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FAANG Valuations:

A Mismatch of Old Metrics and New Companies

The FAANGs: A Mismatch of Old Metrics and New Companies

The group of stocks known as the FAANGs (Facebook, Apple, Amazon, Netflix, and Alphabet) have garnered significant attention from investors and market pundits. Conversations around these stocks have focused on how they characterize the "new economy," how they represent the demise of "value" investing and the superiority of "growth" investing in this new economy, and how their rich valuations on traditional metrics are indicative of massive overvaluation. What we think is getting missed in these conversations is how legacy accounting practices struggle to measure value for more modern, research and development (R&D) intensive companies.

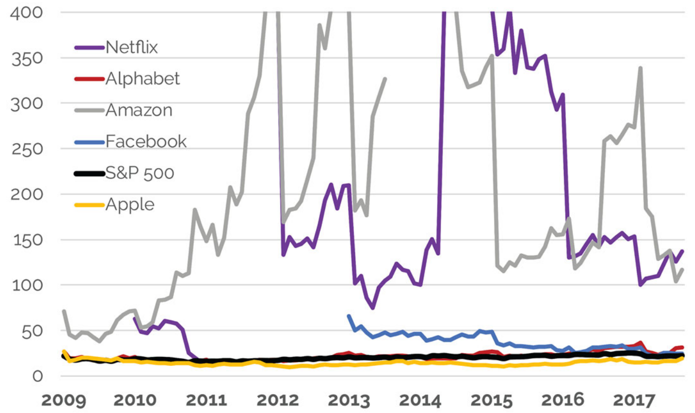
The FAANGs do represent the so-called "new economy" in that the component companies contain relatively little in the way of traditional physical assets like large factories and manufacturing plants. Instead, the FAANGs generally derive their value from more technologically-based intangible assets like patents, algorithms, software, and user interfaces—all of which were built on extensive research and development spending. The companies also benefit from network effects in which their large and entrenched customer bases allow them to continuously improve their algorithms and customer experiences to maintain their competitive advantages. These intangible assets are extremely valuable and generate tremendous cash flow. Despite this, they are generally ascribed little if any value under standard accounting rules. Consequently, traditional asset and earnings-based valuation metrics are significantly challenged for these "new economy" companies.

In our piece "Accounting for Value in a Changed Economy," we wrote extensively about how accounting rules have struggled to keep pace with the modernizing economy and why traditional valuation metrics have lost comparability as a result. We think the debate around the FAANGs offers an excellent example of this and demonstrates why an updated valuation methodology is needed.

Asset and income-based measures of valuation tend to punish asset-light "new economy" companies. A major reason for this is that such companies spend heavily on research and development which is expensed as incurred and is not counted as an asset. Companies that spend comparatively more on capital expenditures, by contrast, can look very different on an accounting basis since these expenses are capitalized as assets and then expensed slowly over time via depreciation charges. This accounting treatment means that the net income of an R&D-intensive company will be depressed relative to a company that spends more on capital expenditures. The R&D-focused company will also have significantly less in the way of accounting assets and equity value.

Because of accounting distortions, P/E ratios for the FAANGs are elevated and not comparable with the overall market P/E..

Figure 1: FAANG P/E Ratios

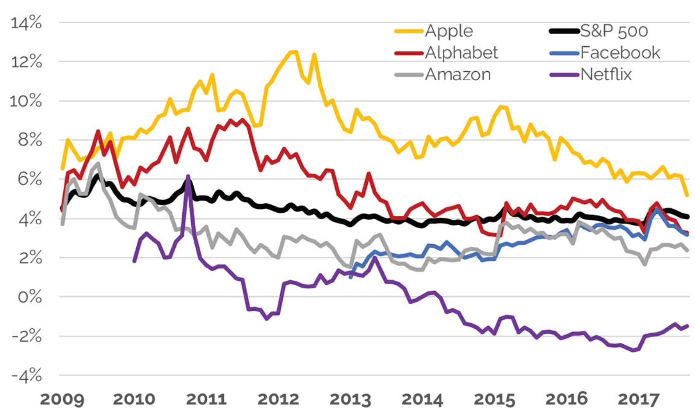


Source: FactSet, Based on consensus estimates for current

For the FAANGs, the result of this accounting difference is that measures of valuation based on price-to-book value (P/B) or price-to-earnings (P/E) ratios will not be very meaningful or comparable to more traditional companies or the market overall. A chart of the individual FAANG P/Es since the end of 2009 shows exactly this **(See Figure 1).** The P/Es of Amazon and Netflix bounce nonsensically from one extreme to another. The P/E ratios for Facebook, Apple, and Alphabet appear to make more sense, but are still distorted and not directly comparable with more traditional physical asset-based companies or the market overall.

