Why is my **stock undervalued**?

A myriad of factors influence valuation. It takes work to determine the key drivers of a valuation disconnect and to develop a sound plan to address it.

We often say that we have rarely met a public company CEO or CFO who didn't think their stock was undervalued. All joking aside, valuation issues are top of mind for management teams and boards of publicly traded companies who often want insight on what drives their stock valuation and more importantly, what they can do about it. This is not surprising because valuation matters.

Companies that are fairly valued have ongoing access to capital, the ability to use their stock as currency to attract talent, and are generally less susceptible to activist attacks or unfriendly takeovers.

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Hoping there will be a quick fix to addressing a valuation gap, many executives say, "There must be something wrong with our messaging – our investors and analysts just don't seem to get our story." What they frequently come to understand is that a myriad of factors influence valuation, and it takes work to determine the key drivers of a valuation disconnect and to develop a sound plan to address it.

Company performance and **the perception of that performance** lead the long list of factors that impact valuation

PERFORMANCE

If your company is performing well – growing revenue, cash flow, margins and earnings – and has a plan and the financial resources to continue that upward trajectory, this will likely be reflected in your stock price.

Conversely, if performance metrics are declining, results are inconsistent, or your company needs additional capital to execute its growth strategy, this will be reflected in a discounted valuation.

A key consideration to understanding your company's valuation is how the statement of cash flows compares to the income statement. The statement of cash flows is a true indicator of the cash being generated by your company and any disconnect between cash flow and the income statement will be reflected in your valuation.

Additionally, since investors focus on the future, company guidance and growth rates as well as confidence in them play a key role in valuation.

PERCEPTION

The goal of a strategic investor relations program is to positively impact the perception of company performance. According to IHS Markit, highly effective IR maximizes valuation by supporting a premium of 15% and lowering volatility by 5%, as measured by beta.

Conversely, ineffective IR leads to a discounted valuation of 10% or more. Critical elements of a strategic investor relations program that can impact valuation include the following:

INVESTOR NARRATIVE / EQUITY STORY

Effective IR starts with clearly and effectively communicating your company's equity story and investment messages – your market opportunity, strategy, performance and long-term value creation potential – and successfully engaging and attracting the right sell-side analyst coverage and investors.

WALL STREET PROFILE

Your investor communication and engagement practices need to drive support from the sell-side and institutional investors. Companies with strong equity stories and Wall Street profiles tend to benefit from strong buy and sell-side interest and sponsorship.

Beyond performance and future expectations, a host of **other factors influence valuation**

QUANTITATIVE FACTORS

A wide range of quantitative metrics such as stock price, market cap, trading volume, liquidity, and short interest also factor into the marketability of a stock which can impact valuation. For example, many investors don't buy stocks that are trading below $5.00. They also avoid stocks that have an insufficient trading volume to enable them to build either build a large position or to liquidate a position without disrupting the market. Market cap also matters. As companies transition from small cap to mid-cap and mid-cap to large cap, the range of investors and types of investment managers and funds, both active and passive, that can own the stock becomes exponentially larger which drives the demand side of the equation.

MACROECONOMIC FACTORS

As recently witnessed, macroeconomic factors such as the overall health of the economy, the outlook for GDP growth, interest rates, inflation, and geopolitical risk, can weigh into investment decisions. While the macro environment is outside any company's control, how it demonstrates adaptability to changing conditions can play a key role in its valuation.

SECTOR SPECIFIC FACTORS

At any point in time, certain industries go in and out of favor. For example, under a Trump administration, pro-business policies and a focus on deregulation is expected to drive investor interest in highly regulated sectors such as financial services and energy while creating new challenges for renewable energy companies given the administration's plans to do away with EV tax credits. The same applies to different segments of the equity market from micro-cap to mega-cap. As such, stock valuation must be evaluated in the context of demand for specific industry and equity market sectors at any point in time.

SUSTAINABLE COMPETITIVE ADVANTAGE

Investors look for companies with a competitive advantage or moat that creates barriers to entry and positions them to win "more than their fair share" of business in their addressable market. Competitive advantages include factors like proprietary technology, a strong brand, market leadership position, and data and analytics that drive returns.

CAPITAL ALLOCATION

Investors want to own companies whose managers have an owner's mindset regarding capital allocation. That means a clear, rational, and disciplined approach to allocating capital to the highest return opportunities – organic growth, M&A, dividends, and share repurchase programs – that is proactively addressed in investor communication.

INTANGIBLES

Intangibles that drive valuation are far ranging and include: the quality and credibility of management, the board and corporate governance practices, execution, brand, customer value proposition, customer engagement, reputation, transparency, corporate culture, and innovation.

While it's not always possible to quantify the exact impact of intangibles on valuation, the impact is visible in news headlines every day. Consider Nvidia whose valuation has benefitted tremendously from its reputation for technology innovation or, on the flip-side, companies like Boeing whose valuation has been hard hit by execution and credibility issues.

In summary, valuation is a complicated topic – a myriad of factors impact valuation and disconnects are rarely about the message alone. Thoughtful analysis and competitive benchmarking of qualitative and quantitative factors are critical to identifying the most important drivers of a valuation gap and the actionable steps to address it. Given the many benefits of having a fairly-valued stock, it is well worth the effort.

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