ValuAnalysis

Some unusually high valuations justified, says ValuAnalysis research

Nvidia shows why frothy markets are not quite bubbling over

- Research from valuation specialists on ‘The Price of Growth’ illustrates why **Nvidia**, **Amazon** and **Tesla** price-tags could in fact be rational
- Rent levels, operational leverage and capital consumption are key to understanding “extravagantly priced” shares

London, 16 October 2020 – There is an objective rationale for “extravagantly priced” shares like **Nvidia**, **Amazon** and **Tesla**, according to new research, “The Price of Growth”, from ValuAnalysis, which lifts the bonnet on valuations of high growth companies. Despite a ‘bubble’ consensus view on equity markets that continues to grow, a new ValuInsight paper demonstrates what effort of imagination is required to rationalise some current high multiples, by examining alternatives to the classic “fading return” model and operational leverage.

Pascal Costantini, Founding Partner at ValuAnalysis, and the report’s author, said: “Swathes of column inches have been dedicated to an increasing consensus view – that we are in a bubble. We have purposely selected NVIDIA, Tesla and Amazon to show why it may be too early to make such a call, for now. We are fully aware of the perceived foolishness of such a statement, generally, but you will see in this ValuInsight that the embedded market assumptions on management’s required execution to see these three stocks rationalising their current high multiples are fairly banal. It is not such a great leap.”

The Antifade Model

Generally, companies’ valuations follow the classic “fading return” model where it is assumed that all returns fade to the cost of capital, eventually. Yet ValuAnalysis research confirms that a growing number of disruptive companies are not following this path – instead their economic rent (the ratio of free cash flow to economic assets) increases over time rather than decreases and is described as the “Antifade”.

Operational Leverage

Some companies are implementing or rolling out transformational technologies, which are leveraging their asset base in a way unseen and unknown in previous instances, with the clear consequence of expanding the economic rent.

ValuAnalysis has identified a number of structural trends that are driving leverage across industries;

- A ‘platform effect’ (or instant global reach) is generating hypergrowth for some global companies such as **Amazon**
- An energy challenge is triggering a total re-think of the Automotive sector, with **Tesla** at the centre of this revolution
- A sanitary challenge is stimulating research and innovation in Pharmaceuticals
- Dematerialisation of payments is increasing the franchise of companies like **Visa**
- Growth is accelerating in some previously cyclical sectors, in particular semi-conductors. 5G, an acceleration in computing and artificial intelligence and Industry 4.0, are driving this. **NVIDIA** is a key player.

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NVIDIA

NVIDIA trades on a "modest" 61.5x normalised net Free Cash Flow. Optically high multiples may suggest that investors are not prepared to embed a short-term fade provision for these companies. What propels the multiple is the combination of an expected antifade and a high growth rate.

NVIDIA's contribution to the innovation of chips and artificial intelligence, coupled with a strong positioning in key verticals (datacentres, autonomous vehicles, gaming) has allowed the company to deliver c. 30% growth in revenues expected for this year (2020 reported in January 2021) and four consecutive quarterly "beats". Furthermore, it is not a random assumption by the market to assume NVIDIA has an inordinate ability to leverage its assets by focusing on dominating a narrow field of the semiconductor industry with a business model that is 'fabless', implying less capital intensity. The market believe that NVIDIA can carry on expanding its rent whilst growing at double digits, which more than justifies a 60+ multiple.

Additionally, if the merger with ARM were to go ahead this would constitute a major enhancement of these trends.

Amazon and Tesla

Tesla is the archetype "speculative" stock, with a valuation that "does not make sense". The company trades on c. 630x normalised operating free cash flow, 16.2x net economic assets and has an operating rent of 2.6%, 10x less that of Microsoft, for an enterprise value that is not far from 30% of the software company. However, when taking into account the simple drivers of the Battery Electric Vehicles replacing Internal Combustion Engine vehicles, the current valuation makes a lot more sense.

It is plausible that Electric vehicles will have at least an 8% share of the market in 2025. With a market share of c. 21% Tesla may sell 1.5m to 2m vehicles, up at least threefold from the 500,000 units expected to be sold in 2020. Assuming the average selling price continues to fall, Tesla will still turn over c. $80bn by then. A leveraging of its asset base (especially its R&D effort) and a modest margin enhancement would propel its rent to high double digits, whilst growing at perhaps twice the auto market. On that basis, Tesla could be trading on a market multiple in 5 years' time.

Amazon is the most established and largest "antifade" company. The operating rent has been stable during the past decade, i.e. the company is not yet fading. The company generates about $21bn of normalised net Free Cash Flow and trades on about 78x this amount. However, **Amazon** is <u>all</u> about leverage. To justify the current multiple, all that is required is to see an uplift of this rent by 300 basis points. The more Amazon is able to repel its fade, the higher the multiple is likely to stay. Crucially, "fade-beating" is at the heart of the company's execution. This is epitomised by Jeff Bezos, in his 2016 letter to Amazon shareholders, calling the fading phase Day 2; "Day 2 is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death. And that is why it is always Day 1".

ValuAnalysis has developed a cash flow model where accounting data is transformed into relevant economic numbers by breaking down a company's market value into its three components: Replacement Value, Franchise Value and Growth Value. This process enables the investment managers to identify companies whose competitive advantage is under-appreciated by the market.

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About ValuAnalysis

Authorised and regulated by the Financial Conduct Authority, ValuAnalysis is an independent investment boutique focusing on equities and specialising in valuation. The firm has developed a proprietary research model which identifies companies whose competitive advantage is under-appreciated by market participants.

The Partners have over twenty-five years of experience using, adapting and re-engineering the 'economic value-added' models used by industry consultants into stock market valuation models. These models replicate the thought process of an entrepreneur taking real investment decisions: what capital to commit where, at which cost, and for what return. Applied to the stock market, these tools provide invaluable insight about a firm's sustainable competitive advantage and the level of its economic rent.

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