entry and exit points on the stock (but only after it meets our stringent

Our Methodology – The Valuentum Buying Index continued on next page

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valuation criteria).

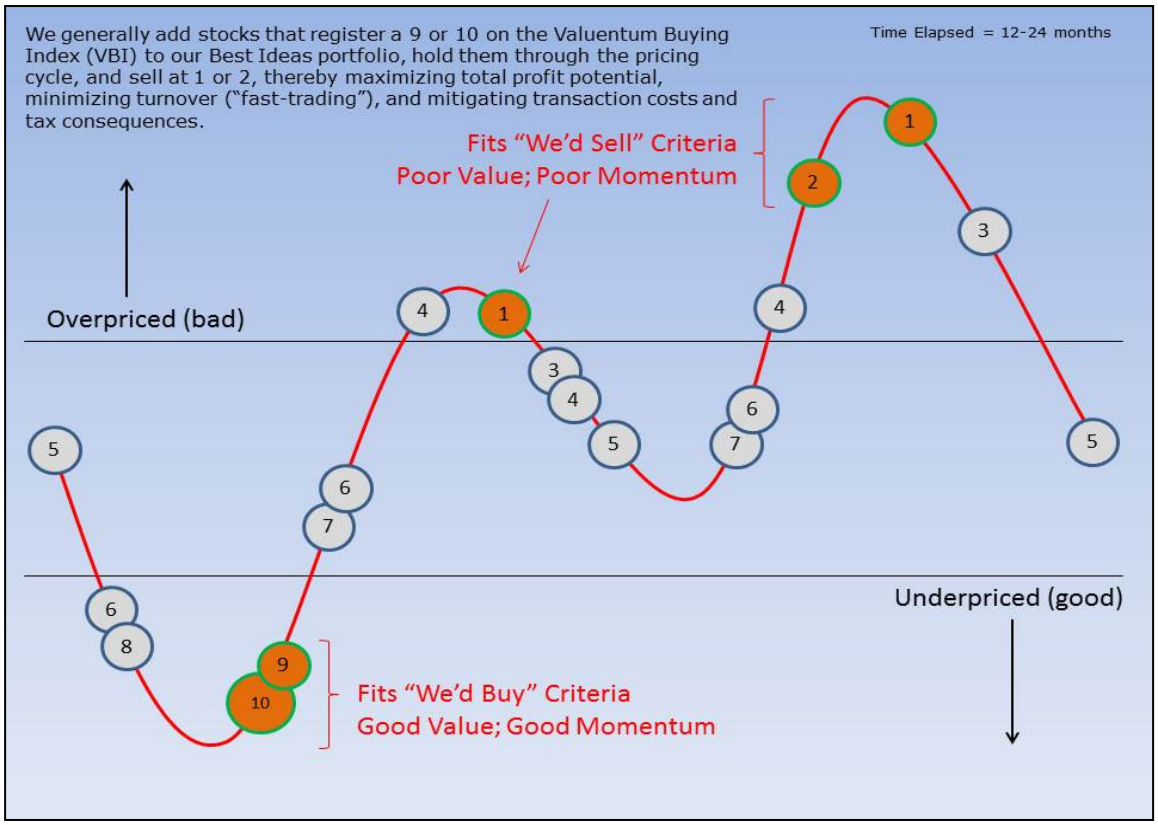
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with respect to a technical and momentum assessment of a company's stock.

We embrace the idea that the future is inherently unpredictable and that not all fundamental factors can be included in a valuation model. By extension, we use technical and momentum analysis in an attempt to help safeguard against value traps, falling knives, and the opportunity cost of holding an undervalued equity for years before it potentially converges to "fair value." Other research firms may not consider opportunity cost as a legitimate expense for investors.

Putting It All Together - the Valuentum Buying Index

Though the time frame varies depending on each idea, on a theoretically basis, we would expect our best ideas to "work out" over a 12-24 month time horizon (on average) -- the duration of any individual idea can vary considerably, however. We tend to include firms in the Best Ideas Newsletter portfolio when they register a 9 or 10 on our Valuentum Buying Index (VBI) and tend to remove firms from the Best Ideas Newsletter portfolio when they register a 1 or 2 on the Valuentum Buying Index.

