IFB294: Explaining Multiple Expansion and It's Impact on Value

[This transcript was generated by artificial intelligence. Timestamps are not 100% accurate depending on the platform used for listening].

Dave

0:00

Alright folks, welcome to Investing for Beginners Podcast. Today we have episode 294. Today, Andrew and I are going to talk about the concept of multiple expansion and how it can impact the value of a company that you are looking at. So without any further ado, let's go ahead and dive in. Andrew, would you like to start talking about I guess, first maybe let's talk about multiples, and kind of give everybody a little bit of an overview of what that is. So if you're new to the show, and you're not sure what we're talking about, here we go.

Andrew

0:30

Perfect. A multiple is a way to get an idea of how expensive a stock is. And so basically, what you're doing when you use a multiple is you're comparing something about a company to its stock price. The most common multiple is the price to earnings multiple or P E ratio. And you will hear that, on probably so many different stock market shows or stock market articles or analysis, it's everywhere. And that's just a very simple way to look at where a stock's prices, how that compares to the earnings. And that gives you the multiple, the higher the multiple, the more the price is in comparison to the earnings, and vice versa. So a lower multiple, you're paying a lower price on the same level of earnings.

Dave

1:24

That makes a lot of sense. So the different multiples out there. Usually when we're referring to multiples, I think we usually refer to price based multiples. So like common terms or price to earnings, like Andrew was

explaining price to book price to free cash flow. Those are some of the ones that are bandied about in the stock market world. And those are the ones that most people are you familiar with Michael Mobizen refer to them, I think I kind of liked the way he called them shorthand for valuation. And his meaning behind that was is there there a quick easy way for people to kind of get a sense of how much a company is worth.

And that's really kind of what we're talking about. And when you're talking about valuation, you're trying to figure out how much something is worth before you buy it. Just like if you go and buy, you know, a diamond ring or a car, you want to know how much it's worth before you plunk down your money. And that's exactly what we're talking about when we talk about valuation for a stock or for a company. And that's really what these are.

So when you're talking about multiples, they move, they don't they aren't static, so you don't have the price to earnings can change. Well, literally, it can change daily, if the price of the stock is changing, because the earnings will only change quarterly or annually. And depending on the company, but the price can move, sometimes five or six times in a day. So in theory, the price to earnings ratio can adjust from period to period. So it's it can be a bit of a volatile thing. So maybe we could kind of move from there and talk a little bit about the concept of of expansion or maybe forward and past earnings, and maybe kind of how those relate to multiple expansion and, and valuing a company.

Andrew

3:11

To me to understand expansion means understanding what's driving the multiple. So if I were to ask you, Dave, what would make one stock's multiple, higher than the other? Why does one company deserve a higher multiple than the other? What would be the first thing that comes to mind?

Dave

3:33

Oh, boy, I think probably the first thing is the expectations of the market, what they think is going to happen to a company. If you look at Nvidia as kind of an example of an expectation. They recently really exploded in price about a month ago, maybe. And in large part because they came out with an announcement saying that their revenues were going to not quite double but close. And that was unexpected. And so that caused the price of the company to skyrocket. In a day or two. I think it went from $150 A share to close to 400 a share almost literally overnight. And so that I think that's the first thing that pops into my head. What about you?

Andrew

4:14

Yeah, expectations. For whatever reason, like in that example, you're talking about a financial metric that is being revised in a positive way. There are also a lot of intangible ways that expectations can change. As an example, I remember, I mean, Tesla's still going crazy up and down like a roller coaster. So that story, the Tesla story, that stock can change so many different ways, or a multiple number of reasons because of how people feel about autonomous driving and that future because of how people see the potential of Tesla's insurance unit to insure their cars because of what Elon was doing when he was buying Twitter. I literally changed the expectations and the emotions around the company, those things can all affect the multiple.

And I think to the point of when can there be a multiple expansion, if we're talking about expectations, one way for the multiple to have an expansion. And usually when people say multiple expansion, they're talking about something that's sustained. We're not talking about the fact that the multiple went from 15 to 20. In a week, we're talking about a stock that generally trades around the 15th, multiple, now trades around the 20. Multiple. And usually, that's because instead of being an expectation, that's more emotional, it's something that's more lasting. And to me, when I hear something like the NVIDIA example, that sounds more lasting, because if they can keep up that revenue, then they deserve to have an expansion there. Right?

