



Finding “Value” in Growth

Intrinsic Business Value & the Cost of Capital

A key investment philosophy differentiator for Jackson Square Partners is our focus on buying companies with strong competitive positioning (Porter 5 Forces) at a discount to Intrinsic Business Value (IBV). In this paper, we discuss IBV and the key inputs for our discounted cash flow (DCF) analyses that are an important component of our process. This empirically supportable and theoretically robust exercise employs the valuation lens much more frequently used by traditional value investors. The key difference is that we look for more of the *current IBV* of a business to come from *future growth* in the business. It is a value ‘lens’ applied to the growth universe.

Intrinsic Business Value (IBV)

“The intrinsic value of a business (or any investment security) is the present value of all expected future cash flows, discounted at the appropriate discount rate. Unlike relative forms of valuation that look at comparable companies, intrinsic valuation looks only at the inherent value of a business on its own.”¹

Intrinsic value reveals there is a continuum between value and growth, rather than the simplifying construct of discrete style box categorizations. IBV is a universal yardstick that can be applied to compare businesses in different industries, with unique financial characteristics and disparate cash flow durations. In particular, **IBV best captures the value created by businesses undergoing material change** – either due to new management, a business model shift or industry rationalization. Comparable company multiples, frequently used by mainstream growth managers, become far less meaningful when applied to businesses undergoing significant transformation because past is not prologue.

As an example, two PC-centric “value” stocks from nearly a decade ago had their IBVs increase significantly, over time, due to reinvigoration and evolution of their models under visionary new CEOs. Management and business transitions brought tangible positive changes to the financial statements in the

form of faster revenue growth, expanding margins and better capital efficiency – all of which are key drivers of increases to IBV.

The Corporate Finance Institute describes Intrinsic Value simply as:

“The price a rational investor is willing to pay for an investment, given its level of risk.”

If you had perfect foresight on all the future free cash flows of a business, it would be an easy and exact way to value any business. In the absence of prescience, and particularly for businesses undergoing dramatic change, calculating intrinsic value is a very subjective exercise - as much art as science. There are so many assumptions that must be made, and the final net present value (NPV) is very sensitive to changes in those key model inputs.

This uncertainty can be used to the advantage of thoughtful fundamental investors who have the patience and persistence to understand how a business’ competitive advantage profile will evolve over time (the “Porter Five Forces”). This, in turn, reveals how the Porter Five will impact revenue growth, margins and capital efficiency. Each of these

¹ [The Corporate Finance Institute website.](#)

key inputs impacts returns on capital, cash flows and the riskiness of the business looking out over 3-5+ years.

A DCF analysis reveals the key levers for driving IBV: in a business with already robust margins, it is likely to be revenue growth and asset utilization that drive IBV. For a turnaround, it is likely to be improving capital efficiency, expanding margins and enhanced topline growth. For an already good business, like many enterprise software businesses, the IBV increase might flow from decreasing the riskiness of the cash flow stream, which results in a lower cost of capital and higher valuation, ceteris paribus. Software is the emblematic case study: the conversion from selling perpetual license software to a recurring revenue “SaaS” model typically drives huge IBV. This stems from improving results discounted at a reduced rate reflecting enhanced stability of cash flows (manifesting as a lower business model beta). Next is a discussion of the cost of equity inputs.

Cost of Equity Components

Cost of Equity Formula = $R_f + \beta [ERP]$

The Risk Free Rate (R_f): ~1-2%

[\(Daily Treasury Yield via Dept of the Treasury\)](#)

The R_f should reflect current opportunity cost, not a “normalized” number.² A risk free rate should incorporate both zero default risk and also no reinvestment risk. This theoretically would require a slightly different zero coupon R_f rate to be used in discounting each annual cash flow. *“As a practical compromise, however, it is worth noting that the present value effect of using year-specific risk-free rates tends to be small for most well-behaved term structures.”*³ Note that the R_f is shown as ~1.5% and reflects the fact that most growth equities are very high duration, so use of the 30-year treasury bond is warranted in our opinion.

Equity Risk Premium (ERP): ~5-6%

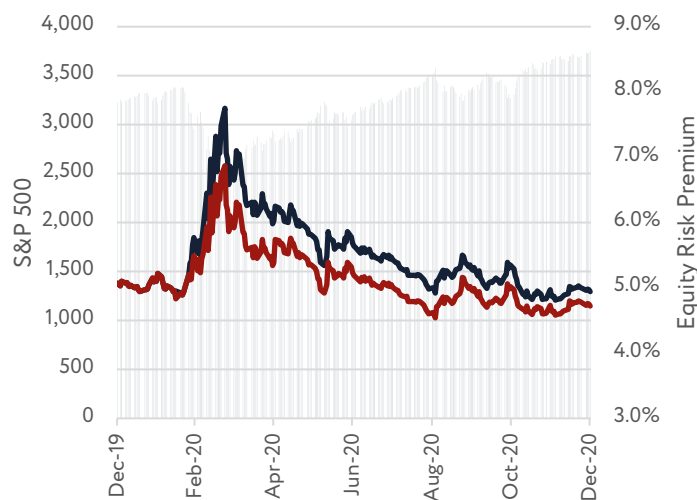
There are multiple ways of trying to estimate the equity risk premium, including Ibbotson’s historical returns data, market surveys and a market-implied ERP. The current implied premium remains the best predictor of actual return premium earned by stocks over bonds, according to NYU Professor Aswath

Damodaran’s annually updated ERP paper.⁴

Damodaran’s current COVID-adjusted ERP, as of October 1st, 2020, is 5.0% (COVID ERP computed with 20% earnings drop for 2020 + 80% recovery by 2025 + Lower % returned cash flows).