In theory, the Valuentum Buying Index attempts to maximize profits on every idea within the Best Ideas Newsletter portfolio, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. A value strategy (10 --> 5), for example, may truncate potential profits, while a momentum strategy (4 --> 1), for example, may ignore profits generated via value assessments. The Valuentum Buying Index seeks to capture the entire profit potential, as shown below.



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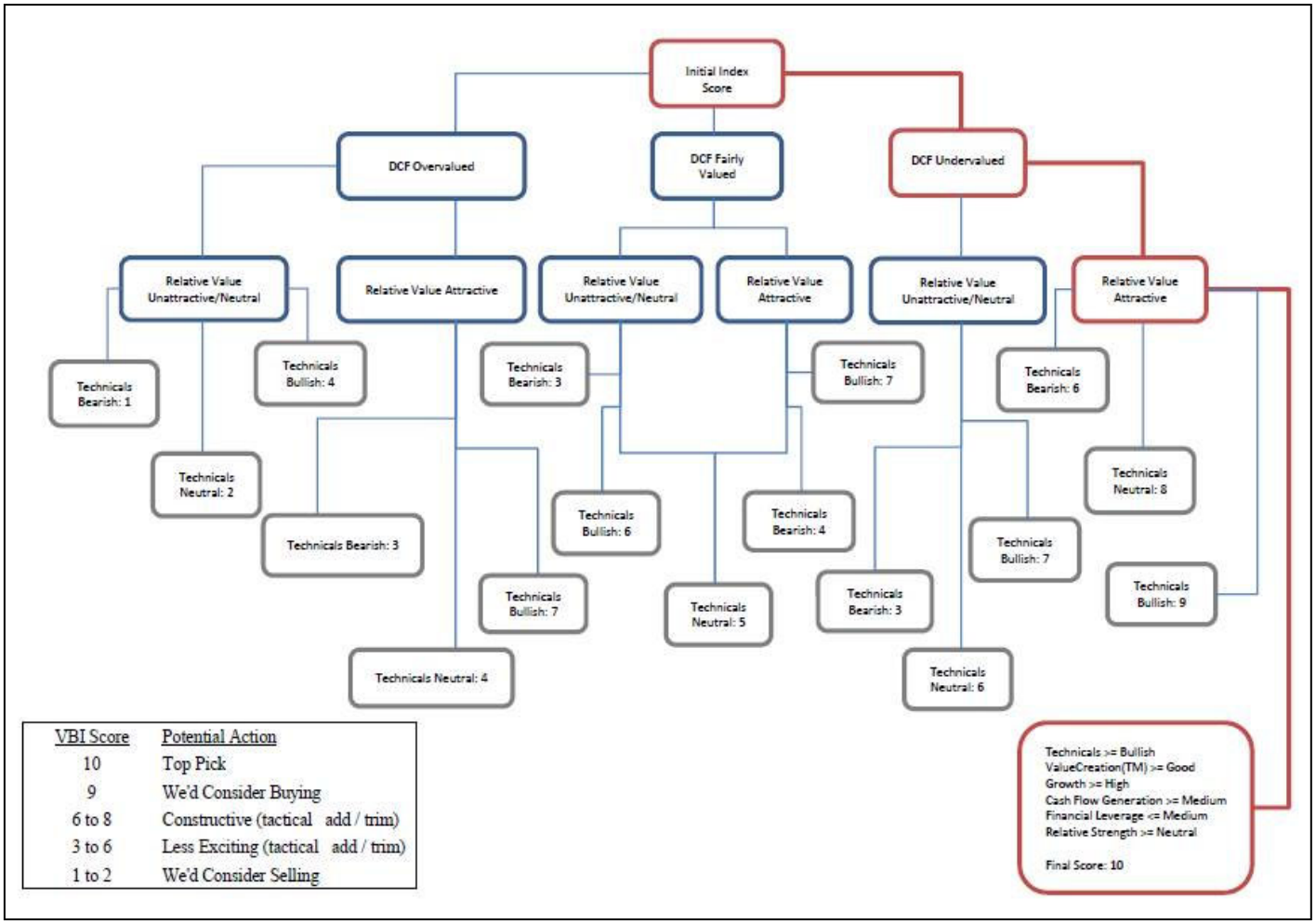
Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on the Valuentum Buying Index (a "Top Pick"). Please click here to view an enlarged pdf version.

