

# Where the Rubber Meets the Road

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As the equity markets progress into what we see as the early stages of a new “Bull Market” following the painful 2022 “Bear Market,” we will use this commentary over the next two months to spotlight two of our widely held equity positions whose stock prices have been on a wild rollercoaster ride over the last three years.

It is commonly accepted practice to attempt to determine whether a stock is over-valued or under-valued based upon the price-earnings ratio (p/e) relative to the overall market's p/e ratio or sometimes relative to companies with a similar growth profile. Early in my asset management career, I used the p/e ratio or the related growth valuation PEG ratio to determine how attractive an equity investment was.

After working as an equity analyst for several years, arriving at a value thesis for a particular stock became more sophisticated. It shifted from an earnings-driven process to a cash-flow-driven process. As an analyst, I spent a lot of time studying the financial statements of publicly traded companies. When one looks at a company's financial statements, it becomes apparent that many companies' profits and cash flows can produce a very divergent picture of its attractiveness from a value creation standpoint.

S&P Global, the company responsible for creating indexes such as the S&P 500, published an article titled, [TalkingPoints: The S&P 500® Sector-Neutral FCF Index – Why Free Cash Flow is King](#), highlighting the importance of Free Cash Flow in analyzing an equity investment. In this article, the author stated, “FCF offers a deeper understanding into a company's financial health since it shows the amount of cash that a company receives after meeting its obligations. A company with ample FCF has the flexibility to increase shareholder value through strategic investments and acquisitions. Furthermore, FCF can be used to increase shareholder yield via cash dividends, buybacks and paying down of debt. Companies producing plenty of FCF tend to be of higher quality and may be better positioned to weather periods of market stress, as shown historically. Furthermore, in today's environment of high-interest rates, having a healthy cash flow has become particularly important since it reduces a company's reliance on debt markets to finance business operations.”

At Seven Summits Capital, we utilize various tools to quickly analyze a company's historical and forecasted financial metrics. One set of metrics we have grown to place a lot of importance on is the relationship between revenues, net profit, and free cash flow. For a company growing its revenues, regardless of whether they are profitable yet, we prefer that as revenues grow, so does free cash flow. We are increasingly getting away from emphasizing net profit metrics that many arcane accounting rules and loopholes can easily distort.

In the previously quoted S&P Global article, the authors wrote, “FCF differs from net income, which is used to calculate other popular valuation metrics such as the price-to-earnings ratio since it focuses solely on cash transactions and is thus harder to manipulate. Under generally accepted accounting principles (GAAP) and accrual accounting, management is afforded more flexibility when recording sales and expenses. While FCF can still be manipulated (albeit to a lesser degree), it measures the exact amount of excess cash generated by the company in a given period. This is important because

the capital returned via dividends or buybacks can only be funded with cash and not an accounting term such as 'net income.' "

As promised, this month we will take a look at one of two great examples of companies that are stellar free cash flow generators but have been put in the market's "penalty box" because of slowing revenue growth relative to the unusual pandemic period of 2020-21 and misleading net profits.

Although the market seems obsessed with revenue growth and earnings, free cash flow is where the rubber meets the road in the long run.

We began buying shares in Zoom Video Communications (ZOOM) at the beginning of 2024. This is a company that we have never owned in the past. Everyone has heard of the company, especially during the pandemic period that began in early 2020. The company's stock experienced a meteoric rise during that pandemic, forcing individuals to need remote work and virtual communications. Zoom's stock rose from \$76.28 on January 1, 2020, to \$478.14 by November 1, 2020. We looked at Zoom's stock during that period as a mania and stayed away. Since November 2020, Zoom's stock has fallen to the mid-\$60 level by January 1, 2024. We decided to dive deeply into the company, its financials, and value opportunity. We are value-opportunity seekers, and Zoom fits the profile of the type of situation we are attracted to.

