

Not all FAANGs are Created Equal

Published on: 16 March, 2018 | Author: Investment Team

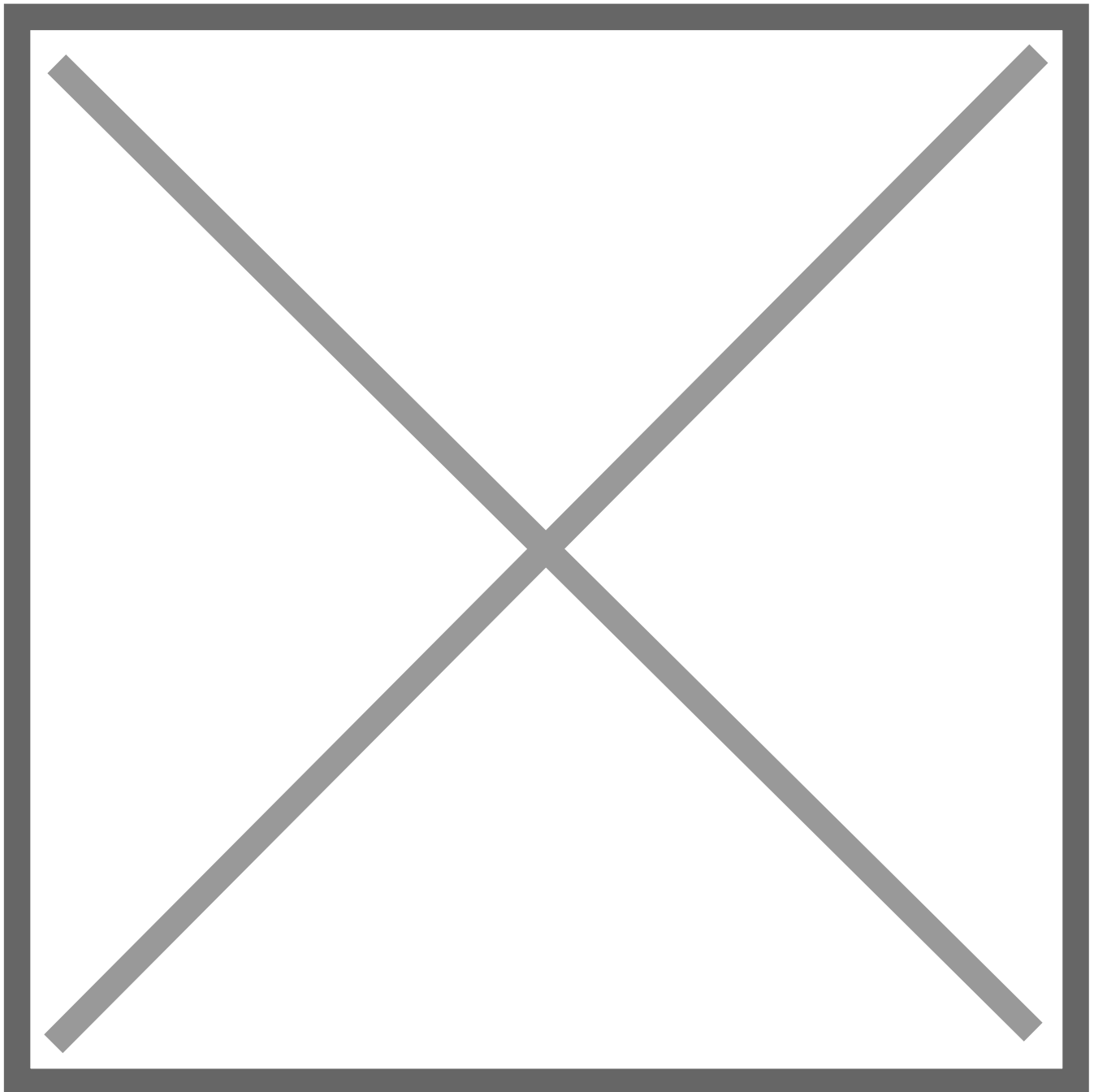
Investing is laying out money now with the reasoned probability that you will receive more money in the future, adjusting for your good friends Mr inflation and Mr Tax who will help themselves to a portion of your earnings. When you buy shares in a company or put money in a fund, you become a part owner of a company or a group of companies and have a claim on any of its future earnings.