First, the company would need to be 'UNDERVALUED' on a DCF basis and 'ATTRACTIVE' on a relative value basis. The stock would also have to be exhibiting 'BULLISH' technicals. The firm would need a ValueCreation rating of 'GOOD' or 'EXCELLENT', exhibit 'HIGH' or 'AGGRESSIVE' growth prospects, and generate at least a 'MEDIUM' or 'NEUTRAL' assessment for cash flow generation, financial leverage, and relative price strength.

This is a tall order for any company. Firms that don't make the cut for a 10 are ranked accordingly, with the least attractive stocks garnering a score of 1 ("We'd sell"). Most of our coverage universe falls between 3 and 7, but at any given time there could be large number of companies garnering either high or low scores, especially at market lows or tops, respectively.



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About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

FAQ: Why do you use such a wide fair value range for certain companies?

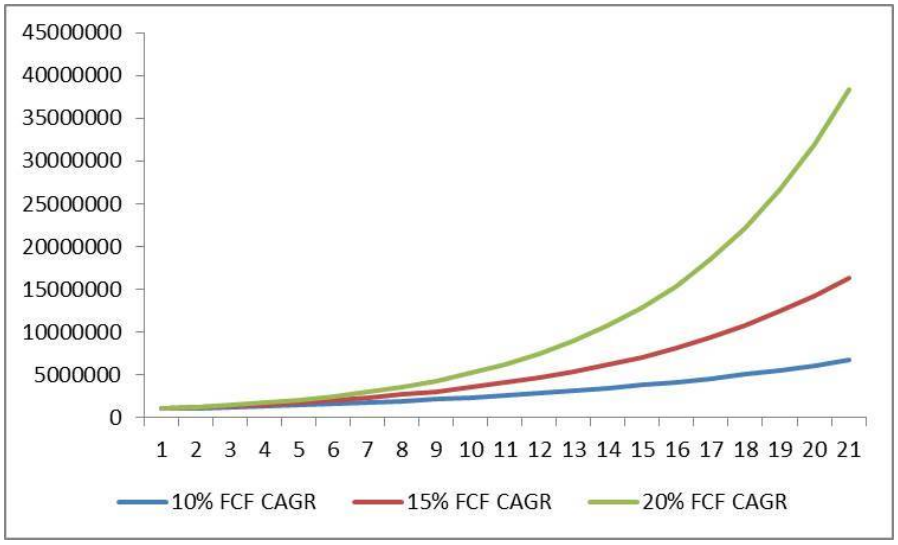
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth exactly $25 or a firm's stock is worth exactly $100. The reality is that, in the first case, the company's shares are probably worth somewhere between $20 and $30, and in the latter case, the stock is worth somewhere between $75 and $125.

Why? Because all of the value of a company is generated in the future (future earnings and free cash flow), and the future is inherently unpredictable (unknowable). If the future could be predicted with absolute certainly (knowable), then a stock analyst could say a company's shares are worth precisely this, or that a firm's stock is worth precisely that. Not *because he or she would know where the stock would be trading at*, but because he or she would know precisely what future free cash flows would be (and all other modeling facts-not assumptions in this case) and arrive at the exact and non-debatable value of the firm.