Below is a chart of Zoom Video Communications (ZM) share price over the last five years:

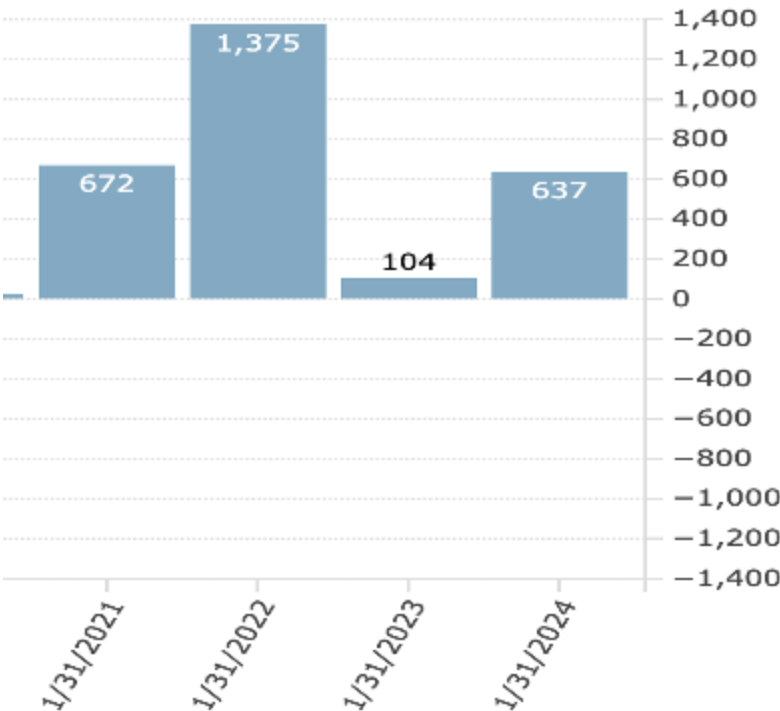


What attracted us to Zoom was not its 32x trailing twelve-month P/E ratio or its 3% revenue growth during FY2023. What attracted us was its cash flow metrics. From FINVIZ.com, Zoom has a Price/Free Cash Flow ratio of 14, has \$6.9 billion of cash on its balance sheet as of January 1, 2024, and

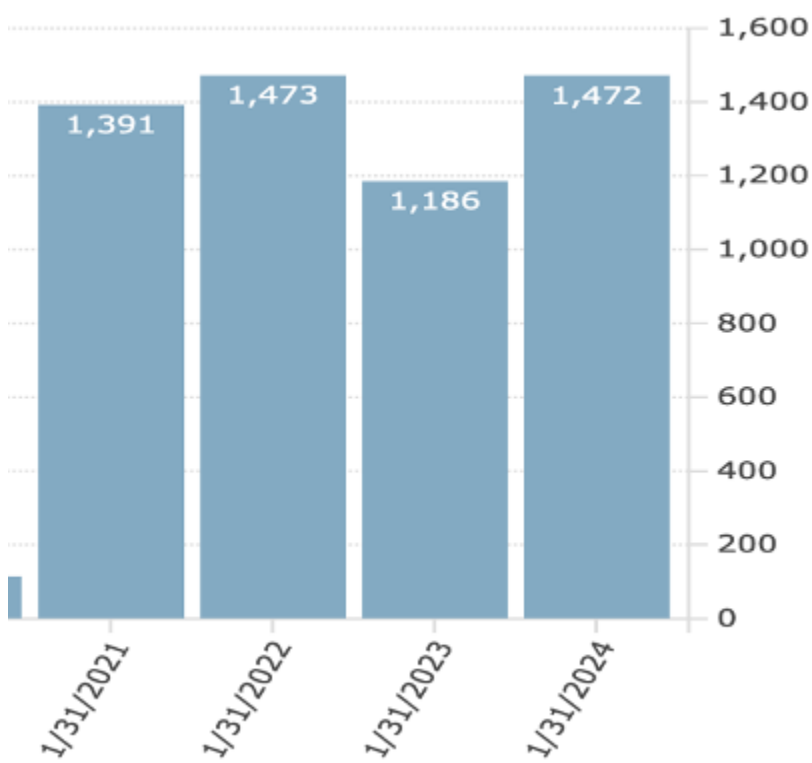
generated \$1.472 billion in Free Cash Flow during FY 2023 vs. just \$637 million in Net Profit. Based upon the stock performance of late, the market is fixated on Zoom's latest Net Profit versus the company's \$1.375 billion Net Profit that it posted in FY2022, which, in Zoom's case, with an FYE of January 31, comprised 11 months during 2021.

