Equity Valuation and Earnings Quality

Interview preparation summary · HF track

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INT.HV.1.a · Reading the Accounts

Read a P&L, balance sheet and cash flow statement together to see whether profit is turning into cash and what is really happening in the business.

The three statements describe one company from three angles, and an analyst reads them together. The income statement shows profit on an accruals basis, the balance sheet shows what the company owns and owes, and the cash flow statement shows how profit became cash after non-cash items and working capital. Start with operating cash flow against net income over several years: a persistent gap needs an explanation. Then look at receivable, inventory and payable days against revenue growth, since rising days absorb cash. Compare capital expenditure with depreciation to see whether the asset base is being maintained, and compute free cash flow after capex. Finally check that the statements articulate, for example that retained earnings roll forward from opening balance plus net income less dividends. Details vary by accounting standard, but the logic holds. Interview point: lead with cash conversion, then name the working capital line that explains it.

WORKED EXAMPLE: IS A GROWING PROFIT TURNING INTO CASH

An interviewer says: a company reports revenue of 900 (800 last year) and net income of 90 (80). Depreciation and amortisation is 40, receivables rose from 120 to 200, inventory from 100 to 150 and payables from 90 to 110. Capital expenditure was 70. Use a 365-day year and ignore other items. Is the profit turning into cash?

Answer: Operating cash flow is 20 against net income of 90 (22% conversion) and free cash flow is -50, driven by receivable days rising from 54.8 to 81.1.

> **Interview tip:** Say the conversion figure first (about a fifth of profit became cash), then name the two lines that explain it. The interviewer listens for whether you treat the gap as a question to test, not as proof of fraud.

INT.HV.1.b · Reading the Accounts

Spot quality-of-earnings red flags in accruals, working capital, one-offs, capitalised costs and revenue recognition.

Quality of earnings asks how much of reported profit is repeatable and backed by cash. The screens are simple. Accruals: net income well above operating cash flow, scaled by assets, especially when persistent. Working capital: receivable and inventory days lengthening faster than sales. One-offs: exceptional items that recur are normal costs, and adding them back inflates adjusted profit. Capitalised costs: spending moved from the income statement to the balance sheet lifts profit now and creates amortisation later. Revenue recognition: revenue growing faster than billings, shrinking deferred revenue, early recognition of multi-year contracts and sales near period end. Changes in estimates, such as longer asset lives, raise profit with no extra cash. None of these proves aggressive accounting, since each has innocent explanations, so they are prompts for further work. Interview point: name the flag, quantify its effect on profit and say what innocent explanation you would rule out.

WORKED EXAMPLE: CLEANING UP A HEADLINE PROFIT

A company reports operating profit of 180 and an adjusted figure of 210 after adding back 30 of exceptional restructuring. The exceptional items for the last three years were 25, 30 and 35. This year it also capitalised 45 of development costs and charged 15 of amortisation. Net income was 100, operating cash flow 60 and average assets 800. How much is the headline flattering the profit? Ignore tax.

Answer: Cleaned operating profit is 150 against a headline of 210, so the headline is flattered by 60, or 28.6%.

> **Interview tip:** Give the cleaned number and the percentage gap first, then the two adjustments in the order you tested them. The interviewer listens for the reason you rejected the add-back: it recurs.

INT.HV.1.c · Reading the Accounts

Assess balance sheet and liquidity risk to judge whether leverage can force a short thesis to pay off.

A short based on balance sheet stress needs three things: leverage that is high, a timetable that is short and a reason the lender or market will not simply roll the debt. Measure leverage as net debt to EBITDA and coverage as EBIT or EBITDA to cash interest. Then lay out the maturity profile against cash and free cash flow after capex, to see whether a repayment wall is coming and whether the company can meet it. Check covenants and how much EBITDA can fall before a breach, and include leases and other debt-like items such as pensions. Finally weigh the practical costs of the short: borrow fee, crowding and squeeze risk. Leverage without a trigger is a slow, expensive position. Definitions of net debt and EBITDA vary, especially for leases, so state yours. Interview point: say when the balance sheet bites, not only that it is weak.

