Chapter 17

Develop Company Financial Models to Elicit Insights

In the previous chapter, I discussed some key Microsoft Excel features and best practices for setting up a workbook or worksheet. In this chapter, I go a step further by covering the basic elements required for setting up and building company financial models. While I attempt to lay a foundation, this is another area where analysts should consider taking formal training courses to fully master the skills needed for building effective models.

I've met many buy-side analysts who don't maintain any models for their companies and instead rely on consensus for valuation purposes. I have a tough time getting my head around this, because having a *unique financial forecast* is often the primary factor for differentiating an analyst's stock call. But as I discuss later, a good differentiated stock call can also be driven by a superior view on *valuation* or *market sentiment*. So for buy-side analysts who don't model, understand that it will be difficult to generate alpha by having a financial forecast that is superior to market consensus. With that said, during my research for this book, I met a number of successful practitioners who start with consensus and then tweak it based on their perception of where consensus is wrong. The remainder of this best practice assumes that

the analyst builds company models in an effort to identify when the market is wrong about a stock.

While modeling is important, don't overdo it. Only dedicate the amount of time needed to help pick stocks. A buy-side analyst with over 10 years of experience believes, "When modeling a company, put in enough that matters but not too much to make it a burden to update." Detailed models can be a security blanket for many analysts, especially new ones; the more rows and columns a spreadsheet contains, the more secure the analyst feels. The problem is, the assumptions about the critical factors can only be validated by seeking insights from others—getting on the phone or out of the office to determine where the market is wrong.

Just as Goldilocks had to find the porridge that wasn't too hot or too cold, equity analysts should create financial forecasts that aren't too detailed or too simplistic. Drew Jones, a former Morgan Stanley analyst and manager of analysts, believes the essence of modeling should be to "spot future catalysts not recognized by the Street and frame the valuation debate." His philosophy is consistent with our model-building framework that focuses on the two to four critical factors discussed earlier. Analyzing historical and current trends in a company and its sector should help an analyst understand the pricing or growth of a key product or the inflation in a key cost input that *is likely to move the stock during the investment time horizon*. These factors deserve the most attention.

It's worth noting that sell-side analysts are expected to have detailed models for all of the companies they follow, which is a realistic request from clients, but much of a model's minutiae can usually be delegated to more junior members of the team. The senior sell-side analyst and most buy-side analysts should be focusing their financial modeling on the two to four critical factors in order to determine how much they can impact the stock. If the analysis shows that a factor is unlikely to move a stock, stop spending time on it. This is so difficult for analysts who try to model every aspect

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