Approaching Valuation Through a Long-Term Lens

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Was the stock market overvalued at the end of 2021? Is it undervalued now? What about companies whose stocks have lost more than half their value in 2022? Are they a buy?

Particularly this year, valuation has become a pervasive conversation as the Federal Reserve has embarked on its most aggressive financial tightening path in 40 years. On any given day, you are likely to hear some version of these questions answered confidently by well-informed and impressively credentialed financial professionals. The problem is that all those questions are unanswerable without the benefit of hindsight.

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In seeking long-term earnings power, we do not believe valuation can be framed as a series of yes/no questions to be answered regularly and acted upon accordingly. Our approach to valuation is about much more than establishing a price target, comparing current price-to-earnings or price-to-sales ratios against history or peers, or calculating a short-term expected rate of return. The issue with these methods is that, as we have seen throughout the past year, valuations can be a rapidly moving target in the short-term, driven less by fundamentals and more by changes in monetary policy, economic indicators, and investors' emotions.

As with everything we do, Riverbridge's approach to valuation is focused on each company's fundamentals and done through a long-term lens. Over a full market-cycle, management quality and a sustainably differentiated business model delivering value to customers are ultimately the drivers of stock performance; as such, we focus on assessing those factors first, and then determining whether we believe we are paying a fair price for the company's long-term earnings power potential. This avoids the dual traps of convincing ourselves to buy a low-quality company simply because it appears relatively cheap or passing over a high-quality company because it appears relatively expensive.

Our primary valuation goal is to pay less than a strategic buyer would pay to acquire a company. This is a complex, interwoven process which must consider today and tomorrow, internal and external forces, the expected and the unexpected. We focus on factors such as competitive moats, durability of earnings, economic sensitivity, and other long-term variables which may influence a company's ability to build earnings power. Even companies that look similar often command substantially different valuations because no two companies have the same growth opportunities, share the same capital structure, reinvest the same percentage of earnings, or face identical competitive threats.

As part of our research process, we will build financial models to help us understand the levers of the business, isolating factors within control of management and the external factors that are beyond a company's control. Understanding the inner workings of a company is the critical first step to identifying an appropriate valuation framework. Financial modeling assists in analyzing what drives a company's revenues, the costs to serve customers, the capital and investments required to grow the business, and the resiliency of earnings. We are willing to pay a premium for companies which possess a sustainably differentiated market position, consistent unit growth, a flexible and well-capitalized balance sheet, and a management team committed to building long-term earnings power.

Deservedly so, Riverbridge's portfolios have historically traded at a relative valuation premium to their primary benchmarks because we are committed to seeking companies with durable earnings power, sustainable competitive advantages, strategic customer relationships, strong balance sheets, and high returns on invested capital. As evidenced by our long-term track records, over the course of a full market cycle, we believe these characteristics are worth paying for.