Montaka Global Investments

Winning in the age of enterprise -digital transformation Part II of II

Mark Twain said it better than we ever could. "*It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.*" And when it comes to the valuation of some of the world's greatest software businesses today, it is hard to know for sure what is so.

In Part I of this two-part whitepaper, we identified the digital transformation of the enterprise as a prospective, structural trend that is now accelerating as a result of COVID-19. Within this trend are a number of attractive markets with high barriers to entry and limited competition. We believe the long-term winners of these attractive markets make for compelling investment opportunities to the extent they remain undervalued. In Part II that follows, we show the dangers of employing typical valuation heuristics in this space; and evaluate the significant opportunity costs associated with missing out on investments in the world's greatest businesses.

Andrew Macken, Christopher Demasi & Lachlan Mackay

August, 2020

VALUATION AND THE DANGER OF HEURISTICS

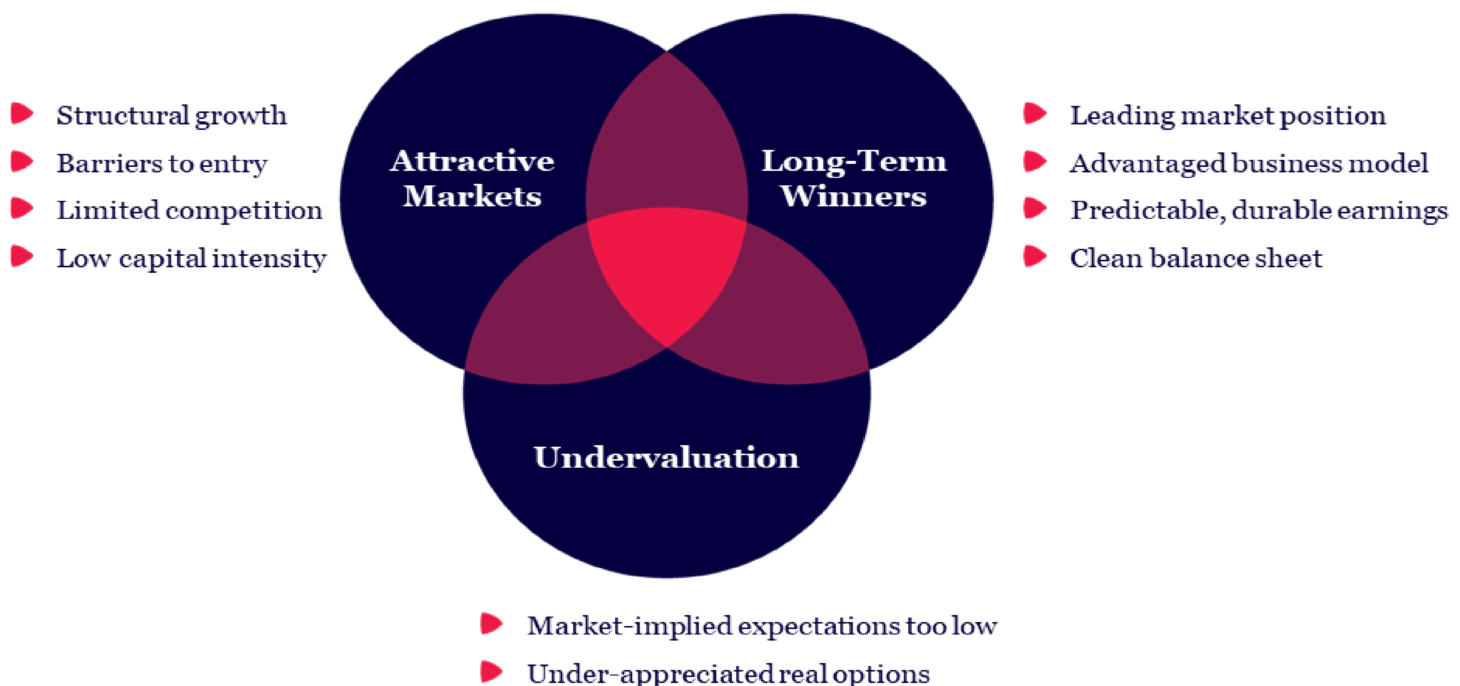
It is one thing to identify the long-term winners in attractive and structurally growing markets. But it is another to find those which are undervalued. This is the simplified objective of the Montaka investment team. This is why we come to work each day.