But the truth of the matter is that nobody knows the future, and analysts can only estimate what a company's future free cash flow stream will look like. Certain unexpected factors will hurt that free cash flow stream relative to forecasts, while other unexpected factors will boost performance. That's how a downside fair value estimate and an upside fair value estimate is generated, or in the words of Warren Buffett and Benjamin Graham how a "margin of safety" is generated. Only the most likely scenario represents the point fair value estimate. Any stock analyst that says a company is worth a precise figure--whether it's $1 or $100--falls short of understanding one of the most important factors behind valuation.

But why the large range in many cases?

Well, there are many firms in our coverage universe that have a very large range of outcomes in their future free cash flow growth. And because discounting free cash flows is an integral part of calculating the fair value estimate of a company, the range of fair values will also be large. To illustrate this point, let's take a look at the difference between the levels of free cash flows in Year 20 under three different future growth rates: 10%, 15%, and 20%. Though the growth rate between each scenario is but 5 percentage points, the magnitude of the free cash flow difference is astounding many years into the future, and our discounted cash-flow process considers the long-term intrinsic value of firms.



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Under these future free-cash-flow scenarios, if we assume an 8% discount rate and 100,000 shares outstanding (and no debt), the difference in the fair value estimate between the upside case (green line) and downside case (blue line) would be an incredible $68 per share ($82 per share less $14 per share). That's a huge fair value range (80%+), and all because of just a 10 percentage point difference in a future free cash flow growth assumption. For firms that are growing cash flows at 200% or 300% per annum, a large range of fair value outcomes is not only inevitable but also very reasonable. In other words, the Valuentum framework provides an avenue to quantify the upside and downside risks investors are taking in high uncertainty and fast-growing enterprises.

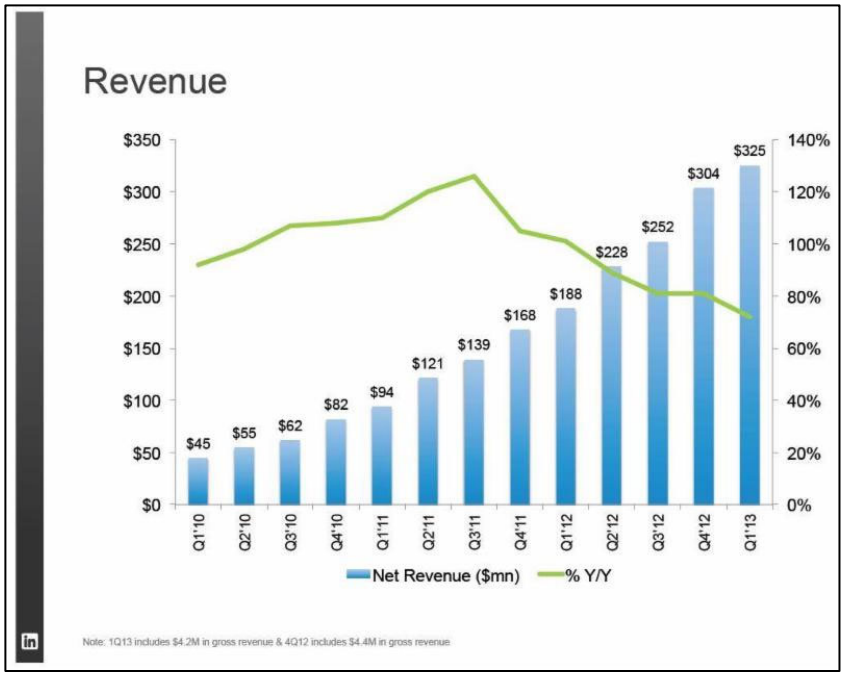

Image Source: LinkedIn

To really hit this point home, shown above is a slide of LinkedIn's (LNKD) revenue from the first quarter of 2010 through the first quarter of 2013. The green line (mapped to the right axis) shows LinkedIn's revenue growth rate. Let's assume revenue expansion translates into similar free cash flow growth expectations (not exactly a precise assumption, given the leverage in LinkedIn's business model), but bear with us for simplistic illustrative purposes. Will LinkedIn's revenue/cash flows expand at a 20% rate, a 40% rate, or a 60% rate (or an even greater pace) through year 20?