WORKED EXAMPLE: CAN THIS COMPANY REFINANCE NEXT YEAR

A company has 800 of debt: 300 due in 12 months, 400 in three years and 100 in six years. It holds 150 of cash. EBITDA is 200, capex 60, cash interest 50 and cash tax 20, with working capital flat. A loan covenant limits net debt to EBITDA to 4.0 times. A short seller asks: is there a funding problem, and how close is the covenant?

Answer: There is a funding gap of 80 over the next 12 months, net debt to EBITDA is 3.25 times, and EBITDA can fall 18.75% before the 4.0 times covenant is breached.

> **Interview tip:** State the gap first (a shortfall of 80 against the maturity), then the covenant headroom. The interviewer listens for you naming what would stop the thesis working, namely easy refinancing.

INT.HV.2.a · Valuation and Earnings Models

Use P/E, EV to EBITDA, EV to sales and free cash flow yield on a public equity, and say when each one misleads.

Each multiple answers a different question and fails in a different place. P/E is price over earnings per share: simple, but distorted by leverage, tax and one-offs, and misleading on cyclical earnings at a peak or trough. EV to EBITDA compares operating businesses across capital structures, but ignores capex and so flatters heavy investors; leases must be treated consistently between EV and EBITDA. EV to sales suits loss-making or early businesses but ignores margin, so a high-margin firm can look expensive and be cheap on profit. Free cash flow yield, free cash flow over market capitalisation, tests what shareholders can actually receive, but a single year can be distorted by working capital or capex timing. Match numerator and denominator: equity value with post-interest earnings, enterprise value with pre-interest profit. Interview point: choose the multiple for the business and name what it misses.

WORKED EXAMPLE: FOUR MULTIPLES FOR ONE COMPANY

A company has 200 million shares at a price of 30, net debt of 1,500 and minority interests of 100. Revenue is 5,000, EBITDA 1,000, depreciation and amortisation 400, interest 100, capex 450, tax rate 25%, and working capital is flat. Work out the P/E, EV to EBITDA, EV to sales and free cash flow yield, and say which one misleads. All figures are in millions except the share price.

Answer: P/E is 16.0 times, EV to EBITDA 7.6 times, EV to sales 1.52 times and free cash flow yield 5.4%, and EV to EBITDA misleads because capex absorbs 45% of EBITDA.

> **Interview tip:** Give the four numbers quickly, then pick the one that misleads and say why in one sentence. The interviewer listens for you linking the multiple to what it ignores, here capex.

INT.HV.2.b · Valuation and Earnings Models

Build a quick earnings model from revenue, margin and share count to EPS, and derive a target price with a sensitivity.

A quick model has few lines and exposes the drivers. Forecast revenue from volume, price or guidance; apply an operating margin; subtract interest and tax; divide by the diluted share count to get EPS. Then set a target price by applying a justified multiple to EPS, supported by the stock's own history and its peers, and compare with the current price. The value of the exercise is the sensitivity: fixed costs and interest make EPS move by more than the margin does, so show what a one-point change in margin or a different multiple does to the target. Separate the upside that comes from earnings growth from the upside that depends on re-rating, because the second needs its own reason. Tax rates, share counts and the multiple basis vary by company and region, so state them. Interview point: give EPS, target and upside, then the one sensitivity that matters.

WORKED EXAMPLE: FROM REVENUE TO A TARGET PRICE

An interviewer says: a company has revenue of 2,000 and you expect 8% growth. You model a 15% operating margin, interest of 24, a 25% tax rate and 150 million shares. The stock is at 15 and you think a P/E of 13 is fair. Build EPS and a target price, then show what a one-point lower margin does. Millions except per-share figures.

Answer: Base EPS is 1.50 and the target price is 19.5 (30% upside); a one-point lower margin gives EPS of 1.39, a target of 18.10 and 20.6% upside.

> **Interview tip:** Say EPS, target and upside in one breath, then state the single sensitivity that matters (margin). The interviewer listens for you showing the downside case without being asked.

INT.HV.2.c · Valuation and Earnings Models

Value a stock relative to peers and to its own history, and say when the comparison misleads.