There are many ways to determine the intrinsic value of a company. The FAANG companies – Facebook, Apple, Amazon, Netflix and Google, which are some of the fastest growing companies in the world are highly cash generative and asset light businesses. The best way to value these companies is to determine how much cash they can generate from now till kingdom come, discounted at an appropriate rate. To value a company this way, 3 assumptions need to be made:

1. How much will the company's earnings grow during its 'growth phase'? We will assume that the growth phase will last for another 10 years.
2. How much will the company's earnings grow after the 'growth phase' till perpetuity? We will assume this will be 3% nominal (the long-term average inflation rate in the USA).
3. If you had to park your investment elsewhere, how much would you expect it to grow in the long run i.e. what is your opportunity cost to investing in any of the FAANG stocks? We will use the long-term annualised returns of the S&P 500 (including re-invested dividends) which has grown at an annualised rate of 10% (nominal) over the last 100 years.

In finance, these assumptions are used in what is called the discounted cash flow analysis. It is a method of estimating the present value of all future cash flows. Like any tool, it is only as good as its user so garbage in = garbage out.

Discounting future cash flows is used to determine the present value of a business and requires assumptions about how much future earnings can grow. However, if we invert the problem and try to determine how much future earnings need to grow to justify the current price, the results are quite interesting and are shown in the Figure below.



The historic earnings growth rate is calculated over the last 10 years. Over this period, Facebook and Apple have grown at the fastest rates whereas Amazon has grown earnings at the slowest rate. What is even more interesting is that Apple only needs to grow earnings by 6% annually to justify its current share price. This is significantly below its historic growth rate of 31% and more importantly, it is very easy to achieve. A 6% nominal growth rate is only 3% in real terms (adjusting for inflation). With its large cash hoard (about \$280 billion) it can acquire other companies, increase the dividend and buy back shares. Perhaps it's not a surprise why Apple is the largest holding in Buffett's Berkshire Hathaway – it's a classic value stock disguised as an overvalued growth stock.

Contrast this with Amazon. It has grown earnings at 12% a year and for the current stock price to be justified, it needs to grow earnings by almost 50% annualised over the next 10 years. This is incredibly difficult to do because while Amazon has grown its revenues by about 43% annualised over the last 20 years, it can't replicate this going forward because it would mean Amazon's revenues will be larger than the World GDP. The only way it can achieve such a high earnings growth rate is to increase the amount of profits it gets to keep from its revenues and Amazon is a notoriously low margin business.

Could Amazon achieve this sort of earnings growth? It's certainly not impossible but seems very unlikely. In any case, buying Amazon at today's prices (peak optimism) offers no margin of safety and as Mr Buffett aptly said a long time ago 'You pay a very high price in the stock market for a cherry consensus'.

Note: All opinions are our own and are not a recommendation to buy or sell short any of the securities listed here.

Important Information: Any views, insights, or commentary are for general information only, do not constitute personal investment advice or research, and are intended for UK residents. They may not be appropriate in all jurisdictions. While sourced from information we believe to be reliable, we make no guarantee as to accuracy or completeness. Past performance is not a guide to future results, and the value of investments can go down as well as up.

Regulatory Disclaimer: Tacit Investment Management is the trading name of TIML Limited (No. 9228395), part of Tacit Holdings Limited (No. 10611211). Both companies are incorporated in England and Wales, with the registered office at 14 Hanover Square, London W1S 1HN. TIML Limited is authorised and regulated by the Financial Conduct Authority (FCA ref. 670184) and approves and issues this communication under Section 21 of the Financial Services and Markets Act 2000. Please note, tax and estate planning services are not regulated by the FCA.