It's a very, very difficult question to answer. Remember how significant that 10 percentage point spread was in the hypothetical example above? Well, it's even more significant for LinkedIn. We know LinkedIn's free cash flows will expand, and expand fast, but just how fast is certainly debatable. To a very large extent, that's why LinkedIn's range of probable outcomes (fair value range) is so large. Understanding the cone of fair value outcomes of a company is helpful because the size of the range tends to be positively correlated to the equity's volatility. If you recall, look at what happened to LinkedIn's stock recently when investors ratcheted down their long-term growth assumptions (and by extension, the company's intrinsic value).

Shares collapsed in a huge way.

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But it was largely because of that same weakness in equity pricing that drove Microsoft (MSFT) to take the leap to buy LinkedIn's equity outright just a few months later. Over just a very short period of time, LinkedIn's shares effectively collapsed and then surged as the chart below shows (its intrinsic value range didn't change much, however). Having a fair value range that adequately captures both the upside and downside cases for a company's shares remains an integral part of stock investing. Not only does it help hone in on the potential risk-reward profile of an equity at any given time, it also helps reveal the attractiveness of various "entry" or "exit" points using a robust free-cash-flow based and fundamentally-sound intrinsic value estimate as the anchor.

We're scouring our coverage universe for firms that are trading outside of their respective fair value ranges. A firm trading below the low end of its fair value range, for example, is undervalued, while a firm trading above its fair value range is overvalued. The fair value range for each company captures the inherent uncertainty of the trajectory of that firm's unique future free cash flow stream. For the 1,000+ companies we include in our coverage universe, we provide a discounted cash flow derived fair value estimate and a corresponding fair value range -- *and a robust discounted cash-flow process is only one aspect of our service*.

How We Use the Valuentum Buying Index in the Best Ideas Newsletter Portfolio

By Valuentum Analysts

We often receive questions about how we use the Valuentum Buying Index (VBI) rating system, one of the key metrics we use to source ideas, but we think it is equally important to mention up front that it is only one of the many facets of our website and services. For example, if you haven't checked out the Dividend Cushion ratios on the stocks in your portfolio or the dividend growth product (from individual reports to the newsletter and beyond), surely you are not maximizing your membership! Don't forget about the Economic Castle rating and the Nelson Exclusive publication, too.

No matter your strategy or process though (it is not for us to say what is best for you), the Valuentum Buying Index rating system is still a helpful tool to have at your disposal, even if you are not using it. Admittedly, the VBI, as we call it, is not as easy to evaluate as 1, 2, 3, or even buying 9s and 10s and selling 1s and 2s until their VBI changes upon the next update. Generally speaking, we measure the process over longer-term time periods--from the time a company registers a rating to a defined time in the future--not an interim update basis. Please read more our case study, where Valuentum Buying Index ratings, as of September 2013, were recorded and the performance of stocks were measured from that time through September 2014.

The Valuentum Buying Index Has Checks and Balances

With prudence and care, the Valuentum Buying Index process and its components are carried out. Our analyst team spends most of its time thinking about the intrinsic value of companies within the context of a discounted cash-flow model and evaluating the risk profile of a company's revenue model. We have checks and balances, too. First, we use a fair value range in our valuation approach as we embrace the very important concept that value is a range and not a point estimate. A relative value overlay as the second pillar helps to add conviction in the discounted cash-flow process, while a technical and momentum overlay seeks to provide confirmation in all of the valuation work. There's a lot happening behind the scenes even before a VBI rating is published, but it will always be just one factor to consider.

Within any process, of course, we value the human, qualitative overlay, which captures a wealth of experience and common sense. We strive to surface our best ideas for members, and flying blind is never a good strategy, in our opinion. In probably one of the most obvious cases, for example, an experienced investor knows when a price-to-earnings (P/E) ratio isn't informative (as in the case of negative or negligible earnings), but a quantitative rating system that uses a P/E ratio may not know any better. That's why the VBI has checks and balances and focuses on the discounted cash-flow process first and foremost, but the human, qualitative overlay is still extremely important, especially when considering various business models and unique "un-modelable" risks. In our opinion, a golf club is only as good as the player that uses it, and in a similar light, a financial model or a rating system is only as good as the user that applies it.

