FCL *Capital*

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Valuation and its mysteries

In late 1999 a PHD student from Stanford was feeling anxious and stressed. Over the prior several months he had developed with a colleague an algorithm that according to him, could better search for web pages and directories from across the web.

The technology seemed promising and through a series of introductions the student was able to eventually be in touch with Vinod Khosla, one of the most prominent venture capitalists in the San Francisco Bay Area.

Khosla liked the work of these doctoral students and made an offer to buy the whole technology, including all its future commercial revenue, for the price of $ 1 million.

Since this technology was similar to one being developed by one of the companies Khosla funded, a web portal called Excite.com, Khosla got in touch with the company's executives with the idea for them to make a joint bid.

The $ 1 million dollars offer was accepted by the couple of students.

Before they signed the deal, however, Excite's management was reluctant.They just didn't see a lot of difference between their own technology and the one being acquired.

Ultimately, Khosla entered the scene again.The students seemed to really wanted to sell , make some cash as compensation for their work and effort and quickly go back to their studies.Khosla was able to talk them down to $ 750.000 plus 1% of Excite.

Their only condition, according to Excite's then CEO[1], was that Excite would replace their existing technology by the technology was being sold. This was they felt they would have a bit more of an upside and their stake would be worth a bit more.

As you know, the student in question was Standford's PHD graduate Larry Page, and the company founded from their work, Google, now worth close to $ 200 billions of dollars is according to many, including myself, the most amazing company ever created by mankind.

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In 1987 Bill Gates was also feeling nervous. The previous year his company, Microsoft, had done a very successful IPO.

Gates had a fear that now that Microsoft's stock had more then trebled in price since the IPO and the company was worth almost $ 3 billion dollars, many of its employees were millionaires, at least on paper and could not feel as much motivation as before.

Besides, running a public company was obviously very demanding and very different than running a startup.

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[1] http://www.internethistorypodcast.com/2014/11/the-real-reason-excite-turned-down-buying-google-for-750000-in-1999/

Like most companies, some analysts loved the company and its prospects, while others were bearish.

But after 1987’s meteroric rise and a valuation of almost $ 3 billion dollars, even Gates was reluctant and thought the stock price was a bit inflated.

In one investor event in that year, a bearish stock analyst told Gates that his company was overvalued. Gates agreed.

In the following 13 years Microsoft stock price rose almost two hundred times

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Back in the time Excite passed the opportunity to buy the incipient Google, there was only web portal larger than them. It was Yahoo.

The peak of Yahoo’’s glory was in 2000 when it was worth nothing less than $ 125 billion dollars.

Over the years, its model started to lose ground to Google’s speed, reliability and convenience. Yahoo never really was able to regain its prominence but kept trying. In 2008, its founder, Jerry Yang, turned down a buyout offer for Yahoo worth 44.6 billion dollars, certain that this offer was too low.

In 2006, Yahoo, desperate to find new avenues of growth, offered $ 1 billion dollars for a promising startup called Facebook. Most of the board of Facebook decided to accept the offer, considering it fair. In the board were some of the most prominent investors in Sillicon Valley , including Peter Thiel.

Mark Zuckenberg, however, didn’t want to lose control and decided to ask for just a bit more. After a while, Thiel said he remembered saying, "We should probably talk about this. A billion dollars is a lot of money." They hashed out the conversation. Thiel said he and Jim Breyer pointed out: "You own 25 percent. There's so much you could do with the money." Thiel recalled Zuckerberg said, in a nutshell: "I don't know what I could do with the money. I'd just start another social networking site. I kind of like the one I already have."

And for very little details, Yahoo didn’t buy Facebook, now worth almost $ 200 billion dollars, for a billion dollars ten years ago.

Yahoo, however, didn’t have a great fate: after being worth $ 125 billion dollars in 2000 and turning down a $ 45 billion offer in 2008, the search business of the company was finally sold for $ 4.5 billion in 2014.

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This letter is dedicated to valuation and its mysteries. And the first insight that comes to our minds is this: valuation is something so complex and something still so badly understood that even the insiders and founders, people that know or should know like no one else about the value of their companies, sometimes have no clue about how much their companies are worth.

And we are not talking about dumb people.We are talking about some of the most brilliant capitalists on Earth like Larry Page, Bill Gates, Jerry Yang and Peter Thiel. If they don't know how much their companies are worth, how can the world know?

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Mystery 1: The future is uncertain and full of surprises, even for insiders

One of the most classic metrics investors use when monitoring a company and its stock in the behaviour of insiders, like board directors and controlling shareholders. This is a very justifiable exercise and this house has been doing insiders monitoring, just like most value investment houses, almost since its founding day.

The rationale is simple: insiders know better than anyone else about how a company is going and if they are heavily selling, you better watch out.