Projecting the future value of long-term winning businesses in attractive markets is far from a trivial exercise. Indeed, one could mount a strong argument that **many of the world's very best businesses have proven to be consistently undervalued by public equity markets**. We demonstrate some evidence of this dynamic further below.

Two interrelated reasons for this structural undervaluation of the world's best businesses, in our view, are as follows: (i) the very best businesses have the highest probability of being able to evolve their business models over time, leverage their real options to expand into new lines of business and create new real options, or investment opportunities, over time. We believe this probability is consistently underweighted by the market. And (ii) the market undervalues the real options owned by the world's very best businesses. Said another way, these options are either underappreciated and therefore undervalued; or they are appreciated and still likely undervalued.

Amazon is one of the most extraordinary case studies in this regard. Beginning as an online bookseller, in 1997 CEO Jeff Bezos predicted that "*... Online commerce in general should prove to be a very large market...*" while explaining that prioritising investments would be one of their biggest challenges. Amazon's investments transformed the business over time. Amazon Prime was launched in the US in 2005 and deployed globally over the following years. Amazon Web Services was launched in 2006, developing into the dominant cloud computing service it is today. Fulfillment by Amazon evolved into an automated mass inventory management business with the 2012 acquisition of Kiva Systems. Amazon added grocery to their offering in 2017 when they purchased Whole Foods Market, which in turn expanded the scope of Prime.

Amazon leverages data and scale to create and evolve their ecosystem, putting the customer first as they prioritise investments. Their culture of investing in long-term real options continues today, as evidenced by their recent acquisition of autonomous driving company Zoox. Meanwhile, Amazon's existing businesses continue to thrive. Amazon's inherent ability to leverage new business opportunities only improves with scale and experience. And this has been consistently underappreciated by the market.



We believe there is at least one more important reason for the systematic undervaluation of the world's best businesses: flawed valuation heuristics employed by investors. That is, short-cut metrics that are commonly employed by investors to assess the degree of undervaluation or overvaluation of a given business. These typically come in the form of ratios of market valuation to an underlying fundamental driver. For example: price-to-earnings, enterprise-value-to-earnings, enterprise-value-to-sales and price-to-book-value, to name just a few.

There are a number of important reasons that cause the undervaluation of the world's great businesses by investors employing valuation heuristics of this nature.

- These heuristics struggle to deal with the high and relatively-sustained growth rates that the world's best software-based ecosystem businesses can deliver as they replace legacy technology spend;
- These heuristics do a poor job of reflecting the advantaged-economics of these privileged businesses models; and
- These heuristics fail to reflect the value of the current and future real options owned by the world's best businesses.

In practical terms, accurately reflecting the future value of the world's best businesses would often result in valuation multiples so high that most investors would scream overvaluation.

Salesforce (NYSE: CRM)	2006	2020
Enterprise value (EV), US$M	4,243	161,109
EBITDA, US$M	41	1,882
EV/EBITDA	104	
Fair EV based on current, US$M	42,425	161,109
Fair EV/EBITDA based on current	1,041	86
Multiple above actual	**10**	

Amazon (NASDAQ: AMZN)	2006	2019
Enterprise value (EV), US$M	15,615	942,738
EBITDA, US$M	594	39,999
EV/EBITDA	26	
Fair EV based on current, US$M	273,078	942,738
Fair EV/EBITDA based on current	460	24
Multiple above actual	**17**	

Facebook (NASDAQ: FB)	2012	2019
Enterprise value (EV), US$M	55,872	541,315
EBITDA, US$M	1,187	30,866
EV/EBITDA	47	18
Fair EV based on current, US$M	277,780	541,315
Fair EV/EBITDA based on current	234	18
Multiple above actual	**5**	

Source: Bloomberg; Montaka

And from an historical perspective, this would have been true in the past. But the world has never seen these particular global ecosystem businesses models, built in software, that have become mission-critical for the world's enterprise community.

