IFB368: The Role of Stock-Based Compensation in Company Valuation

Alright folks, welcome to Investing for Beginners podcast. Today we have episode 368. We got 1 great question from Steven that we're going to answer. But before we do that, we're gonna kind of weigh a little groundwork to lead up to the question. So what we're going to talk about today has to do with valuation.

00:00:50 Dave

And stock based compensation. But before we get to stock based compensation or the dessert, we're gonna talk about a little bit of veggies and hopefully some protein and maybe a starch. So with that let's let's dive into valuation maybe from a a 30,000 foot overview what is it and why is it?

00:01:09 Dave

Important.

00:01:11 Andrew

Basically the very very basics is when we buy shares of a stock, we're buying part ownership in the business. So we're not trading little pieces of paper and gambling. This is part ownership stake in the business and so.

00:01:27 Andrew

Every business, in theory has a a value. It has a a particular worth.

00:01:33 Andrew

And So what that what any business is worth is what valuation is trying to describe. And so if we know what the business is worth, we can know whether buying a piece of a business is fair or a good price or not and that can help determine.

00:01:51 Andrew

How much return you make on the stock?

00:01:55 Andrew

When you buy and sell.

00:01:58 Andrew

How do you kind of look at valuation and what helps you think about valuation when?

00:02:03 Dave

Well, when you're buying, I think it's critically important and.

00:02:05 Andrew
Stock.
00:02:09 Dave
The price that we pay matters a lot, and I think we need to be cognizant of that and I try to think of it like you would buy anything else, whether it's a car or a house, a guitar, you're always trying to find the best price you can for that particular.
00:02:30 Dave
Asset.
00:02:31 Dave
And the same applies to buying companies. You're, as you said, we're buying a piece of that company. We're unfortunately not wealthy enough to buy the whole company, but we can buy a piece of that company and when we buy that piece of company part of the way that we get a good return on our investment.
00:02:51 Dave
Is the growth in the value of that asset or that our piece of the pie?
00:02:56 Dave
Right. And so the better price that you pay the longer you hold the company, the better chance you have of having a better return and that's what we all want and you know, going back to Warren Buffett as always, he likes to say that he likes to buy his stocks.
00:03:16 Dave
The same way he likes to buy his socks when they're on sale, and I think I think that really just kind of says it all when you're thinking about valuation and and when and how do you buy a company that's I guess how I try.
00:03:30 Dave
To look at it.
00:03:31 Andrew
That's great. Yeah, that's awesome. Nice quote. Yes.
00:03:35 Speaker 1
Right.
00:03:36 Andrew
So how do you do valuation? What? Who sets the rules and and?
00:03:40 Andrew
How is it done?
00:03:42 Dave
Well, as far concerned Michael Bobson and Professor Oswald the motor and set the rules and we just have to live in their world and follow them. I'm kind of kidding. Sort of. There's a myriad of ways that you can go about valuing a company.
00:03:58 Dave
The most common in not only in the layman's terms, but also in professional investors is using things of that nature will are great shortcuts to value companies, and then the other ways, the ones that you and I like are discounted cash flow models and those are.
00:04:18 Dave
Ways that you can kind of.
00:04:20 Dave
Used to project what the future cash flows are going to be and then discount them back to the future or to the present. And then that's how you can kind of try to figure out the value. It sounds a lot like