That said, for the sake of transparency, we measure the performance* of the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter. The portfolios, in part, represent data points measuring the outcome of the work we do on the website, rolled into an assessment: our best ideas for each respective strategy. The ideas in the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter have been evaluated by our analyst team for consideration in the newsletter portfolios. The thoughts behind the weighting of each idea and the portfolio management process revealed in full transparency on a month to month basis may be worth the cost of a membership alone, even if you're not using the portfolios!

Here's why this is important. In a market environment where more than 90% of large-cap funds have trailed the S&P 500 in the 5-year period ending August 31, 2016, the Best Ideas Newsletter portfolio* has exceeded its benchmark return over a similar time period. What's more, we showcased this performance in full transparency, and we wrote every single day, and some days weren't all that great. When patience

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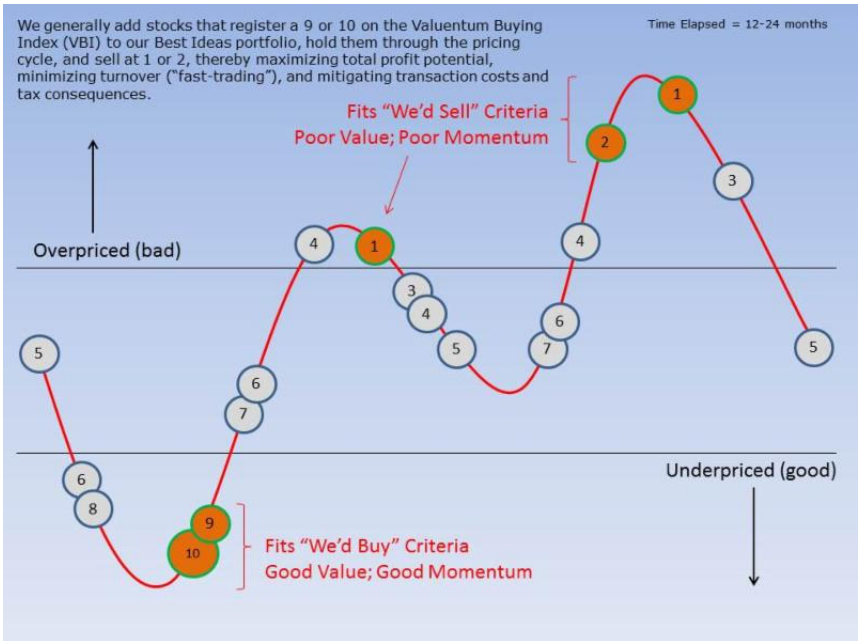
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

** Actual results may differ from simulated information being presented. The Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio are not real money portfolios. Results are hypothetical and do not represent actual trading.*

The Valuentum Buying Index Is One of Many Important Factors to Consider

That said, let's talk about how the VBI helps to inform which ideas we include in the Best Ideas Newsletter portfolio. This is where some clarification is probably important. For one, the word choice is critical, "inform," because the VBI is generally just one factor that goes into whether we add a company to the Best Ideas Newsletter portfolio, even if the VBI is one of the most important factors. Second, the timing element or duration concept is a key consideration. We've noticed via our statistical backtesting that a momentum factor can be much more pronounced (powerful) over longer periods of time. This was one of the interesting findings of our academic white paper study (2012). We try to consider this dynamic with the update cycle of our reports (and the time horizon for ideas to work out). That's why our reports are updated regularly (generally on a quarterly basis) or after material events and not daily or weekly. Perhaps most practically though, we don't think portfolio churn is the way to generate outperformance. Momentum may be high turnover, but Valuentum is low turnover.