On our metric of distilled cash yield, valuations are more meaningful and comparable with the market and other companies.

Figure 2: FAANG Valuations on Distilled Cash Yield



Source: FactSet

Despite the problems with using traditional metrics to value "new economy" companies, the financial media and much of Wall Street return time and again to P/E and P/B and generally fail to recognize the lack of comparability. Seeing the need for a better measure, Distillate Capital developed a proprietary measure that focuses on the normalized cash generating ability of any company. This metric circumvents the distortive impact of accounting policies to restore comparability between "new economy" companies focused more on R&D and "old economy" companies that invest more in physical assets.

When using this normalized cash flow-based measure of valuation to assess the FAANGs, a very different picture emerges **(See Figure 2).** The valuations for Amazon and Netflix are figures that make sense and are comparable to other companies in the market. The metrics for Apple, Alphabet, and Facebook also become more meaningful.

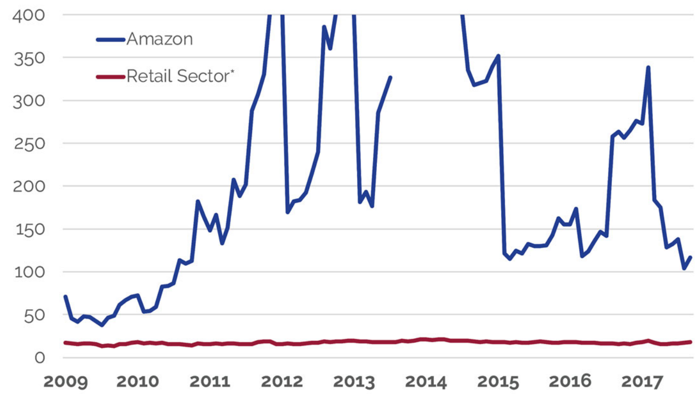
By company, Apple has historically been inexpensive and remains more attractively valued than the overall market with a higher normalized cash flow yield than the average company. Alphabet's valuation was more appealing than the overall market until only very recently. Facebook has generally been more expensive than the overall market although it was recently valued more attractively after a large sell-off in early 2018. Netflix was briefly more attractively valued than the market after a steep sell-off from over $40 to under $10 in 2011, but since then has been considerably more expensive. Lastly, Amazon offers one of the most interesting cases. Amazon was cheaper than the S&P 500 for parts of 2010, became significantly more expensive from 2012 through 2014 and then became almost as cheap as the market again in 2015 and 2016 before becoming more expensive recently.

Amazon is also of particular interest because of how it compares to the retail sector overall. The retail sector is notable in that it includes many traditional companies with brick and mortar stores and distribution centers and thus large accounting-based asset values. Amazon by contrast is the embodiment of the newer more R&D-intensive company with relatively few physical assets. Similar to its P/E compared to the overall market, the accounting treatment of Amazon's high R&D (or "Technology & Content" as the company calls it) spending and relatively smaller capital expenditures have caused its P/E to drastically exceed the average P/E for the retail sector **(See Figure 3)**. This has led many people to think of Amazon as a consistently (and extremely) expensive stock compared to the retail sector. Instead, based on our alternative valuation framework, which takes into account and adjusts for the widely used accounting conventions related to leasing activity in traditional retailers, Amazon's price is much more comparable to the retail sector overall and was even less expensive than the sector in 2010 **(See Figure 4)**.

We think the FAANGs provide an excellent example of how accounting distortions have made old metrics of valuation less meaningful for more research and development-intensive "new economy" companies. With more and more of the overall market now represented by such companies, issues of comparability are getting worse. To counteract this problem, we drew on our extensive experience as fundamental analysts to design a valuation methodology that gets around accounting problems to put all companies, whether "old economy" or "new economy," on an equal footing. Using this methodology to evaluate the FAANGs offers a more nuanced picture of valuation than is usually presented.

Amazon's P/E does not provide a useful point of comparison to the retail sector due to its relatively high level of R&D spending and comparatively smaller level of off-balance sheet lease liabilities.

Figure 3: Amazon P/E vs. the Retail Sector



*Source: FactSet, *P/E is based on consensus earnings estimates for current fiscal year and the retail sector is equal-weighted ex-Amazon earnings.*

On our valuation metric of distilled cash yield, Amazon is more comparable to the retail sector and has at times been less expensive than the sector or valued almost equally with the sector despite its strong growth profile and dominant market position.

Figure 4: Amazon's Distilled Cash Yield vs. the Retail Sector

*Source: FactSet, *Retail sector is equal-weighted ex-Amazon.*

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