The two charts below show Zoom's Net Profit and Free Cash Flow. The first chart shows Zoom's net income, which we believe the market has been keying off on regarding setting a price for Zoom's stock. The second chart shows a more consistent picture of the company's financial performance. When we analyze Zoom's ability to create shareholder value, we are focused on Free Cash Flow generation.

Annual Net Income



Annual Free Cash Flow



One can see from the Free Cash Flow chart above why Zoom has accumulated nearly \$7 billion in cash on its balance sheet. The question that an investor should logically ask when a company has very strong free cash flow and holds cash worth nearly one-third of its entire market capitalization is, what will they do to make the company and its stock more valuable? Generically, a company with high cash levels can return it to shareholders through dividends or share buybacks, pay down debt, invest the cash to grow and make the existing business more competitive and productive, or acquire other companies that would be a good strategic fit. For Zoom, a debt-free company, how its cash is used is likely to be viewed very positively by investors.

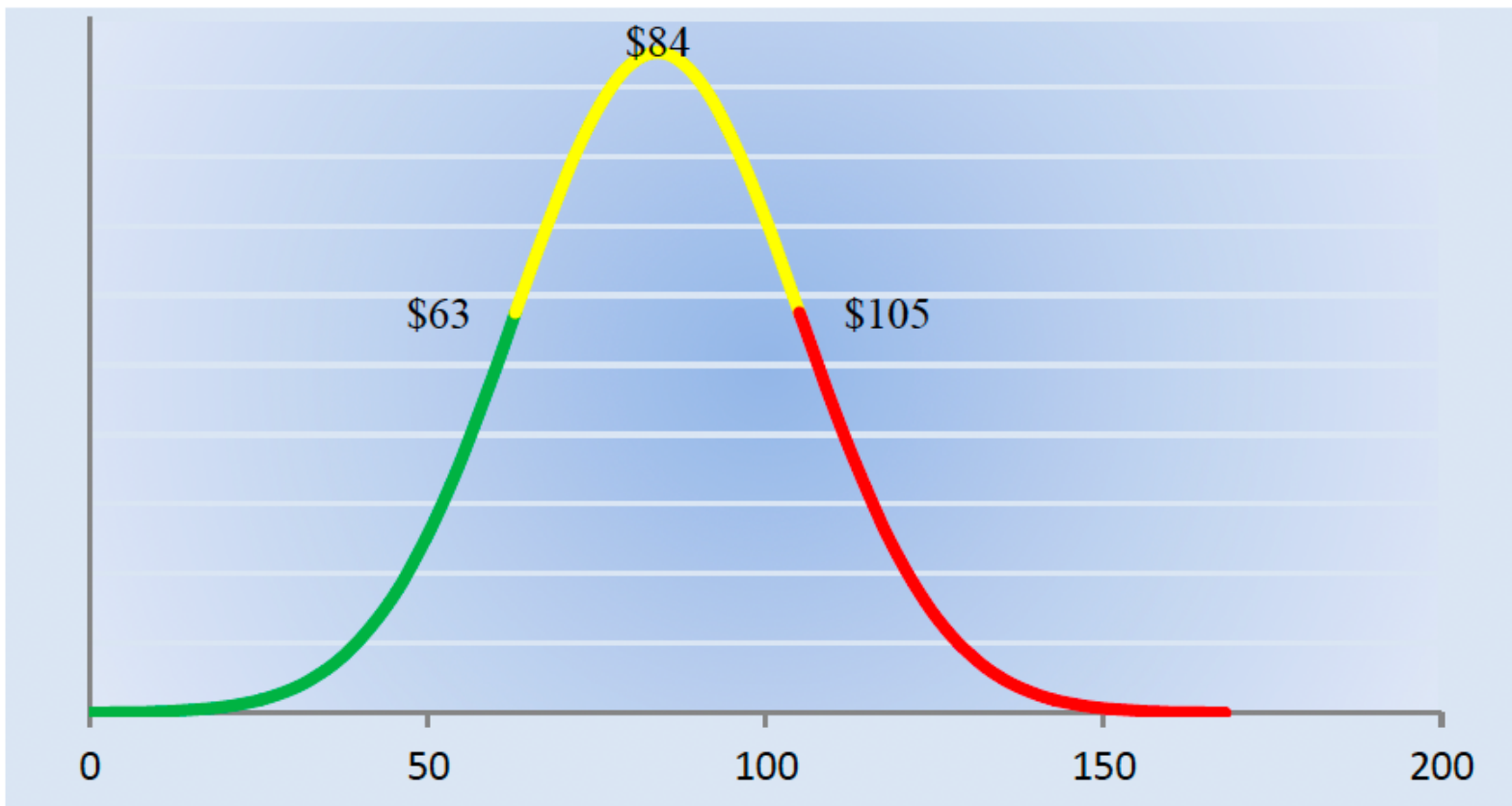
Zoom is a leader in a very competitive space, and its competition comes from the largest companies in the world, Microsoft, Cisco Systems, and Alphabet (Google). Thus, Zoom cannot let its guard down and must continue to improve its technology and client experience. So far, Zoom has fared very well in its competitive battle with its goliath competitors. According to Demandsage.com, Zoom is the clear leader in video conferencing, with 57.24% of the market compared to 24.57%, 6.29%, and 6.10% for Microsoft, Google, and Cisco Systems, respectively.