voodoo. It's not. There's not a lot of inputs that you need and they can be very helpful, especially for different.
00:04:40 Dave
You know, for certain kinds of businesses, they can be probably the best way to to value them.
00:04:46 Andrew
Yeah, totally.
00:04:49 Dave
So what are your thoughts on valuation? Like, how do you think about how do you value a company?
00:04:57 Andrew
Yeah, there's two separate approaches. There's the free cash flow to the firm and the free cash flow to the equity ones. Looking at the income statement and balance sheet and the other ones looking at the cash flow statement. So I I've gravitated towards the free cash flow to the equity model, which looks at the cash flow statement.
00:05:17 Andrew
And have been using that for over 4 years and so feel that I've gotten pretty familiar with.
00:05:24 Andrew
What makes that model tick where? Where are its flaws? Where are its advantages and how can I use that?
00:05:33 Dave
For myself to make myself a better investor. So for me that's been a helpful model to learn. Yeah, it's a great one. I have veered more towards the free cash flow to the firm model, which as you said, focuses more on the income statement and the balance sheet and that is the one that I have chosen to use. But I have different models.
00:05:53 Dave
For different kinds of businesses. And so it maybe is not as.
00:05:58 Dave
Useful in all situations, and that's something you have to keep in mind when you're using these tools is their tools, and you can't use them for it's not going to fit for every single thing. It's not like the man with a hammer going around looking for every every nail so they can # something. I like the free cash flow of the firm model because it really.
00:06:20 Dave
It really boils down to the operational efficiency of the company and the revenue growth of the business and how well they invest. And so those kind of to me are three of the main areas that I try to analyze when I'm looking at a comp.
00:06:33 Dave
Money, and I think a big reason why I do that is because I use those models to value the company and so it makes sense to try to think deeply about the inputs that are going to go into the model so.
00:06:48 Dave
Maybe you could help educate me a little bit on the free cash flow to equity because I'm not as familiar with it. So could you kind of lay out what is the the basic structure of how that model works and what would be some of the main inputs you would need to know?
00:07:07 Andrew
The inputs are pretty simple. You have a free cash flow per share input. You have a growth rate of that free cash flow per share. Then you have the discount rate that you're.
00:07:18 Andrew
Discounting it by.

00:07:20 Andrew
So.
00:07:22 Andrew
I guess where I start to veer off course and get fancy is I I like to play with the free cash flow.
00:07:30 Andrew
Number as my input, but I believe strongly that that's a very important thing to do if you're going to do a model like this. I know Donna Doran off and on also mentions you got the normalized working capital and things like that. So what you will see in the cash flow statement is depending on what year you're looking at.
00:07:50 Andrew
There might be a lot more variation in the numbers just because of the way cash might happen to go in and out of the business in any given.
00:07:58 Andrew
There. And so I do try to normalize every number that goes into that free cash flow because because the free cash flow formula is simple, it's cash from operations, subtract capital expenditures and that's your free cash flow. But all the other parts that make up that cash from operations.
00:08:18 Andrew
Need to be adjusted so if there's.
00:08:21 Andrew
An inflowing cash from deferred taxes that they were supposed to pay taxes on two years ago, and they finally paid it. And so we have an outflow or an inflow of cash that's not going to happen next year probably or the next 10 years. So you have to adjust the free cash phone number for that.
00:08:38
M.
00:08:39 Andrew
That's what I do, and that's a big piece. I I think I find some decent value in that where for example, Costco is a good.
00:08:46 Andrew
Example of this.
00:08:48 Andrew
They their model generates.
00:08:51 Andrew
Cash flow. So if you're looking at a company like Nike, they have to put money out to buy shoes inventory in order to grow. So if they want to sell more shoes than they did last year, they have to buy more shoes. That's working capital cash that comes out less free cash flow for shareholders.
00:09:11 Andrew
Costco has it flipped because they sell things so fast, their vendors actually give them.
00:09:18 Andrew
The inventory and they actually sell the inventory faster than the vendor and they have to pay their vendors. So that's free cash flow available to shareholders. And so when I run a model on something like Costco with the positive working capital.
00:09:34 Andrew
I I tend to get a lower valuation than other models might suggest.
00:09:39 Andrew

Because it's looking at those cash flows. So that's just one example, but it's also led me astray. I I adjusted free cash flow for target back in 2021 because I assumed all their investments and inventory.

00:09:54 Andrew

Would balance out and that those would be good investments. They were not and the stock got killed and I took a beating on that one. So you do have to be careful on the adjustments, but you can also find value if you make intelligent adjustments. I guess where the PE ratio might look higher but.

00:10:12 Andrew

Looking at the free cash flow or the cash flow statement shows you that, hey, there might be something else going on here.

00:10:20 Andrew

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00:10:31 Dave

So this might be a dumb question, but when you're using that kind of model, you're not looking at the income statement.

00:10:39 Dave

As far as it impacting your inputs for the model, how do you think about? Like how do you correlate?