Relative valuation asks whether a stock is cheap against something. Against peers, compare like with like: same business model, similar growth, margins, returns, leverage and cyclicality, and the same accounting basis for leases and one-offs. Against its own history, use a long enough window to cover a cycle, and ask whether the business is still the same one. Remember leverage magnifies re-rating: with fixed net debt, a given rise in enterprise value is a larger rise in equity. Growth-adjusted measures such as the PEG ratio help when growth differs, though they ignore risk and the duration of growth. Triangulate with more than one benchmark and express the answer as a range. A discount is only an opportunity if it is not deserved, so test why it exists. Interview point: adjust the peer multiple for a real difference and say why.

WORKED EXAMPLE: TRIANGULATING VALUE FROM PEERS AND HISTORY

A company has EBITDA of 300, net debt of 600 and trades at 7.5 times EV to EBITDA. Four peers trade on 8.0, 9.5, 10.0 and 12.5 times. Its own ten-year average is 8.5 times. It grows more slowly than the peers, so you apply a 15% discount to the peer median. What equity value does each approach give? Millions; ignore minorities.

Answer: Equity value is about 1,886 on the growth-adjusted peer multiple and 1,950 on history, against 1,650 today, an upside of about 14% to 18%.

> **Interview tip:** Offer the range and say which number you trust. The interviewer listens for you adjusting the peer median for a real difference, not quoting the raw 41%.

INT.HV.3.a · Consensus and Value Traps

Work out what a consensus number implies for the stock and where your own estimate could differ.

Share prices move on results relative to expectations, and consensus is the usual proxy for them. Start by working out what the current price implies: at a sensible multiple, what earnings is the market paying for, and how does that compare with the Street? Then decompose the debate: is your difference in revenue, margin, tax, share count or the multiple? Equal profit can hide different views on drivers. Express the gap in EPS and in price at an unchanged multiple. A view needs a reason the Street is wrong or slow, such as anchoring to guidance, evidence you can cite, and a catalyst when the market will see it. Remember that published consensus can differ from what investors really expect, and that the quality of a beat, guidance and cash flow matter as much as the headline. Interview point: name the one line where you differ and what would show you wrong.

WORKED EXAMPLE: WHAT THE PRICE IMPLIES AND WHERE WE DIFFER

A stock trades at 82.5 on 15 times consensus EPS. Consensus has revenue of 3,900 and an operating margin of 12%, interest of 28, a 25% tax rate and 60 million shares. You agree on revenue but model a margin of 10.5%. What EPS is the market assuming, what is yours, and what does the difference mean for the price at an unchanged multiple? Millions except per share.

Answer: The market assumes EPS of 5.50, your margin view gives 4.77 (13.3% lower), implying a price of 71.5 against 82.5 at an unchanged multiple.

> **Interview tip:** Say the whole debate is one number, the 1.5-point margin gap, and that it is worth 13% of EPS. The interviewer listens for you naming what evidence would prove you wrong.

INT.HV.3.b · Consensus and Value Traps

Test whether a low-multiple stock is cheap for a reason, and spot a value trap before buying it.

A low multiple is a question, not an answer. Ask why the stock is cheap and whether the reason is temporary. Common traps: a business in structural decline, where sales fall and capex is needed just to stand still; cyclical earnings at a peak, which flatter the P/E; one-off gains that inflate EPS; a high dividend yield that cash flow does not cover; hidden debt, leases or pensions; and management that allocates capital poorly. Value a shrinking cash flow as next year's flow over the discount rate plus the decline rate, and reverse-engineer what decline the price already assumes. A real bargain has evidence that the cause is fading, such as stabilising revenue or returns on new capital above the cost of capital, and a catalyst, since without one a cheap stock can stay cheap for years. Interview point: say what the market is assuming and what would change it.

WORKED EXAMPLE: CHEAP FOR A REASON

A stock trades at 9.00 on reported EPS of 1.50 (6 times), and a PM calls it a bargain. The EPS includes a one-off gain of 0.30. Free cash flow per share next year is expected to be 1.00, but revenue is falling about 6% a year and you use a 9% discount rate. Year-end flows, ignore tax. Is it cheap?

Answer: The stock is on 7.5 times underlying earnings and is worth about 6.67 a share if cash flow declines 6% a year, against a price of 9.00, so it is a probable value trap.

> **Interview tip:** Walk down the three levels: reported multiple, underlying multiple, then value allowing for decline. The interviewer listens for you saying what rate of decline the price already assumes.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.