Though the time frame varies depending on each idea that we consider for the Best Ideas Newsletter portfolio, we would expect our best ideas to generally work out over a 12-24 month time horizon (on average). Not all ideas will be successful, however. Our "holding period" is targeted to be much, much longer for some ideas in the Dividend Growth Newsletter portfolio, as income and dividend growth are other key factors (in addition to the Valuentum Buying Index and capital appreciation potential). The time horizon or duration concept is where the Valuentum Buying Index rating system becomes more complicated than a simple 1, 2, 3. For example, we tend to "add" stocks to the Best Ideas Newsletter portfolio when they register a 9 or 10 on the Valuentum Buying Index (VBI), "hold" them for some time depending on a number of variables (the VBI, market conditions, sector weightings within the portfolio itself), and then we tend to "remove" stocks from our Best Ideas Newsletter portfolio when they register a 1 or 2 on the VBI. You'll notice that we have a qualitative overlay for the Best Ideas Newsletter portfolio (and one for the Dividend Growth Newsletter portfolio, too, based on dividend-related considerations).



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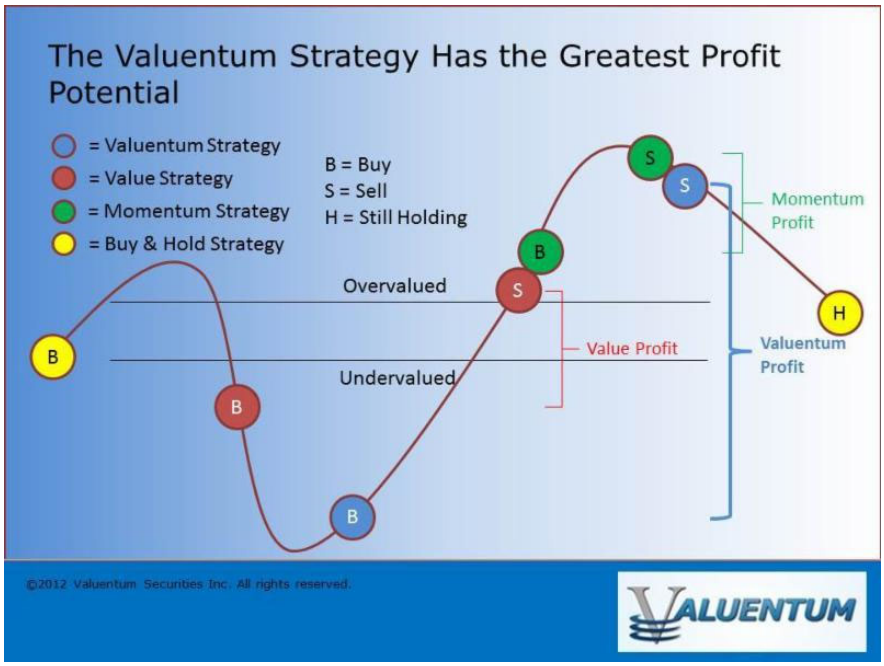
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. For example, as shown in the image above, a value strategy (10 --> 5) truncates potential profits, while a momentum strategy (4 --> 1) ignores profits generated via value assessments. At Valuentum, we're after the entire profit potential of each idea. So, for example, if a firm is added to the Best Ideas Newsletter portfolio as a 10 and is removed as a 5, we would have truncated profit potential by not letting it run to lower ratings. Most of our highly-rated Valuentum Buying Index rated stocks have generated the "outperformance" of the Best Ideas Newsletter portfolio, but these stocks' ratings declined over time as they were held (a good thing -- a declining VBI rating generally means the share price has advanced, assuming all else is well).



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Not All Highly-Rated Stocks Are Added to the Newsletter Portfolios

Regarding the Valuentum process, as it is executed in the Best Ideas Newsletter portfolio, we do not "add" all stocks that register a 9 or 10, nor do we add the ones we do immediately thereafter. For example, Google (GOOG, GOOGL), now Alphabet, a current Best Ideas Newsletter portfolio "holding," registered a 10 on the Valuentum Buying Index, but we remained patient and didn't "add" the company to our portfolio until after it reported earnings at the time, providing us with an even better entry point (as new information came to light). There are more "structural/timing" instances like the one with Alphabet, for example, that are extremely difficult to capture in any model, and understandably aren't as obvious to those outside looking in. Macro-economic, broader market valuation, and sector weighting considerations are other factors that impact the qualitative portfolio management process.