00:10:47 Dave

Revenue growth maybe you know profitability as far as margins go, how do you I guess correlate those to the model? Like how does that have any impact on what you think about the company because the free cash flow obviously doesn't exist if the company isn't generating revenue and is profitable. But by the same token, it doesn't really.

00:11:08 Dave

Impact the valuation. And so I guess I'm I'm curious how you think about that?

00:11:14 Andrew

That's a fantastic question and a perfect segue, so.

00:11:20 Andrew

The the next input is growth rate. So just the way my spreadsheets kind of laid out, I have revenue growth over last 10 years operating margins over the last 10 years. And I just want to see it visually and then I'm taking what I see in the income.

00:11:39 Andrew

Limit what I see from return on invested capital or Roc. Anything I see in the balance sheet and then putting all those together to make a growth rate.

00:11:50 Andrew

Number and so some of the, I don't know if shortcuts is the right way to do it, but some of the base assumptions I make which make that process a lot easier is I'm assuming margins stay the same for a 10 year period.

00:12:08 Andrew

So they can improve and they have improved obviously by stocks where the margins improve. I don't want to bet on it. I want that to be icing on the cake.

00:12:18 Andrew

Well, sometimes I make an exception, but let's just say for the majority of cases, OK, I'll pay margin. We're assuming is going to be the same. The other thing is I'm.

00:12:28 Andrew

Again, 9090% of the time I'm looking at ROC's higher than, let's say, 15% or 10%, so that weeds out a lot of the companies that.
00:12:40 Andrew
You don't realize they're actually not that valuable until you run a free cash flow of the firm model.
00:12:47 Andrew
Look at the way they reinvest. You're like.
00:12:49 Andrew
Oh my goodness, this is.
00:12:51 Andrew
They're this is not sustainable like they're growing and they're burning cash and it's just not going to end well by not even putting those companies in the basket. I eliminate a lot of that, which would potentially chip me up if I wasn't because the model is not thinking about.
00:13:09
It basically.
00:13:10 Andrew
So those are the two of the big assumptions or shortcuts or filters that I'm using that is not freak out for the equity necessarily branded. But there's an Andrew brand that in my opinion helps me.
00:13:24 Dave
Mitigate some of the downsides of focusing so much on free cash flow and trying to come up with a growth rate without getting too nitty gritty into reinvestments. Does the growth rate that you are looking at does that correlate with revenue growth rate or free cash flow growth rate?
00:13:44 Andrew
The growth rate for the model is based on free cash flow.
00:13:48 Andrew
So for me I'm I'm basically I take a revenue growth rate. Any additional growth from buybacks?
00:13:55 Andrew
And that's it, because I'm assuming a flat margin all the way through.
00:14:00 Dave
OK, alright. That makes sense again as a more of a novice with this kind of model, how do you measure any sort of reinvestment?
00:14:11 Andrew
Yeah, that's another good question. So.
00:14:14 Andrew
Part of it is.
00:14:16 Andrew
Baked into the free cash flow side of it. So the when I normalize working capital, I try to look at historically how much has a company has this company needed in working capital to grow. So again, to steal from Domador, professor Donna Doran, if historically a company is needed 4%.
00:14:37 Andrew
Of working capital over a 10 year period to grow. Then I'm gonna model out.
00:14:45 Andrew
That or particular growth rate and so?
00:14:49 Andrew
I probably don't talk about this enough in the write ups, but if you look.
00:14:52 Andrew
Closely.