Dave

5:53

Yeah, that makes a lot of sense. So what else would drive I guess fluctuations with things like the news, for example, help drive fluctuations in the price of a company, and particularly when we're talking about between periods where the company tells you this is what the financials were. So if something happens in, let's say, February, so between the first and the third, in the first quarter of the year, between when a company would report, you know, and, you know, they had an oil spill, if it's an oil company, for example, something like that, I think would probably drive the narrative of the price changing. Am I correct on that?

Andrew

6:29

Yeah, for sure. I think of a recent example. This is dating myself now, because it's almost been like three years or something. But the whole and inflation act that Biden signed, that's billions of dollars going into the type of infrastructure companies that are involved, and those fundamentals have changed for the better

because of that. So when you saw those gains with stocks, and I'm just gonna use a couple examples, since I'm familiar with them, they're in my portfolio, Martin Marietta, or commons, the stocks that are driven by construction and expansion and infrastructure. When you see those, it's news that's maybe less noise and more substantial. And I think that would be an example where the reality has changed because of the news. And it's not just because, you know, some company used to turn on Twitter and doesn't trend anymore. We're talking about things that like, really impact, right?

Dave

7:25

Yeah, that makes a lot of sense. So between, I guess, the expectations that investors expect for a company to produce I know that expectations certainly drive Tesla, he said that the wild fluctuations but everybody in Twitter recently, everybody's been talking about what they expect Twitter to do, or Twitter, they expect Tesla to do in their next earnings call as far as like how many vehicles are going to produce, for example. And there's a lot of expectations that they're going to hit this certain number. And so that weeds people to either really buy into it, or if they're not as enthusiastic about Tesla as other people, maybe they may be selling, because they don't expect that and they expect the price to come down. So I guess beyond those kinds of ideas, are there any other impacts or aspects of the market that could impact a multiple and how it fluctuates?

Andrew

8:17

To me, I think another thing that drives multiples in general is how much people expect a company to grow. And I know that kind of sounds like expectations, but we're really talking about the upside potential for growth. And so there are these buckets, which, you know, nobody's defining them, nobody's sitting down and, and pulling companies out of the ether and dropping them in a growth bucket or value bucket or mature bucket or young bucket. But those are things that are behind the veil, kind of happening with these companies all around the market.

As companies get categorized, they can have a higher or a lower multiple expansion, or I'm sorry, a higher lower multiple. And so when you have a company that can transform from one stereotypical bucket to the other, that's where you can see another multiple expansion. So the classic example, again, the stock I have, so full disclaimer, but a company like Microsoft, during the 2000 10s was a huge company, people thought it was mature, they didn't see much of the upside potential in Microsoft Windows, which that has all been true. That hasn't been what you would think of as a high growth business. But in the meantime, Microsoft's created a whole new fast growing cloud segment that has the data centers and the servers that drive a lot of

what you see on the internet today. And because they now had this much higher upside potential, they went from a kind of slower growth mature bucket to this, okay, we have much faster above average growth again, and there are multiple expanded a lot from that difference in perception and record numbers to back them up.

But if you looked at the financials in the mid 2000 10s, Microsoft already had pretty decent growth. But now the fact that they're kind of put in this new tech emerging kind of high growth industry, they had multiple expansion that you saw that stayed and that they still kind of have and deserve, because of a new upside potential from their new business segment. Do you have like other examples that kind of fit between the whole buckets idea?

Dave

10:30

Yeah, I think probably the one that springs to mind is more recent is Google with the advent of not Advent, but I guess the explosion in awareness around AI. And Microsoft's you know, seeming lead in AI that really drove pessimism towards the Google machine. And even though Google has been, you know, a fantastic business for a long time, and is really dominant in the areas that they play in and have been very active using AI for a long time behind the scenes. Whereas Microsoft had, it was far more out in front with the Chappie chat GBT. And being just their announcements were way better.

There was a Google a failed Google announcement, like a day after Microsoft did theirs. And it was very rushed job. And it was really bad. Anyway, those things all helped contribute to, instead of an expansion, actually a contraction of the multiple for Google. And because everybody was afraid that Bing was coming for Google search, and that Microsoft's investments in AI are going to overshadow anything that Google had done, and really turned Google people about Google very bearish, very down on the company for a period of time, six months or so. And it really drove the company's multiple down before that, it was in the high 20s to low 30s.

