Putting a Price Tag on Slippery Stocks
By David Kathman, CFA | 05-07-99 | 12:00 AM
Chris Davis and Owner Earnings
Chris Davis of the Davis New York Venture Fund NYVTX gave a Stocks 501 presentation in which he explained the concept of "owner earnings," which he prefers over reported earnings in calculating P/Es. Owner earnings represent the excess cash a company generates after paying to maintain its growth. Variations on this idea (essentially the same as what we here at Morningstar call free cash flow) have become increasingly popular as a measure of how much money a company is actually generating for its shareholders, separated from all the accounting assumptions that color reported earnings.

To figure owner earnings, Davis starts with reported net income and adds back depreciation and amortization, since they're noncash charges that don't actually represent cash in anybody's pocket. He then subtracts out nondiscretionary capital spending--the money the company has to spend (on factories, equipment, and so forth) in order to maintain its current level of growth. Finally, he subtracts out the cost of any stock options the company has issued. To do this, he takes the total number of options issued during the year and calculates the market value of the shares corresponding to these options, then assumes that the options are worth 30% of that value. In treating stock options as a real cost, Davis is following the lead of his hero, Warren Buffett, who has in recent years railed against accounting rules that allow companies to issue valuable options that don't show up in their income statements. He used Sealed Air SEE as an example of a company whose earnings would be cut in half if it treated stock options as an expense.

Davis thinks that a P/E based on owner earnings gives a better measure of a stock's true value than traditional P/Es, but he doesn't stop there. When a company owns a significant number of shares in other publicly traded companies, he subtracts the value of those shares from its price in order to get a P/E for its core business. He gave the example of Tribune Company TRB, which owns valuable stakes in AOL, iVillage IVIL, and several other Internet stocks that make it look more expensive than its main businesses (newspapers and television) warrant. He also keeps a close eye on debt, which can make a stock look deceptively cheap. For example, Allied Waste Industries' AW superficially attractive valuations mask high debt leverage, which makes the company much riskier than it first might appear.

You've probably heard the saying, "If all you have is a hammer, everything looks like a nail." That certainly applies to evaluating stocks, since valuation measures are basically just tools that can be used wisely or misused. If you just use plain old P/E, you're missing out on a lot--putting price tags on stocks is such a complex and tricky business that it helps to have a variety of different measures in your toolbox for different situations. As the great minds at our conference showed, there are lots of alternative valuation tools available out there for the smart investor who knows where to look.
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