Consider the following thought experiments. In 2006, Salesforce was trading at an EBITDA multiple of 104x – not exactly cheap by any typical measure. And yet, if we discount the current Salesforce enterprise value at an annual rate of, say, 10 percent back to 2006, the "fair value multiple" at the time was more than 1000x EBITDA!

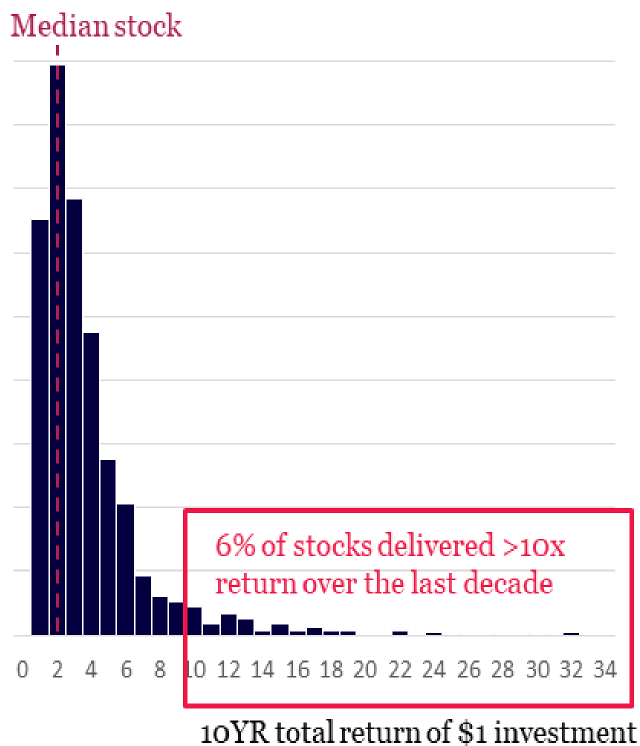
In the case of Amazon, the business was trading at 26x EBITDA in 2006. By the same logic as above, equity investors should have been willing to pay up to around 460x EBITDA! Even Facebook in 2012 at 47x EBITDA was a bargain. Investors should have been happy to pay more than 230x EBITDA!

And the above analysis assumes an approximate 10 percent cost of equity. The final important reason why the heuristics of the past do not make sense today relates to the protracted low interest rate environment in which we find ourselves. As we pointed out above, for every two percent reduction in appropriate discount rate applied to the cash flows of many of the businesses we discuss in this whitepaper, the fair valuation multiple should expand in the order of +50-70%!

COMO: THE COST OF MISSING OUT

Finally, while avoiding the overpayment for assets is a core belief of Montaka's at all times, it is worth considering the opportunity cost of missing out on investment in such long-term winning businesses in attractive markets.

Our starting place is understanding the distribution of stock returns over a long horizon. In the world around us, many measures like height or IQs, follow standard normal distributions. That is, most observations are around the average, with a balance of some above and some below, and not many outliers – there are not many four-foot or eight-foot-tall people, for example. Stock returns are different.



*Analysis based on US listed stocks with > US$5m in daily liquidity; sample size of 1,818 stocks
Source: Bloomberg; Montaka

Stock returns are not so evenly distributed and are much more skewed. The few outliers account for nearly all of the long-term market return. This is a power law, like the "80/20 rule", which says that 80% of an effect – like a country's wealth – is explained by 20% of causes – like the richest people – but even more extreme.