Shortly after Zoom's FY2024 earnings conference call, the company announced a \$1.5 billion stock buyback. In Barron's Up & Down Wall Street editorial section in the March 4, 2024, print editions, Ben Levison wrote about Zoom's large stock buyback, "Zoom Video Communications announced on Feb. 26 that it would buy back \$1.5 billion, or 7% of its own shares, causing the stock to leap 8% the following day. Quoting Peter Levine, the Evercore ISI analyst who follows Zoom, Ben Levison wrote,

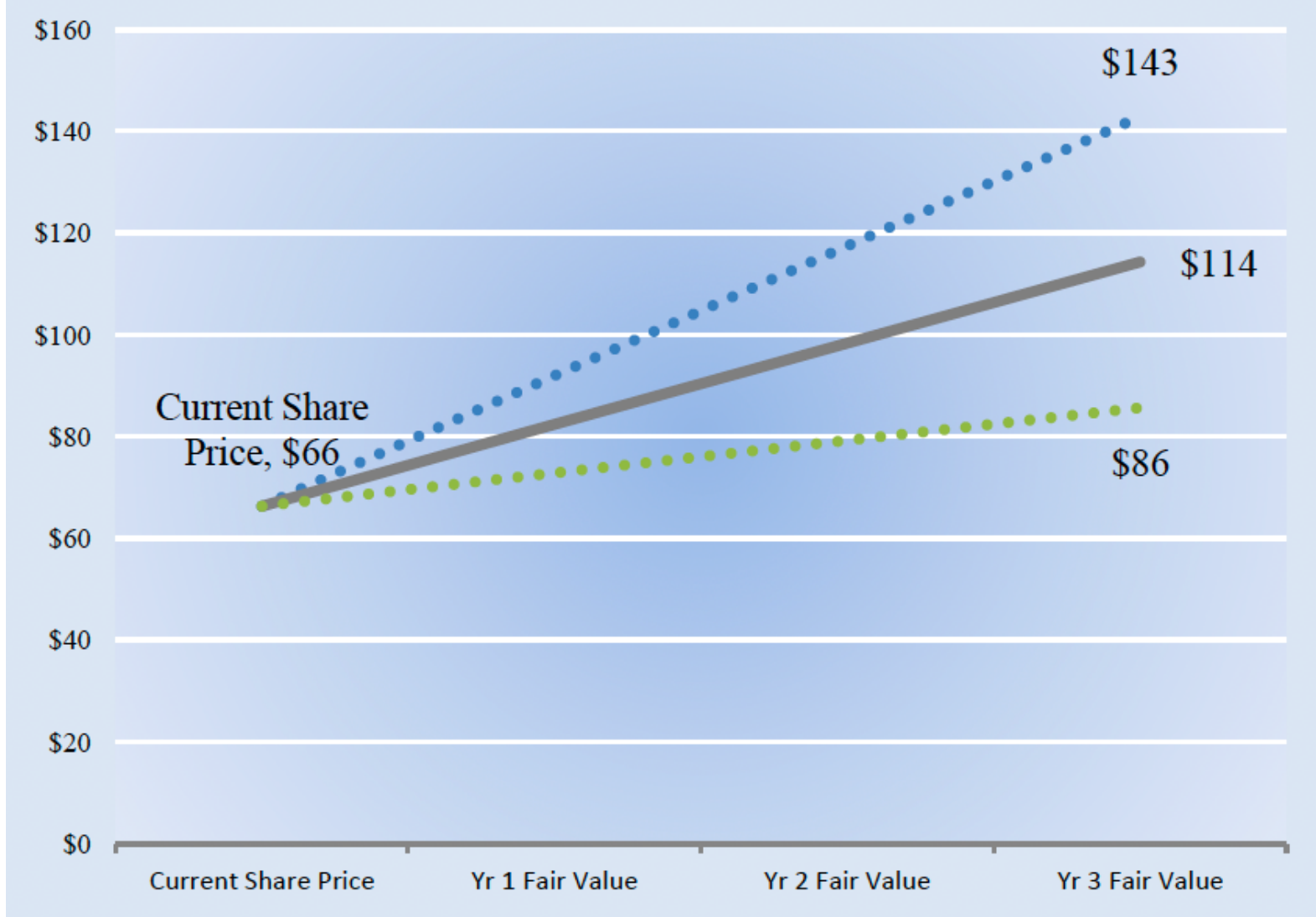
“With \$7 billion in cash and \$1.46 billion in (free cash flow) projected in fiscal 2025, there was some excitement surrounding the announced \$1.5 billion buyback or 7% of the shares.”