00:14:53 Andrew
Enough. You would see it, but.
00:14:55 Andrew
If there's a higher growth rate than I'm estimating, then I'm putting a lower free cash flow in the model. So when I have a range of two different growth rates and two different free cash flow numbers, that's why you see the differences. So you know you can't have your cake and eat it too. Either you have more free cash flow or shareholders because you're accepting lower.
00:15:16 Andrew
Growth or you need to reinvest that. And so if I'm assuming a higher growth?
00:15:22 Andrew
Rate on the revenues or the free cash flow, then the free cash flow?
00:15:29 Andrew
Number input is going to be lower to account for that.
00:15:32
OK.
00:15:33 Dave
That makes sense. That makes sense. And I think that's pretty smart. So you mentioned buybacks, that's not something I play with much. So what are your thoughts on that and how it impacts your model?
00:15:48 Andrew
It can impact my model quite a bit, and it probably makes me lean more towards companies that buy back than than not and so.
00:15:59
MHM.
00:16:03 Andrew
In the model I've this is where return on domestic capital comes in. I have it baked in where it shows me a general estimate of.
00:16:12 Andrew
How much cash is leftover for shareholders after they do the reinvestments and then we're going to assume that?
00:16:20 Andrew
That could be used for buybacks, not that that's going to be, but that it it it's available.
00:16:26 Andrew
And then that can help increase the growth rate of whatever I'm whatever I'm looking.
00:16:32 Andrew
At OK this.
00:16:34 Andrew
The basics of it I try to not let it.
00:16:36 Andrew
Get too high.
00:16:38 Andrew
I won't.
00:16:38 Andrew
I won't say like, oh, yeah, 6% growth a year per from buybacks, that's that would be pretty insane. It happens. But yeah, we're not going to.
00:16:47 Andrew

Plan for it.

00:16:48 Andrew

And so, but giving that wiggle room helps me find like a Dick's Sporting Goods, for example, where the revenue growth.

00:16:57 Andrew

If you think about OK, they have a lot of stores, maybe it's saturated, maybe the revenue growth is not as high as it used to be.

00:17:04 Andrew

So a lot of people will value that lower, but because I'm they have a high ROI C and I'm seeing a lot of free cash flow available. And if they don't want to grow revenues, they can just buy back shares then that's where my valuation model can sometimes be higher than somebody.

00:17:21 Andrew

Else's.

00:17:23 Speaker 5

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00:17:53 Dave

Yeah, yeah, that makes sense.

00:17:55 Dave

All right. OK. So now that we've kind of, I feel like, wade, the groundwork for DCF models and and especially how you use the free cash flow to equity, let's talk about the questions. So the question was how do you deal with stock based compensation in your DCF? Do you project free cash flow margin?

00:18:15 Dave

Expansion or use the current free cash flow margin. So this is a great question from.

00:18:20 Dave

Steven, so maybe.

00:18:21 Dave

Before we dive into that, what when he's talking about stock stock based compensation, what does? What is he referring?

00:18:29 Andrew

Yes, there is a line item on the cash flow statement that's called stock based compensation and.

00:18:37 Andrew

And I don't know how to not get into the.

00:18:39 Andrew

Nitty gritty on this.

00:18:41 Andrew

Like, how would you describe all the income statement? Like help me out here.

00:18:46 Dave

The way I think about it is it's an expense that the company uses to.

00:18:54 Dave

Motivate and pay and incentivize their employees.

00:18:59 Andrew
Hmm.
00:19:00 Dave
And what they're doing is they're giving them, depending on how it's structured, shares of the company for a certain price, sometimes it's something they have to earn. Sometimes it's the opportunity to go buy it in the market at that price, it just kind of depends on how each company sets it up. But generally it's it's a they consider.
00:19:19 Dave
Take your quote non cash expense because it's not necessarily money you're paying out right away, but it's money that the company will owe to the employee at some point.
00:19:31 Dave
And so that's that's how I look at it.
00:19:34 Andrew
Yeah. And to that point, that's a great explanation. Thank you for keeping it English.
00:19:40 Dave
You're welcome.
00:19:43 Andrew
A lot of them will quote UN quote pay for it at the end by buying back shares later to offset it. And so even though a company might not be a buyback type of company, a lot of them will still buy back enough so that.
00:19:59 Andrew
They're they're making up for that without diluting everybody else.
00:20:02 Dave
Right. Couple things to keep in mind when you're thinking about stock based compensation and it's impact on the financials #1 is it includes.
00:20:14 Dave
All the.
00:20:16 Dave
You know, peasant employees, if you will. So it includes basically everybody, but it also includes management in that. So that's that's all wrapped up into that. And then the other part of it like Andrew was saying is that companies will.
00:20:32 Dave
Put that on their books as money they owe. But then they try to offset the impact of us as investors by buying back shares and what they're really trying to do is offset the dilution. So when they give, when they give stock based compensation to anybody and they exercise their right to.
00:20:52 Dave
Own those shares now the the piece of the pie has gone from 10 pieces to 11 pieces, which means that all of us get less of the company, and so the companies know this. And so the way they try to offset.
00:21:06 Dave
For shareholders is by buying back shares. So even though they gave Andrew an extra share, they buy back another share. And so instead of it being 11, it's still 10. And so instead of going down to 9, it's still at 10. So it stays even and probably the best example of this if you want to see this kind of play out on in a financial statements.
00:21:17 Andrew
Yes.