And then even now, it's trading around a 20 pe, which means that it's, you know, you could consider it your quote, cheap if you wanted to, and compare it to the power of what what the company does, because it's still the leader in search. It's still why by magnitudes of, you know, huge, huge number, and YouTube is number two in search. And it's, you know, in video at dominates. And, you know, my daughter watches way more YouTube than she does Netflix, for example. So you can see it in the numbers, too, has the growth for those things slow, yes. But the narrative was that Microsoft was coming for Google. And they may still be and they may, they are chipping away, I think a little bit, but nowhere near to what people were expecting. And it

caused the price to drop for Google for a period of time, and it still really hasn't recovered much. And so those kinds of things, you know, kind of opposite, what Andrew was talking about have really led to a contraction because people are so bearish, or so down on what had happened to Google. And so that's to me was maybe not necessarily from the growth to the value. But in essence, maybe it is because it went from a growth company to now it's a value company, because it's so cheap.

Andrew

13:12

Right? I'm glad you brought that up. In my opinion, it seems that it's way more frequent. I don't have data to back this up. But just from observing the market, it seems like you have a lot more multiple compression than you had kept multiple expansion. And that's to be frank, the reason why I avoid a lot of growth stocks is because it's one of those inevitable is at a certain point, you won't be hot, fun and exciting anymore, and that compression is gonna happen. And that can be a very easy way to lose money.

And a lot of times those multiple after the multiple contraction, you don't get an expansion. Again, it's the Microsoft examples, pretty rare because they basically had to start a brand new business, it doesn't happen every day. So to think about maybe multiple contraction, maybe we can dive into that a little bit. When I think of another recent example of multiple contraction, I think of meta and what happened there. And you can argue that the capital allocation of that company was really being debated and investors were worried because on one hand, you have this crazy growing business with plenty of free cash flow.

But on the other hand, if you have a manager who's spending a lot of that and none of its going back to shareholders, that's the whole point of owning the stock is to get the free cash flow eventually. And when you get this, when you get the idea that the person in charge is never going to return that to you. It can create that multiple compression because you're like basically saying their profits that they're earning aren't as valuable because we're never going to see them. And that's what you saw happen with mana. They did recover after after they talked about being more calm. OS conscious people interpreted that as, okay, we're gonna have more prudent capital allocation, and maybe it's not going to be so wasteful.

So we'll see that stories still playing out live. But when I think of multiple compression, you can have, like you were saying the buckets where a growth stock becomes more matured, and it's considered that and people don't see as bright future for it. You can also see from the capital allocation side, how that can cause multiple compression. And probably there's like a million other reasons why a multiple can compress. But that's just a few that to kind of get started.

Dave

15:40

Yeah, yeah, for sure. I love that example of metta. I mean, was there a more hated company in the stock market, you know, over the last year, year and a half, probably not, there was nothing positive coming out of any sort of news or any sort of media related to that everybody was very, very, very down on on meta. And like you were saying, simply because Mark Zuckerberg had decided to try to go in a different direction than spend a lot of the money that they had to try to, in essence, build a new business. And time will tell if that actually bears any fruit.

But it's certainly you turned everybody very bearish on the company and caused, I think I remember at one point, it was trading around a 12, or 14 pe, which is, you know, prime value investing territory, you see something like that, especially a tech company with those kinds of margins, and cash flow generation, that's kind of crazy, I think, you know, companies, I think will go through different periods or seasons. And depending on, depending on what it is that you're doing, you're going to see different kinds of contraction over a period of time.

And and I'm thinking about some of the more, I guess, mature businesses, one of the ones that I think that kind of springs to mind right now is is Texas Instruments, where they are going through a bit of a contraction on their multiple right now, because people are nervous, because they've been spending a lot of money to try to build out the capacity. And people that don't necessarily know that much about the business, just see, hey, you know, free cash flows down, and they just look at a superficial level. And then they think, Okay, this is this company's going in the wrong direction, they don't understand the context of what it is that's going on, and why that free cash flow has dropped. And it's dropped, because they're reinvesting in the business. And it's going to help them in the long run.

But in the meantime, that's caused the stock price to kind of pull back. And it's caused the multiples to pull back from where they were a couple of years ago, before they started on this enterprise. So that's one of the companies that it's not a fast grower, like Microsoft is, for example. But it's a solid company that's done really, really well and will continue to do really well. But it's just going through a Thiessen, if you will, that causes the multiple to contract. And it could be an opportunity for people that know the business well, to reinvest in a more discovery, I do own the company. So just an FYI. But that's one of the things that I've seen, you know, over the last couple years is maybe some more mature companies will see contractions, depending on what they're doing with their businesses, they're trying to adjust and trying to reinvest in different ways that you can seize some pullback on the price of the company. And that can cause a contraction of a multiple.