But why not add every highly-rated stock on the Valuentum Buying Index to the Best Ideas Newsletter portfolio? Think of it as if you were to imagine a value investor not adding and holding every undervalued stock to his/her portfolio. He or she wants the very best ones, in his or her opinion -- obviously, that means having to leave some good ideas behind. And then, of course, there are always tactical and sector weighting considerations in any portfolio construction, yet another reason why the human touch remains a vital aspect of the Valuentum process. At the core of how we use the VBI in the Best Ideas Newsletter portfolio, however, is a qualitative portfolio management overlay. The VBI rating helps to inform the

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process, but the Valuentum team makes the allocation decisions of the newsletter portfolio on the basis of a number of other firm-specific and portfolio criteria. Sometimes, under certain market conditions, we may even have to relax the VBI criteria entirely in order to do what we think is required to achieve newsletter portfolio goals.

Some Examples of the Valuentum Buying Index In Action

Okay, a couple examples. Take pre-split eBay (EBAY), which many years ago included PayPal (PYPL), as an example of our process in action. The stock initially flashed a rating of 10 in late September 2011, and we "added" it to the Best Ideas Newsletter portfolio. The VBI rating changed to a 6 in December 2011 and then back to a 10 in May 2012, but because the rating never breached a 1 or 2, we did not remove the position from the Best Ideas Newsletter portfolio. In the case of pre-split eBay, we sought to capture the entire pricing cycle and avoided truncating it as most pure value investors often do (and what we would had done, if we had removed the stock at that time). In many ways, pre-split eBay/PayPal has become one of the better examples to use for illustrating the prolonged outperformance driven by undervalued stocks that are beginning to generate good momentum. [We no longer include eBay in the newsletter portfolio, but its split-off PayPal is retained.]

There have been more straightforward opportunities in the Best Ideas Newsletter portfolio, too, especially in the case of EDAC Tech, which tripled since it was added to the newsletter portfolio (never registering below a 9 along the way), and then of course, Apple (APPL), Visa (V) and Altria (MO), but it is usually through the nuances of the process that one truly comes to understand it (as in the eBay example). Not to be overlooked either, the Valuentum Buying Index rating also informs us when we may consider "removing" a position from the newsletter portfolios. Kinder Morgan (KMI), for example, registered a 1 on the Valuentum Buying Index just prior to its notorious fall and dividend cut. The VBI ratings on each stock's most recent 16-page report, downloadable directly from the website at www.valuentum.com, reflect our current opinion on the company.

In all, the Valuentum Buying Index rating system, as with all methodologies, helps to inform the investment decision process, but in constructing the newsletter portfolio, a qualitative overlay is not only necessary, in my view, but helps to optimize performance. If the returns of the Best Ideas Newsletter portfolio during the past 5+ years are any measure of the VBI rating system, it is performing fantastically well. Of course, please always contact your financial advisor to determine if any idea or strategy may be right for you.

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About Our Name

But how, you will ask, does one decide what [stocks are] "attractive"? Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth,"...We view that as fuzzy thinking...Growth is always a component of value [and] the very term "value investing" is redundant.

-- Warren Buffett, Berkshire Hathaway annual report, 1992

At Valuentum, we take Buffett's thoughts one step further. We think the best opportunities arise from an understanding of a variety of investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value through momentum investing. And a combination of the two approaches found on each side of the spectrum (value/momentum) in a name couldn't be more representative of what our analysts do here; hence, we're called Valuentum.

Valuentum Best Ideas Newsletter: Volume 10, Issue 5

Valuentum's Best Ideas Newsletter is published monthly. To receive this newsletter on a monthly basis, please subscribe to Valuentum by visiting our website at www.valuentum.com. Or contact us at info@valuentum.com.

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