00:21:27 Dave
Is go to Metas financial statements because they spend a lot of money buying back shares, billions, buying back shares, but they also offer a lot of stock based compensation. And so it really just for the most part just offsets each other. Google is guilty of this.
00:21:43 Dave
As well, it's very prevalent in the hex space. You're not gonna find this on Berkshire Hathaway's statements. You're also not gonna find much of this on like.
00:21:53 Dave
A Costco or.
00:21:55 Dave
You know, on a Riley or something like that. So it's more in the faster growing sector, if you will, tech anything related AI.
00:22:04 Dave
Bio, biochemistry, biotech. You know, those kinds of things. You'll see a lot of that, but like the boring, boring manufacturing companies. Nah, not so much.
00:22:13 Andrew
Yep, that's good clarification.
00:22:16 Dave
All right, so how how?
00:22:18 Dave
Do you deal? So now that we've kind of laid the groundwork on SPC or stock based compensation, how do you deal with it in your?
00:22:25 Dave
DC's.
00:22:27 Andrew
Yeah, I mean, you certainly do want to deal with it because.
00:22:31 Andrew
Like you said, I mean, they're going to have to pay for it. The cash flow statements, weird.
00:22:37 Andrew
It's interesting because it has three sections, and so yes, technically, if you're going by the book.
00:22:47 Andrew
The stock based compensation is not being paid, quote UN quote from the operations.
00:22:54 Andrew
But like they've said, they're going to pay for it from financing activities, which is an another part of the cash flow statement. So if you're really thinking about it logically as a rational investor.
00:23:09 Andrew
When a company creates free cash flow, how much is available to me as a shareholder that they could potentially give back to me or reinvest in the business to grow themselves?
00:23:21 Andrew
If there's money, if there's a bunch of money that has to.
00:23:23 Andrew
Go.
00:23:23 Andrew
To the to the buybacks, just to for us to break even on on the dilution, that's realistically not money that was ever going to go to the business. Sure the number is in the cash flow statement. I'm getting a little bit riled up because it it blows my mind how much people want to argue about this.

00:23:41 Andrew
On Twitter.
00:23:42 Andrew
Yeah, technically.
00:23:45 Andrew
The numbers on on on the cash flow statement, but they're gonna have to pay. Otherwise you're gonna see that pie go from 10:50 to 20 to 30 to 50 and, oh, by the way, do you know what that does?
00:23:57 Andrew
To your stock.
00:23:57 Andrew
Price you can look at square or.
00:24:00 Andrew
Block.
00:24:01 Andrew
As an example of of what can happen your stock price so.
00:24:01
Yeah.
00:24:06 Andrew
That definitely needs to be accounted for. The way I try to do I try to.
00:24:11 Andrew
Keep.
00:24:11 Andrew
It simple, I looked at the S&P 500 took just like a big picture average.
00:24:18 Andrew
Most of them are somewhere around 4% of cash from operations is stock based compensation. So if a company like all.
00:24:26 Andrew
That is higher than that. Let's say 20% of their cash from operations is stock based compensation. So the 4%, that's 16%. I'm just saying, Nope, that's not free cash flow that doesn't get to go into my model. And I just do that with.
00:24:41 Andrew
Every.
00:24:41 Andrew
Company. And so that, yeah, it's conservative. Yeah, it's pessimistic.
00:24:46 Andrew
But I also think it gets me out of a lot of potential dilution trouble or a lot of situations where.
00:24:52 Andrew
There.
00:24:52 Andrew
Like wow, this company is so profitable. But how come the shareholders never get anything? Well, you know, like deeper the.
00:24:58 Andrew
Cash will save it so.
00:24:59
Right.
00:25:00 Dave