Andrew

18:34

That's a great point, I think of target. Historically, they had this expansion into Canada, and it went horribly. And then they horribly they got out of there, and then you get multiples can expand their contract because of certain business decisions that may or may not be agreed with. I think it's interesting that Texas Instruments and you see the divergence between Texas Instruments and the rest of the semiconductors and Nvidia. That's almost like Nvidia is no longer a semiconductor company, right?

Yeah. But, but that's an interesting thing, too, is certain industries do have multiple expansion and contraction as a rule of thumb, that's almost the that's par for the course these types of businesses will have multiples that fluctuate just like the market does. And maybe even more so and that's because they're more cyclical, so cyclical meaning they tend to have outsized profits during a economic boom, and they tend to really have compression during an economic bust. And so there are a lot more up and down. And you'll see those type of businesses I like to look at those and I like to look at their price to book ratio. And you can see how that expands and contracts because the earnings of very cyclical company will go all over the map depending on where you are in the economic cycle.

But for are a cyclical you can still use like price to book or even price to sales. And that's a much more steady, maybe not price to sales because their sales can also jump but price to book can be a great way to see just how much the market thinks that that industry is going to go through. Like he likes to say they've the struggle bus or how much that industry has a bright future ahead. And counter intuitively, you probably want to go against what the common consensus is about an industry's future be able to buy low and sell high on those types of businesses.

So again, that's where the cyclical type of businesses that have huge swings and profits with the economy that can include semiconductors that can include some of the infrastructure names like Cummins, like I mentioned earlier, can include businesses like that can include raw materials, companies, all of those can swing a lot and margin expansion and contraction is par for the course. And that's not the same as the rest of the conversation we've had up to

Dave

21:00

this point. Yeah, yeah, that's very true. That's an interesting observation about semiconductor, it seems like India has kind of become its own separate entity, kind of apart from all the other ones. And it's interesting,

and I love the idea behind price to book I'd never thought about that was was cyclical companies. I think that's, that's a fascinating idea. Because, you know, kind of like you were saying, the book value of the company is not going to fluctuate as much as revenue may or the earnings being, and it's going to be a lot more stable. One would hope. And so that would probably, I had never heard that before. It's that's an interesting idea. Especially when I think of some cyclical industries as being more tech focused, and you kind of tend to ignore price to book when you're thinking of more some more tech, heavy or tech, forward kind of industry. So that's, I think that's a really good idea. I kind of like that

Andrew

21:53

A should have run the numbers behind it, you'll I've done it with a lot of different companies, you'll see like, buying at a low price, the book actually does work for these makes sense?

Dave

22:02

Yeah, it does make a lot of sense. That's kind of a brilliant insight. I guess the last thing for me guess the last kind of question that always kind of pops into my head when I think about this is what are the dangers of trying to play the multiple expansion slash contraction game? Hmm.

Andrew

22:20

Yeah, that's a very good, very, very good question. Because I think if you want to be a conservative investor, if you want to have a margin of safety emphasis on the safety, if you want to reduce the amount of times you lose money, you should be assuming that a company's not going to have a multiple expansion and still be okay with the price you're paying. So to give an example, if you're buying a stock at a P E of 35, when it usually trades at a P E of 25. But you think that the multiples gonna stick around that 35 forever. And if you don't, you're wrong.

That could be a money losing endeavor, because multiple expansion does happen. And it is nice, but it's not normal, it needs to have to be sustainable, it needs to have some big breakthrough that happens, like a new business segment, or, you know, Rush investment dollars in an industry that's completely revitalized it, or some new innovation that takes an industry to the next level, these things are unpredictable. So you don't want to build an investment strategy around them, because you can't count on it. So if you continue just buying in the hopes of margin expansion, and I'm thinking for the investors that get their hands dirty and do

valuation models, if your valuation model is anticipating a multiple expansion, that's going to be a tough way to consistently make money over the long term.

Dave

23:49

Yeah, it absolutely would. I think that's one of the dangers of I think about, I mean, video is the one that's kind of coming to my mind is one of the dangers about investing in what just recently happened with our business, because the price shot up so much, that it the expectations for that revenue growth, have to continue beyond just coming quarter, for that price to be justified. And it kind of goes back to, you know, sometimes old things are still viable.