Observing the returns of US stocks over the last ten years we see that many stocks fail to make any meaningful return and the median performance equates to a low-single-digit compound annual return. On the other hand, there was just a small proportion of stocks that were proverbial "ten-baggers" or more over the decade and these stocks also provided the vast majority of the market return.

By corollary, missing out on capturing the returns of these winning stocks would have materially constrained the compounding potential of an equity portfolio.

For equity investors that focus on owning long-term winners in attractive industries, the likelihood of avoiding losers should already be high, providing a positive tailwind to portfolio performance. Truly outsized returns, however, will only be generated by participating in the long-term compounding of structural winners. Investors that are overly sensitive to movements in prescriptive valuation assessments based on the current form of the business may not allow themselves to do this. Those who are less sensitive and mindful of the dynamic described above, may find themselves feeling like they are slightly overpaying at the time of investment, but that still works out very well because of the extreme upside potential of excellent businesses in time – **good things happen to great businesses**.

This is far from an argument suggesting stocks, in general, are cheap or expensive. And it is far from an argument supporting the irrelevance of price when making an investment. Instead, it is an acknowledgement that: (i) the market has consistently underestimated the opportunities that the world's greatest businesses can create for themselves; (ii) the market has drastically undervalued many of these businesses at various points in time; and (iii) in the context of the interest rate environment facing us for the foreseeable future, cash flows which are durable, predictable and growing are worth significantly more today than they have ever been before. In making these acknowledgements, it follows that investors need to keep an open mind going forward.

* * *

The structural growth in enterprise digital transformation is not like most other trends. This particular structural trend is: (i) global, not local; (ii) dominated by software – the economics of which are extraordinarily favourable (essentially zero marginal cost of reproduction and distribution); (iii) leverages the power of large pools of data to create valuable network effects; and (iv) is accelerating in a unique time in human history: interest rates will likely remain depressed for a protracted period of time.

It is for these reasons that both of the following will probably be true: (i) standard valuation heuristics that have historically been appropriate in other industries will likely meaningfully undervalue the long-term winners in the attractive markets within this space; and (ii) the long-term opportunity costs to investors associated with missing out on these long-term winners will be very large.

It is for these reasons that, following the COVID-19 lock-downs, the Montaka funds meaningfully increased exposure to the businesses we believe will be the long-term winners in the attractive markets within this accelerating trend.

Montaka Global Investments

Do you want to get in touch with us?

Please call Matthew Briggs (Business Development) or Craig Morton (Chief Financial Officer) on 02 7202 0100 or email at mbriggs@montaka.com or cmorton@montaka.com. You can also visit our website www.montaka.com to gain insights and learn more about us.

Important Information

This document was approved by MGIM Pty Ltd (MGIM) ABN 62 604 878 533, AFSL No. 516942, a subsidiary of Montaka Global Investments. Montaka Global Investments provides research services to MGIM.

The information provided in this document does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial advisor if necessary.

Future investment performance can vary from past performance. You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Investment returns reviewed in this document are not guaranteed, and the value of an investment may rise or fall.

This document is based on information obtained from sources believed to be reliable as at the time of compilation. However, no warranty is made as to the accuracy, reliability or completeness of this information. Recipients should not regard this document as a substitute for the exercise of their own judgement or for seeking specific financial and investment advice. Any opinions expressed in this document are subject to change without notice and MGIM is not under any obligation to update or keep current the information contained in this document.

To the maximum extent permitted by law, neither MGIM, nor any of its related bodies corporate nor any of their respective directors, officers and agents accepts any liability or responsibility whatsoever for any direct or indirect loss or damage of any kind which may be suffered by any recipient through relying on anything contained in or omitted from this document or otherwise arising out of their use of all or any part of the information contained in this document.

MGIM, its related bodies corporate, their directors and employees may have an interest in the securities/instruments mentioned in this document or may advise the issuers. This document is not an offer or a solicitation of an offer to any person to deal in any of the securities/instruments mentioned in this document.