I am very pleased with Zoom’s management decision to embark on a material stock buyback at what we believe is a very attractive price level versus our assessment of the company’s intrinsic value. At Seven Summits Capital, we do not look to Wall Street sell-side analysts for valuation information because we have learned over the last 25 years that such information does not align with our long-term time horizon. Instead, we utilize objective fundamental research sources such as Valuentum and Simplywallstreet.com to supplement our proprietary research capabilities. Below is Valuentum’s graphical illustration of Zoom’s stock valuation in terms of underpricing (green), fair pricing (yellow), and overpricing (red). This distribution curve looks at Zoom’s stock valuation based on the most recent financial metrics and the resulting forecast of cash flows discounted back to a present value.

### Range of Potential Outcomes



The next graph is Valuentum’s attempt to provide a range of future stock prices for Zoom based on worst-case, base-case, and best-case forecast assumptions over a 1, 3, and 5-year timeline:



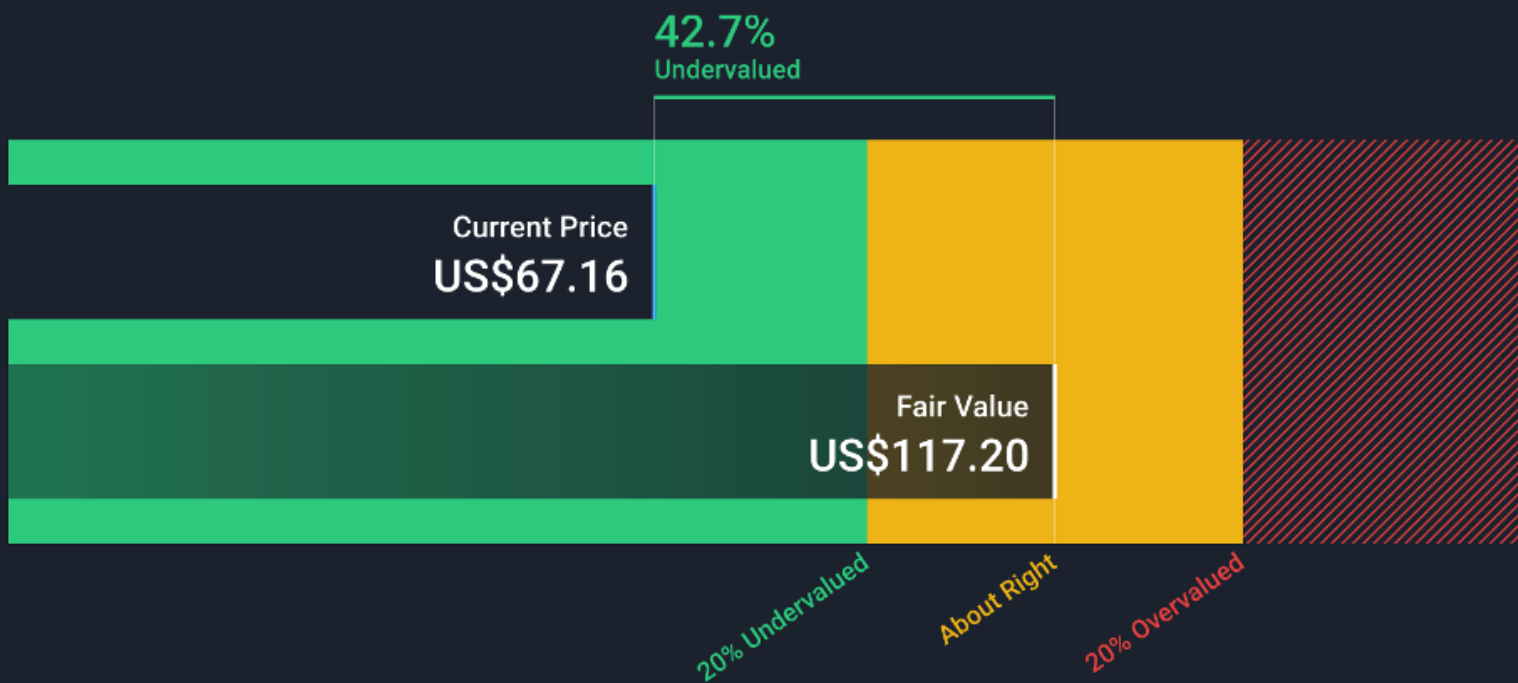
The graph above shows the expected future fair value of the firm's shares relative to its current stock price.

SimplyWall.St.com provides the following illustration of Zoom's fair value using the company's most recent financial reporting to produce a discounted cash flow methodology:



## 1.1 Share Price vs Fair Value

What is the Fair Price of ZM when looking at its future cash flows? For this estimate we use a Discounted Cash Flow model.



Our fair value assessment of Zoom's stock is very much in line with the analysis generated by both Valuentum and SimplyWall.St.com. For this reason, we will continue accumulating Zoom shares while the price remains in the low-mid range of its fair value. Fortunately, several companies we purchased 18-24 months ago have appreciated significantly over the last 12 months and have price levels well above the fair value range. We are using this appreciation to pair back on these great companies to fund our purchases of Zoom.