That that's how I deal with it. How about you? I mean, you got your your model as well. How do you look? Yeah. There's two basic ways. There's the easy way. And then there's a super complicated way. The easy button method is.
00:25:12 Dave
I subtract it from the free cash flow so when I'm calculating free cash flow like you said earlier.
00:25:19 Dave
Take operating cash flow. You subtract capital expenditures from that. I also subtract stock based compensation from that. So I just because what's happening is on the income statement, it's expensed out as it's considered an expense. But on the cash flow statement, because that's the actual money going in and out it and the money.
00:25:39 Dave
Isn't spent, then they add it back as a non cash item on the cash flow statement so it boosts artificially boosts the cash flow of a company.
00:25:50 Dave
And this is maybe not quite as evident as some of the examples we were showing, but sometimes you can look at some very unprofitable companies and then they're bragging about being cash flow positive. And you look at their cash flow statement and you see that, yeah, they're generating, you know, 10 billion in in free.
00:26:10 Dave
Cash flow and 9 of it is stock based compensation, OK, yeah. Oh, sure. You bet. You you're. Yeah. So the easiest way I can explain this is, is that that is money that you don't own. And if you go and spend it and then you don't have it, because when somebody comes asking.
00:26:29 Dave
For their, you know, to redeem their stock based compensation and you don't have it now, you owe them money. And so it's not your money to spend. So it's not. That's my argument that it's not cash flow. Yeah, you can set it aside all you want, but if you put it in the cash flow statement, it's not actually cash. It's you. And I can't go spend it.
00:26:50 Dave
Because it's not our money and that's how I try to compensate for it.
00:26:55 Dave
The other way that you can do it and it it I feel like that's pretty easy and it just it knocks out a lot of the problems of dealing with it. It's just OK we're done. It's it's not, it's not cash. I'm taking it out. It's an expense and just.
00:27:08 Dave
Call it that.
00:27:09 Dave
I guess there's another way I was thinking about the other way you could do it is and this is a little more a little more convoluted.
00:27:15 Dave
And I haven't done it yet, but I read a paper that Michael Moleson.
00:27:20 Dave
Wrote and he talked about basically reconfiguring the cash flow statement and putting items light items in the sections. He thought it really should go in. And so one of the ways that he would do that is he would move stock based compensation from the operations of the business to the financing of the business.
00:27:40 Dave

And that and then he would move something from the financing. I think it was capital expenditures you would move that back actually to the operations of the business. And he said that made those adjustments make more sense.
00:27:51 Dave
Hence, that's one way you could go about doing it. And the third way is I'm not gonna go into the nitty gritty cuz that's way too much math and I don't wanna put people to sleep. But professor the motor and has this great black Scholes model that he uses to calculate the value of the stock based compensation. And then after you do all the.
00:28:12 Dave
All the voodoo to figure out what the enterprise value of the company is. Then you just subtract that amount from the enterprise value and you divide it by your shares and well, you gotta you gotta stock price. But that's a way you could do that as well. And he has that built into his.
00:28:27 Dave
You know his free models that you can download from his website and that's one way to do it, but it's a little more convoluted, though that's kind of how I try to approach it. I'm curious what I've heard. Some people say this and I wonder what your thoughts are. Some people have argued, I've seen them argue that some companies will list BASIC shares.
00:28:47 Dave
And then diluted shares?
00:28:49 Dave
Standing on the income statement.
00:28:52 Dave
Do you think that is a way that you could maybe account for stock based compensation when you're going to value a company?
00:29:00 Andrew
Yeah, potentially. I mean, I've just since the beginning always defaulted to diluted shares outstanding.
00:29:09 Andrew
Because that's assuming that a lot that the the stock options get exercise right? So I think a lot of.
00:29:16 Andrew
Financial websites kind of default to that, so hopefully most people are using diluted instead of basic. But people are funny, you know, they'll do whatever they can to make the numbers look nice to them, right?
00:29:31 Dave
Yes, yes they will. You can several things about a DCF that you.
00:29:35 Dave
Have to keep in mind.
00:29:36 Dave
Number one.
00:29:38 Dave
They're all estimates other than some of the factual numbers that you can plug in from the statements when you're when you're thinking about a growth rate, whether it's for revenue or for free cash flow, it's an estimate. You have no idea what's going to happen next year or ten years from now, it's their estimates arguing about different rates.
00:29:58 Dave
And whatnot. I think kind of misses the point of what?