So it goes back to this the Ben Graham idea of in the short term, the stock market is a voting machine and in the long term, it's a weighing machine. And really what that means is that you hear that you can you make a lot of money investing in something like Nvidia if you get lucky and it goes, you know, to the moon in a short period of time. Absolutely. If you want to hold the company for 1015 20 years and try to make money that way. It's going to be a lot harder because as Andrew was very astutely pointing out that multiple that 75 P e is going to come back to Earth at some point do because the company is not going to be able to continue to grow revenues as fast, it may over a few years, but not for 10 years.

And so that chances are unlikely, let me rephrase that chances are unlikely highly unlikely that it can continue that kind of revenue growth for a really long period of time, because you would hope that as they're generating that much revenue, the earnings are going to grow along with that. And which means that it would keep the same ratio. But if it doesn't, if the price starts to come back, then the P e, if the price comes back and the earnings rise, the P E comes back. And that means that you're losing money on that initial investment. And so that's where the danger of trying to play that game of getting in a hot stock and then writing it for a long time, it could be hard, it could be really hard, because the expectations are that it's going to grow, you know, it's going to grow at 74% revenue growth. I'm not saying that's the actual number.

But, you know, that's what people are expecting to pay for, you know, 400 plus dollars for Nvidia right now. And I'm not saying the NVIDIA is a bad company, or it's a bad potential investment. But you have to price matters, and you have to understand where the price is in relation to what it's worth. And how long is it going to be worth that. And that's really what it comes down to the holding period will have a huge impact on on how well you get a return on that. And, you know, as we've talked about ad nauseam, 50 million times on the show timing, the market is impossible, my crystal ball is cracked. And it's a little fuzzy right now. So I have

no idea what's going on, or what's going to happen. But that's to me, what can be the dangers of trying to play the multiple game of expansion, contraction and trying to, in essence time the market. I'm glad

Andrew

26:42

you brought that up, because that gives me the opportunity to share about even value investors fall victim to the multiple expansion thing. So to talk about target, again, I bought target I bought target before like had a multiple expansion. And then it had the whole pandemic boom, and then it really got the multiple expansion. So I added more to it because I, I believed that everything that I've done, which is now growing at a much higher rate than it ever had historically, I thought that was gonna sustain. So I looked at the stock price.

And I was like, this is cheap again. And I got burned by it, when reality set back in and they realized that the boom from the pandemic was not sustainable. So you do fall victim to that. So there's no way to avoid that completely. But if you can try to think of the other reasons why you might be wrong, then you can avoid getting stuck on the wrong side of multiple expansion and multiple contraction. And that can help your investment results, the more you can avoid some of that.

Dave

27:45

Yeah, absolutely. Again, I think those are important ideas to consider. And no matter who we are, we can fall victim to these biases in our emotions. And it's important to try to have there's really no way to avoid our emotions. Unfortunately, some of the things that maybe you can do to try to try to help you avoid some of that are writing down your thesis, why am I buying this company and doing enough work to understand what drives the growth of the business? Having a checklist can be super, super helpful, because then you can check. You can literally just go to your spreadsheet or a piece of paper and say yep, yep, yep, no, no, no, no, no. And you know, those, those kinds of things can help avoid some of those things.

But you know, we're all human, we all make mistakes. And there's no perfect investor, even Warren Buffett has made many, many, many mistakes. And it's, it's part of the game is you make poor choices, and you just have to learn from them. And that's hopefully what we can help you guys avoid is learning from our mistakes. And the things that we have done wrong, because lord knows I've made a few too. So it's this part of the game. All right. So with that, I will go ahead and get off my soapbox, and we'll go ahead and wrap up the show for today.

Hope everybody enjoyed the show. Don't forget to subscribe to the show on your preferred podcast app if you enjoyed our little show. If you would kindly consider giving us a review. It greatly helps the show. And don't forget to browse the incredible materials we've created for you at E investing for beginners.com. Last week, continue growing your knowledge as an investing for beginners insider with insights and educational tips delivered right to your inbox for free. Sign up today. And with that, we'll go ahead and sign us off you guys go out there and invest with a margin of safety emphasis on the safety. Have a great week and we'll talk to you all next week.

We hope you enjoyed this content. Seven steps to understanding the stock market shows you precisely how to break down the numbers in an engaging and readable way with real-life examples. Get access today@stockmarketpdf.com until next time have a prosperous day. The information contained just for general information and educational purposes. Only it is not intended as a substitute for legal, commercial, and or financial advice from a licensed professional review, our full disclaimer@einvestingforbeginners.com.