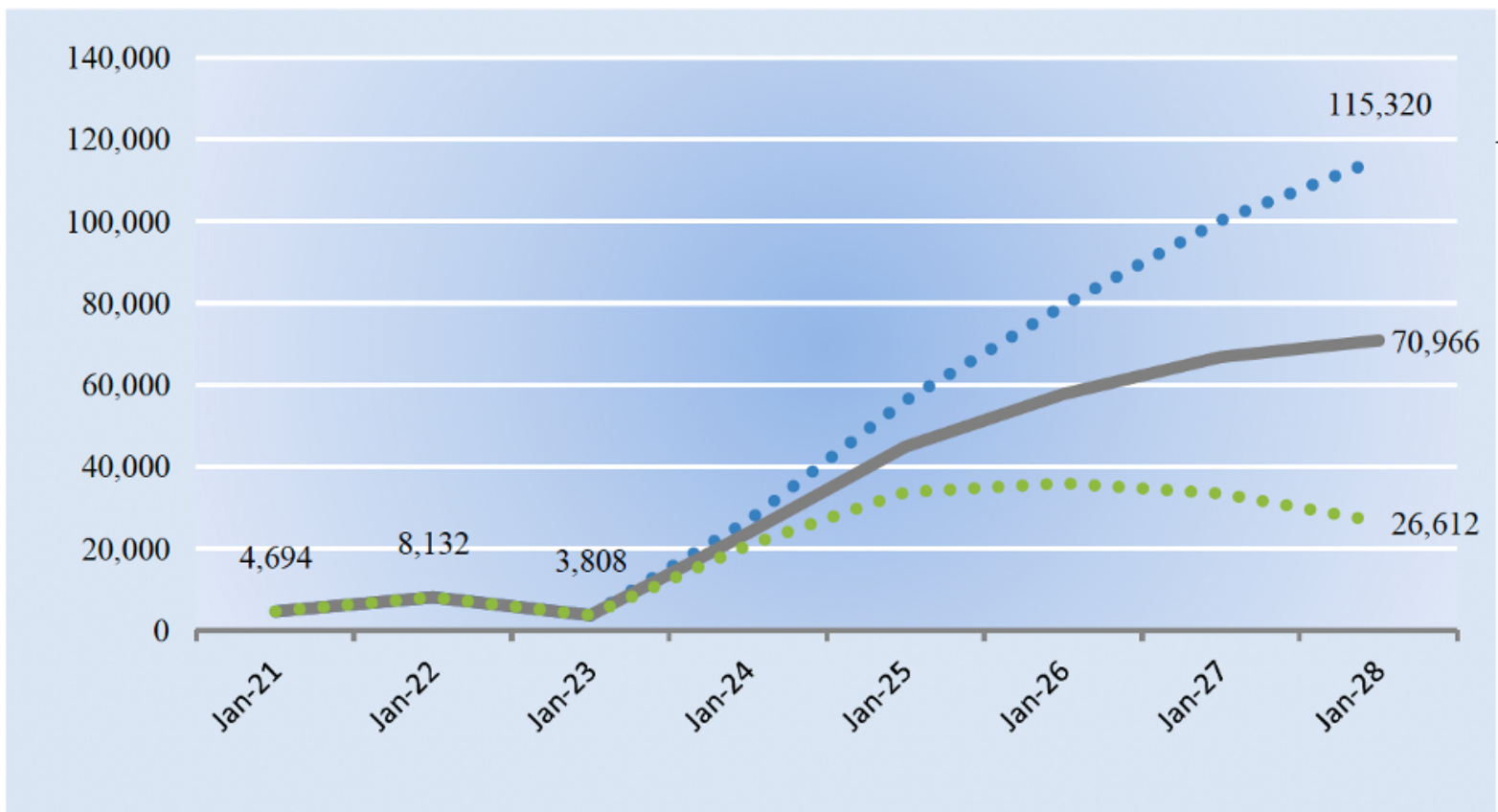
Now, I will take a quick look at the most popular stock in the market to contrast where its value stands to contrast it with Zoom's situation. Given its recent phenomenal appreciation, I get a lot of questions about Nvidia (NVDA) and whether we should be more heavily invested in this company. The answer, when considering valuation using cash flow, is no. NVDA's stock price today puts its price to free cash flow P/FCF above 80x. If I look at Valuentum's base case free cash flow projection for NVDA for FY2020, the forecasts show a free cash flow of around \$70 billion. If one applies a free cash flow multiple of 30x, roughly the current P/FCF multiple that META (Facebook) trades at, this will translate to a market capitalization of \$2.1 trillion. NVDA just recently passed the \$2 trillion market capitalization. Thus, using this metric, NVDA stock at current price levels is already incorporating the next four years of growth in cash flows using a similar cash flow multiple that META trades at today.

See Valuentum's free cash flow projections for NVDA below:



## Projected Free Cash Flow (in millions of USD)

Source: Company Filings, Valuentum Projections



In the chart above, we show our baseline forecast for free cash flow as well as potential upside and downside cases.

We have purchased Nvidia stock in the past during periods when its stock has corrected following a significant jump in price based on exuberant optimism regarding its future growth trajectory. We prefer stocks where the market is unduly punishing a company's stock relative to its future cash flow-generating ability, not companies where the market has priced the company's stock for perfection or better.

It is refreshing to take a breather from discussing macro factors such as interest rates and inflation to provide a glimpse into the activity that occupies most of our time: analyzing and valuing companies. If you enjoy our monthly commentaries, please share them by email or social media with others who may find our writing interesting.



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Disclosure:

**Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.**

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- [The Standard & Poor's 500](#), or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.

- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- [The Dow Jones Industrial Average \(DJIA\)](#), also known as the Dow 30, is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.
- The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately \$4.3 billion, median capitalization of \$1.2 billion and market capitalization of the largest company of \$18.7 billion.

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