The Future Is Over ...... According to Stock Prices

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To explain in the simplest terms why “the market” can price a stock at $40 per share at a point in time and shortly after that price it at $8 per share, I thought that I would provide an example and explain how a forward-looking healthy market prices a company versus a fear-induced preservation-oriented market sets a value.

I am going to use a widely held Seven Summits Capital stock, GoodRx (GDRX), as an example. At the beginning of 2022, GDRX was trading at levels near $40 per share. According to free cash flow (FCF) data on GDRX compiled by GuruFocus, GoodRx’x FCF 3-Year average growth rate was 45.20%. FCF can fluctuate greatly quarter-to-quarter, and that is why it is necessary when forecasting FCF into the future that one looks at a “smoothed” multi-year average FCF.

Stocks trade at FCF multiples ranging from 10X for slow growth cyclical companies in areas such as Energy and Utilities to 40-50X for faster-growing companies in technology, communications, and healthcare. For 2021, GoodRx’s FCF per share equaled $0.35. Our assessment of this cash flow positive and fast-growing market leader is that it will continue to be able to grow its FCF without a significant need for additional capital investment or shareholder dilution. Thus, we can conservatively model FCF, using an average annual growth rate above 30% for the next 3-5 years and above 20% for years 5-10. Using this conservative approach, assuming a 30% FCF growth over the next four years, we forecast $1.00 per share of FCF in 2025. At GoodRx’s current share price of $9, the market is pricing the stock using a 25X multiple of last year’s FCF of $0.35, not only suspending belief that the company’s FCF will continue to grow but also cutting the multiple down from 100x next year’s anticipated FCF to 25X. In essence, the market has suspended all belief that GoodRx will be able to grow cash flows beyond the 2021 level.

GoodRx is no slouch for generating free cash flow (FCF). Using Seeking Alpha’s database of corporate financials, of all U.S. companies, Apple (AAPL) is consistently the FCF king, and no company comes close. Apple’s ability to generate FCF as a percentage of revenue, which is year after year in the mid-30% range, is unparalleled. Thus, it is not surprising that Apple is the most valuable company globally. At its most fundamental level, the value of a corporate enterprise is dictated by a discounting of expected future cash flows to arrive at a present value. Putting Apple aside, the next best generator of FCF is Alphabet (parent company of Google – GOOGL) which in 2021 had a ratio of FCF to Revenue of 26%. Comparing FCF to Revenue ratios of companies is an excellent way to determine how well a company converts revenue to free cash flow. In 2021, GoodRx (GDRX) had a FCF to revenue ratio of 25%. If one looks at a stellar mid-cap company such as Alleghany (Y), the insurance company that Warren Buffett's Berkshire Hathaway recently agreed to acquire, you see a 2021 FCF to Revenue ratio of 15%. Warren Buffett famously became one of the world's wealthiest individuals acquiring very high-quality cash flow generating businesses at a fair price.

Investing in stocks is entirely about discounting the future to arrive at a present fair value. Businesses do not ever grow in a perfect linear line, and GoodRx is no exception to this reality. Due to issues beyond the company's control, GoodRx may not grow 2022 FCF anywhere near the average growth rate of the last three years. However, certain non-recurring issues holding back its FCF growth rates should not jeopardize the company's long-term strong FCF growth.

As we view the current market using GoodRx as representative of how discounting of future growth has temporarily evaporated, we see a small window of extraordinary deep value opportunities and anticipate that this window will close very quickly once investor attention turns again to discounting the future. Using the conservative FCF forecast for GoodRx stock above, we can conservatively forecast a value for the company, which translates to a stock price between $20 -$25 over the next 12-18 months, with an upside over the next 2-3 years of $40-$50.

Simplywallstreet.com performed a thorough discounted cash flow analysis on GoodRx in March 2022 that can be found at: https://simplywall.st/stocks/us/media/nasdaq-gdrx/goodrx-holdings/news/goodrx-holdings-incs-nasdaqgdrx-intrinsic-value-is-potential

In summary, using a 6.7% cost of capital, which reflects the current interest rate and inflation environment, Simplywallstreet's discounted cash flow (DCF) places a current present value on GoodRx at $32 per share. A good way to look at a well-conceived DCF present value is to consider it the mid-point fair value stock price incorporating all past performance and forecasts based upon all of the publicly available company and industry information. Should new information, future growth rates, or a change in the cost of capital necessitate a positive change to the long-term forecast, that mid-point fair value stock price should be reset higher. Conversely, if the long-term forecast needs to be materially cut, the mid-point fair value stock price will lower. It is for this reason that I do not like to talk about target prices; instead, I like to discuss fair value ranges. If I were to place $8 per share on such a fair value range, it would fall below any rationally derived fair value range.

What I laid out above is the thinking process behind making a long-term investment in a company through its publicly traded stock. For a long-term investor, this process does not change regardless of the market environment. However, this cannot be said for markets. Markets rarely are consistent in how they set prices and assign values. From my 25 years of investing experience, markets set prices more often than not well above or well below what a well-conceived and conservative discounting of future cash flows would arrive at. Over the last 12 months, the stock market has abruptly shifted from pricing many stocks well above rational levels to indiscriminately pricing stocks well below rational levels.

This interim investment commentary illustrates that once an investor buys a stock, the market controls day-to-day price setting. I like the present; the market sentiment is so pessimistic that it ceases to discount the future, and stock prices can be set far lower than one would have reasonably thought possible. This temporary dysfunction in market price setting does not mean that the future no longer exists; it simply means that the market is having a tantrum, and what we all know about tantrums is that they are not the standard by which we should measure a person's true character or in the case of a market, should not be the standard by which an investor should measure the value of his or her wealth. Bear markets come and go, and the true discounting function of markets prevails over time with the generation of significant wealth for investors who can discern the difference between market price and intrinsic value. The keystone of setting intrinsic value is cash flow generation. However, when fear turns the market's focus away from discounting future growth and cash flows and instead prioritizes near-term capital preservation, significant price to intrinsic value dislocation occurs.

We do not ever engage in an attempt to time the market. Still, given our acceptance that markets will rarely set prices near rational levels derived from a well-thought-out cash flow discounting process, we do attempt to harvest profits during times of exuberance and accumulate shares aggressively during times like the present.

In a bear market, a period in the market cycle when prices no longer reflect any reasonable discounting of the future, a long-term investor must, at the minimum, look across the valley to the other side when more rational price setting returns. Ideally, the long-term investor should be realigning portfolio holdings to seize on the most mispriced stocks and, if possible, put new cash to work at today's extraordinary price levels.

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Disclosure:

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