

Valuing an Internet Stock

One way is to start with the market price of the stock and determine what kind of revenue growth that price implies. The question then becomes whether that growth rate is realistic. Let's take Amazon.com. An analytical approach called Economic Value Added (EVA) indicates that with the stock at 214 a share, investors are implying that revenues will grow 59.6% a year over the next 10 years, taking annual sales to \$63 billion from the current \$587.6 million.

HERE'S HOW THOSE CONCLUSIONS WERE REACHED

-- First to be determined is the current operations value (COV) of the company--what Amazon.com would be worth if there were no further growth. But hold on--it's not making money now. Sure, but that's due to large startup costs. Once those costs are out of the way, assume that the company will earn a normal operating margin of 10%. So to determine COV, assume the company is earning its average long-term margin and is now profitable. Once the COV is known, it can be used with the market value (MV) to determine the future growth value (FGV).

MARKET VALUE (MV) = CURRENT OPERATION VALUE (COV) + FUTURE GROWTH VALUE (FGV)

NOW, SOME NUMBERS ARE NEEDED

WHAT'S KNOWN FOR CERTAIN?

STOCK PRICE	214
SHARES OUTSTANDING	50.2 MILLION
MARKET VALUE	\$10.8 BILLION

WHAT ASSUMPTIONS HAVE TO BE MADE?

SALES IN 1998	\$587.6 MILLION
OPERATING MARGIN	10%
NET OPERATING INCOME AFTER TAXES (NOPAT)	
(ADJUSTED FOR STARTUP COSTS)	\$41.1 MILLION

-- To get current operation value (COV), start with 1998 adjusted net operating income after taxes (NOPAT), \$41.1 million. What would \$41.1 million over the next 10 years be worth? To get that number, a discount rate, or the cost of the capital

needed to generate those earnings, has to be assumed. Because the stock is volatile, assume a high cost--15%. To get the COV, divide \$41.1 million by 15%, which yields \$274.2 million. With no future growth, that's what the company would be worth. A pittance--only \$5.50 per share. Investors are obviously betting that growth will continue to soar.

NOW, IT'S EASY TO DETERMINE AMAZON'S FUTURE GROWTH VALUE

-- Simply subtract \$274.2 million from the current market value (\$10.8 billion), which gives \$10.5 billion. The question now is: How fast do revenues have to grow over the next 10 years to give you a future growth value of \$10.5 billion? The answer is 59.6% a year, assuming margins of 10% and a 15% capital cost.

-- Next question: Can Amazon.com sustain that kind of growth? As E-commerce draws more competitors, it's probably an unrealistic assumption.

DATA: CHARLES R. WOLF, WARBURG DILLON READ; BUSINESS WEEK
<http://www.businessweek.com/1998/50/b3608011.htm>