Equity Risk Premium for S&P 500⁴

December 31, 2019 – December 31, 2020

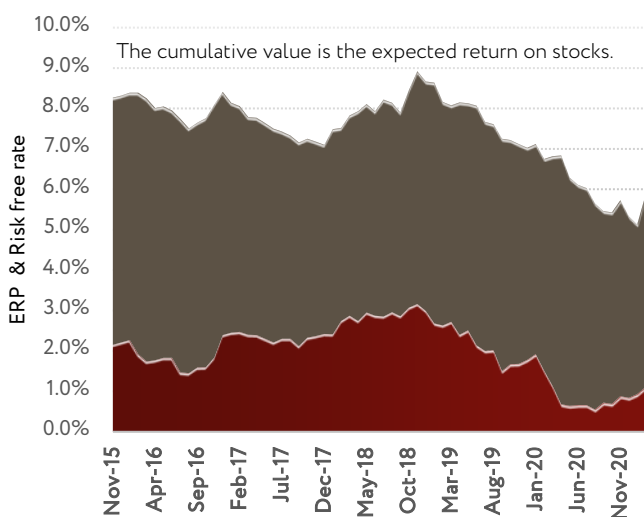


Source: Aswath Damodaran, Damodaran.com

Equity Risk Premium at the end of 2020 was 4.72%, down from 5.2% at the start of the year. Since the risk free rate dropped from 1.92% to 0.93% during the year, expected return on stocks at the end of 2020 was 5.65%, down from 7.12% at the start of the year.

Equity Risk Premium & T. Bond Rates⁴

November 1, 2016 – February 1, 2021



Source: Aswath Damodaran, Damodaran.com

² Source: Aswath Damodaran – “[Risk Free Rates and Value: Dealing with Historically Low Risk Free Rates.](#)”

³ [Estimating Risk Free Rates](#), Aswath Damodaran

⁴ [Equity Risk Premiums \(ERP\): Determinants, Estimation and Implications – The 2020 Edition Updated: March 2020, Aswath Damodaran](#)

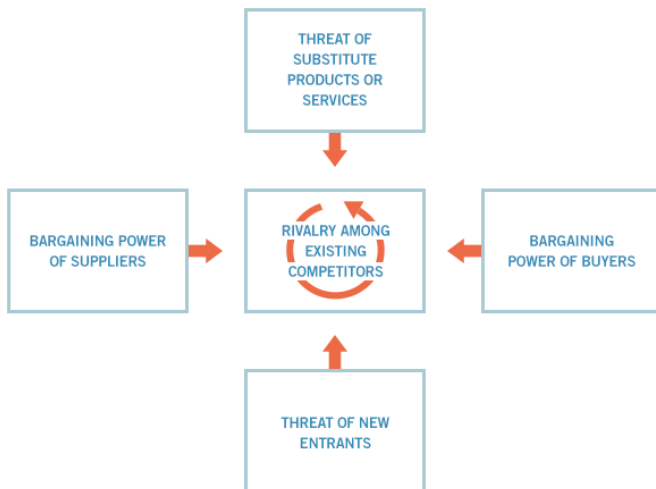
Business Model Beta (β): .5 – 1.5

Typical Jackson Square Range

The standard procedure for estimating betas is to regress stock returns against market returns, or using the beta listed on Bloomberg. This mathematical calculation of beta is problematic because it is *backward looking* and reflects the historical business mix, model and leverage. For businesses that are undergoing a model transition, M&A, New Management or are just new to the public stock market, a “Business Model Beta” (Jackson Square) or a “[Bottom-Up Beta](#)” (Aswath Damodaran term) must be *qualitatively* estimated. This entails estimating the *prospective* volatility of cash flows, earnings and revenues which are less noisy than market prices. In turn, this requires a very keen and forward-looking analysis of how a business model will look in 3-5+ years.

The cost of equity is most impacted by the beta used and assuming an ERP of 5.5%, the cost of equity can range from 4.25% for a .5 β company to 9.75% for a 1.5 β business. This wide range explains why much of Jackson Square’s cost of capital debate focuses on business model evolution and stability of future cash flows, via Porter 5 Forces evaluation.

Porter Five Forces



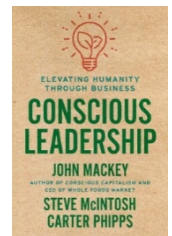
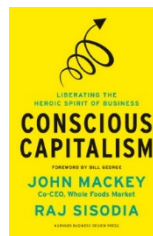
Source: [Harvard Business School](#)

Important Information:

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A Sixth Force: Shared Value (ESG):

We have now explicitly included a “Sixth Force” or what Michael Porter calls Shared Value (“[Where ESG Fails](#),” Michael Porter). These are firms that have a positive profit-driven social impact, beyond its P&L. Examples include the “positive externality” created by investigative journalism and the provision of discounted food in underserved neighborhoods. We *do not* view ESG as a separate analysis or quantitative screening device, but rather as integral to our existing fundamental analysis. Porter’s *shared value* term is an echo of the “[Conscious Capitalism](#)” movement pioneered by John Mackey, who founded Whole Foods over 4 decades ago. We believe that a holistic and integrated approach to partnering with all stakeholders is one that also maximizes returns to shareholders over the long term.



Conclusion

Jackson Square’s longtime focus on discounted cash flow analysis is perhaps the single biggest differentiator vs. our growth peers. It combines the very best of a traditional value framework, but as applied to the more dynamic growth universe. We further refine this valuation discipline by use of detailed business and industry structure analysis that informs the business model beta and *future* cost of capital. Lastly, our prior implicit focus on ESG considerations has been formalized. Our explicit analysis now includes a “Sixth Force,” which details the often-subtle attributes of Shared Value and Conscious Capitalism into a more authentic and qualitative approach to ESG.