There is some academic evidence supporting this reasoning. However, it is far from perfect. There are many instances when insiders , even when they have a great track record, completely misread the prospects of their companies, more usually being overoptimistic, but also not being able at the time to see the full scale of the opportunities ahead, like most examples with which we started this letter.

If no one, even insiders , really knows the true value of companies, here is a second mystery: Mr. Market, as told by Benjamin Graham, is a manic depressive whose mood swings wildly.

Sometimes, once every few years or so, people are euphoric. ``These are new times!``. ``You shoudn't miss out the rally or you will be a sucker!`` Even your wife starts complaining to you that their friends, yoga partners and their husbands are all making money with stocks and you should do something!

Mystery 2: the pendulum swings and euphoria and complacency alternative

Other times, it might seem a different planet, but with the space of a few years, everyone will tell you that it's better to be safe! Stocks are for irresponsible people. And it's all a rigged game anyway.

Jim Chanos is one of the most famous short sellers in Wall Street. A few years back, he gave a course in Yale about Financial Frauds Detection and one of the most interesting conclusions given by Chanos, is that even frauds also follow the cycle: most of them are obviously committed when stocks are booming and people's skepticism naturally falls to very low levels. Then, a few years later, when the tide lowers and you realize who ``was swimming naked the whole time``, the fraud appears.

It might seem that the frauds were committed during the bad years because that's when we hear about them, but the opposite is the case. Think about Enron, Worldcom, Eike Batista in Brazil, and pretty much every financial collapse you can think off: when everyone is in a hurry to get rich and skepticism is low, it seems the sky is the limit for them. Then, when the tide turns, the problems appear.

The pendulum swings in finance. Everything goes in and out of fashion. As the old muslim saying goes, ``this too shall pass``

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In one of the most fascinating TED talks ever given[2], the investor Bill Gross listed the single most important reason startups succeed or fail. Contrary to popular wisdom, it is not the sheer brilliance of an idea: before Google there was Altavista and before Facebook there were Friendster and Myspace.

Instead, according to Gross, it is timing. The coincidence of ideas whose time has come breeds success.

Our next mystery is this: ideas are powerful but don't fall in love with them. Be a ``fox instead of a hedgehog`` as Phillip Tetlock preached in the book Superforecasters.

Mystery 3: Complexity and timing will outsmart the smartest

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http://www.ted.com/talks/bill_gross_the_single_biggest_reason_why_startups_succeed

A side note: we always believed that entrepreneurs' single biggest mistake is not telling everyone about their ideas in fear people might steal them. Quite the opposite: ideas don't have that much value, execution and timing do.So they should tell everybody to stress them out and see if they still stand.

So mystery number 3: ideas are powerful but the world is too complex for us to understand so don't overestimate your wisdom. Timing and unforeseen events are probably more relevant than you think

A following mystery: as minority investors, the market does a reasonable job of guessing which companies are well managed, positioned in promising industries and likely to flourish in the future. But then we overpay for them.

Mystery 4: As investors, we do a reasonable job of identifying the most promising companies.But then, we overpay for them

One of the most incredible paradoxes in the world of finance:: how can a game that is played by so many smart people all over the world, who spend millions of dollars in brains and computer power trying to outsmart each other can be beaten with a single simple hack: take a spreadsheet and buy the cheapest quartile of stocks according to the dumbest cheapness criteria: price to earnings ratio. This ultra simple trick has consistently outperformed the market in the past and its likely that will continue to do so in the future.That is how mysterious the valuation game is.
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Finally, one last mystery: over the past few years the so called ``Index Revolution`` has happened. So , a substantial part of assets under management are now allocated in index funds.

This has largely happened because Vanguard and its imitators showed the world that index investors will do better in the stock market than most investors. And that too many mediocre fund managers decided to start their own hedge funds and give a shot at becoming billionaires.

So , the index revolution, in our view, is a mostly good thing.

That being said, one not so realized paradox: since an increasing amount of assets are going to ``blind`` index funds because it is hard to beat the market, the natural consequence of this asset migration is that for the remaining active investors it will once again become relatively easy to outperform the index (since active managers are now a diminished part of the market.

So the valuation game, which became so much harder in the past few decades, might be back to its starting point.

Mystery 5: we try to outsmart each other. Its difficult. Now that we are giving up it might just work again.

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There are countless other mysteries we could have addded to these five, of course.

Judging the value of a company runs counter to so many human instincts and capabilities.How to properly weight so many facts, so many known unkowns and unkown unkowns? How to read properly the way the future will turn out and properly access the fact that most of the things that worry investors so much will disappear from mind but new worries, that no one is thinking about yet will appear?

Meanwhile, unforeseen opportunities will arise and sometimes the most promising ones will prove unexceptional.

That's the nature of this ultimate puzzle, to which we dedicate our lives and to which no one has ever yet came close to a final answer: how to reach this final conclusion, the ultimate piece of information, the definitive answer: amid all the noise, how to see the true value.

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