00:30:02 Dave
DCFS can offer you and what they really, really offer you other than the ability to try to estimate a price is the operating, the ability to think very deeply about company and why those inputs matter. And if you don't understand, if you don't understand the operations of the business, there's zero chance you're going to understand this working capital.
00:30:23 Dave
Needs. You know, Andrew was talking about Costco and inventory and shoes and turnover. If you don't understand those things about Costco, all that stuff's gonna go flying by you. And so that's where.
00:30:36 Dave
The DCF really offers you the opportunity to do some due diligence and deep work on why this company is a great investment and why it's not and it goes, it goes way beyond just plugging numbers in and and spitting out a result because again, going back to Costco, if you don't understand.
00:30:57 Dave
The cash conversion cycle of the company, in other words how quickly they can turn the money over that they are receiving.
00:31:04 Dave
Come the customer to pay their vendors. That's one of the things that sets them apart from other big box stores is like Andrew said, most most vendors will give them 30, maybe 60 days to pay the bill or buying those shoes. And if Costco can turn those shoes faster and sell them in 30 days.
00:31:26 Dave
Or 20 days then. That means those ten extra days of cash that they can use for something else, and so that just makes them that much more profitable. And that's to me, that's what a DCF allows you to do is to it helps you understand all those things.
00:31:42 Andrew
Oh, yeah, totally. I mean that and even more like you can read about riding a bike. You can watch videos about riding a bike. There's nothing like getting down there and trying to ride a bike yourself. That's the same with the financial statements I feel.
00:31:59 Andrew
Like.
00:32:00 Andrew
You can look at the numbers, but until you actually.
00:32:02 Andrew
Start plugging them in. You might not fully comprehend what's going on.
00:32:07 Dave
Right, right. Exactly. Yeah, exactly and.
00:32:11 Dave
You know, kind of going back to the stock based compensation quickly.
00:32:15 Dave
Depending on the company, it can make a big impact on the value of the company. If you don't account for it and if you don't account for it. If you choose to just ignore it, especially for some of these very big tech companies, or maybe not big tech, but smaller tech companies that are growing really fast if you don't account for that, it could end up biting you in the ****.
00:32:35 Dave
So it is something you need.

00:32:36 Dave
To pay attention to.
00:32:39 Andrew
Yeah, I can't remember which SAS company I was looking at, but I I wrote about. Hey, here's a huge warning sign amount of.
00:32:49 Andrew
Stock based compensation is ridiculous. It's.
00:32:54 Andrew
They better keep growing and they better not stop, otherwise that's going to catch.
00:32:57 Andrew
Up with them.
00:32:58 Dave
Right. Yeah, yeah, exactly. Borrow my it is an issue and it is something you need to think about. And Andrew and I have obviously stronger opinions about our particular way to do it, but I think you you can look at both sides and and to try to decide I think our way is the best and I would.
00:33:18 Dave
Encourage you to do it that way because it builds in a margin of safety for any investment. But the bottom line is be consistent. Don't don't adopt one way for one company and another way for another company just because you wanna you know you like this kool-aid better than that. That kool-aid that's going to lead.
00:33:32 Dave
To heartache and trouble.
00:33:34 Andrew
Alright, well set.
00:33:36 Dave
All right, folks. Well, with that, we will go ahead and wrap up our conversation for today. Want to thank thanks Stephen for sending us fantastic question. If you guys have any questions you'd like us to answer, please reach out to us at newsletter at investing for beginners.com. The link is in the show notes. You can send us any questions there and we'll go ahead and answer them on the air.
00:33:55 Dave
You can also reach out to us on spot.
00:33:56 Dave
Fi The podcast app has the ability to ask US questions so we can do it that way, or you can reach out to us on socials, in particular on the X machine. So with that, we'll go ahead and sign us off. You guys go out there and invest with the margin of safety. And so it's on the safety. Have a great week.
00:34:13 Dave
And we'll talk to you on next week.

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