Narrative And Numbers

The Value of Stories in Business

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MAIN IDEA

How do you establish the true market value of an asset? This is rather obviously an important question for any investment decision.

One school of thought (left brain) suggests value is driven solely by the numbers and therefore number crunchers can calculate market value with formulas and a spreadsheet. An alternate approach (right brain) is to look at the underlying story or narrative behind the asset and use storytelling to come up with a valuation.

A much better approach to valuation is to blend together both the numbers and the underlying narrative. To come up with a good valuation, you have to be able to talk both languages. You have to take the numbers and then give them context on the basis of the background narrative.

Stories without numbers are little more than fairy tails. Numbers without stories are exercises in financial modelling. A good valuation is a bridge which will draw on both the numbers and the stories to come up with a figure that makes sense.

"In effect, valuation allows each side to draw on the other, forcing storytellers to see the parts of their stories that are improbable or implausible, and to fix them, and number crunchers to recognize when their numbers generate a story line that does not make sense or is not credible."

– Aswath Damodaran

Step 1 – *Survey the landscape* . . . . Pages 2 - 3

Before you try and value a company, get to understand its business model and where it stands at present in terms of financials, business mix, marketplace conditions and its background story. Also understand the strengths and weaknesses of the narrative and numbers approaches to valuation.

Step 2 – *Develop a narrative for the future of the asset* . . . . Page 4

Improve your valuation by developing a narrative which encapsulates what you see happening to that company in the future. A good business story will have staying power and will back up what the business is about.

Step 3 – *Road test that narrative against the numbers*. . . . . Page 5

Check the narrative you've developed against history, the principles of economics and your own common sense. Come up with three versions of your narrative – Possible, Plausible and Probable.

Step 4 – *Convert that narrative into key drivers of value*. . . . . Page 6

Convert your narrative into numbers by identifying the key metrics which will tell whether your narrative is playing out or not. These measures will become the key drivers of value.

Step 5 – *Connect those key value drivers to your valuation*. Page 7

The valuation of the asset can now be calculated. It will be based on: cash flows from existing assets, reinvestments needed to sustain those earnings and the projected cash flows from growth initiatives once risk is factored in.

Step 6 – *Keep the feedback loop open and adjust to change* . . . . Page 8

Never forget your narrative is not the only plausible one. Keep the feedback loop open and consider periodically whether an alternative narrative makes more sense or has elements you want to borrow or adopt. Always be willing to improve your narrative as you go along.

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