

WEEKLY REPORT

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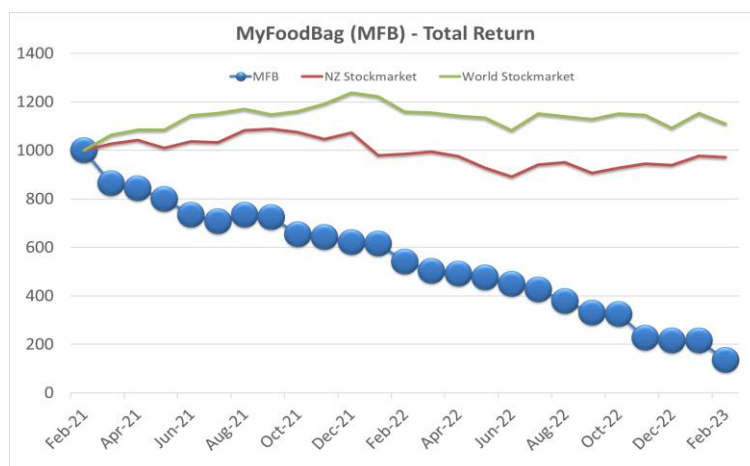
Private Asset Management Ltd

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FOOD BAG DISASTER – AN INQUEST – Part 1

Today we will begin a two part deep dive into the My Food Bag initial public offering. MFB was a new company sold to investors and it listed on the NZX in February 2021. All the academic research on the IPO market concludes that one should avoid the sector on the basis that new issues of companies tend to underperform the broad stock market average. Whilst the performance of My Food Bag (MFB) shares is consistent with the research the extent of its popularity pre-listing and the scale of its subsequent underperformance is pretty much unprecedented in NZ, at least since the Feltex fiasco back in 2006.

As the graph adjacent shows MFB was floated at a price of \$1.85 and today it languishes at just 25 cents. Shareholders have seen their company drop in value from \$448.5m to \$61m – a decline of around \$388m. But even that figure understates the magnitude of the loss – if the \$448.5m original valuation of MFB, at the \$1.85 float price, had instead been invested in an ETF invested in the world stock market it would today be worth around \$530m. Oh dear.



Source: Private Asset Management

That was a big hit to the portfolios and reputations of the institutional investors that backed the company. As at April 2021 there were 6,178 shareholders in MFB and that number includes heavy hitters like Harbour Asset Management (10.8%), Jarden Securities (3.9%), and Milford Asset Management (8.8%). The original investors in MFB, who sold down at the float (Waterman etc), continue to own just under a quarter of the company. It would be interesting to know how the plunge in the MFB price has impacted the IRR of the various Waterman funds who presumably still have an exposure to this stock.

Why has MFB done so badly? A paper, entitled "The Math Of Value And Growth", by Michael Mauboussin and Dan Callahan of Morgan Stanley, provides an insight into the value drivers of a share price. After reading it, and specifically the bit about the sensitivity of PE multiples to changes in growth assumptions, I thought of the MFB disaster.

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The authors demonstrate that the key variables determining the value of a share are its cash flows and the rate at which those cash flows are discounted i.e. the standard discounted cash flow (DCF) model. (A few years back we looked in detail at the DCF methodology based on a paper, also by Professor Mauboussin, entitled “Everything is a DCF Model”). The latest research note shows how even seemingly minor variations in the market’s assumptions as regards growth and discount rates can have a material impact on the valuation of a stock and thus its PE multiple: “The goal of this report is to show how valuations change as we vary assumptions about growth, return on incremental invested capital and the discount rate. We will discuss these changes in terms of PE multiples, but a discounted cash flow model drives the calculations”.

Mauboussin and Callahan start their paper by rehearsing the fundamentals of a DCF model: “The value of a financial asset is the present value of future cash flows. If you don’t believe that, please put this aside and resume your normal daily activities. If you do believe that, you recognize that you have to grapple with an assessment of the magnitude and timing of cash flows as well as the appropriate rate at which to discount them. For a company, the relevant definition of cash flow is the money that can be returned to claimholders, including the owners of the bonds and the stock. Cash flow is the profit the business earns after paying taxes minus the investments the company makes. Investments are outlays today with the expectation of profits tomorrow that make the investments worthwhile.”

The authors then go on to disrespect the popular valuation method of focusing on a company’s price earnings ratio (PE). The authors are sceptical about PE and argue that it is too simplistic and that it obscures the true value drivers of a share price. Using a simple DCF model they show how changes in assumptions in respect of growth in profits, discount rates and return on invested capital impacts the DCF derived value of a company and thus its valuation multiple i.e. PE. That is what we will get into today and in two weeks time we will, using that template, speculate as to the logic behind the dramatic decline in the MFB share price – any excuse to play with DCF models.

First off let’s define what a PE multiple is – it is simply the value of the company (number of shares times share price) divided by its net profit after tax. If a company has a market cap of \$100 and makes \$10 a year in profits then it is trading on a PE multiple of 10. Easy. What private equity companies (like Waterman) try to do is buy companies at low PE multiples and sell them at high PE multiples. The key to doing this is to convince the stock market, which is often the exit option, that the company that is being sold has great growth prospects.

For anyone who has forgotten: the DCF methodology was apparently formulated by a German forester to solve the problem of valuing a forest whereby an investment was made in year one but income and cash flows were typically delayed for 50 years or more. The issue was that people knew you couldn’t compare a dollar received in 50 years time with a dollar invested today but how to measure that properly?

DCF solved the problem – The DCF value of an asset like a share price or the price of anything producing cashflow in the future represents the present value of future cash flows. In other words the share price of a company is simply the sum of all future cash flows of that

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company discounted at an appropriate discount rate. DCF is one of the most widely used models in finance and is used to value bonds, companies, property, indeed any asset that produces cash flow. Below is an illustration of how a DCF model works:

$$\text{DCF value} = \frac{\text{cashflow year 1}}{(1 + \text{discount rate})^1} + \frac{\text{cashflow year 2}}{(1 + \text{discount rate})^2} + \frac{\text{cashflow year 3}}{(1 + \text{discount rate})^3} + \text{etc} + \text{etc}$$

From the formula we see that there are two factors determining the value of a company and the market as a whole - future free cashflows and the rate at which those cashflows are discounted to take into account the time value of money and risk.

Now back to the example outlined by Mauboussin and Callahan: their model suggests that, given certain assumptions, a company which can grow its profits at 10% per year should trade at a PE multiple of about 32x. That is a high valuation relative to the average company with the rationale being that long term growth in profits of 10% pa is very attractive.

In two weeks time we will use a simplified version of the Mauboussin/Callahan DCF model in an effort to understand the decline in the MFB share price.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.