

**Damodaran, Aswath – Narrative and Numbers: The Value of Stories in Business**

Columbia Business School, 2017, [Equity Investing] Grade ★★★★★

The procedure of valuing a stock through is rather simple once it has been learnt. And when looking in retrospect on why old valuations turn out to be incorrect it is rarely due to getting the mechanics of the valuation tool wrong. Instead it is almost always because the sales or profits turned out very differently from what was forecasted since the company, its strategy or business environment developed in an unanticipated way – the narrative was wrong. This is a book on how to combine the numbers of the valuation tools with a narrative that brings life, understanding and, by this, increased precision into the valuation made. The author is a well-known finance professor at NYU who has written a large number of finance books.

As I understand it the book started with the author posting and updating the narratives and subsequent valuations for a number of stocks like Uber, Amazon, Apple, Alibaba etc. online. They now feature as case studies throughout the book. Taking a step back, *Narrative and Numbers* is also a personal journey for Damodaran as he over time has developed from a pure number cruncher to taking a more holistic approach. I find that when a reader is invited to share an author's personal development the result is often very likable. This book is no exception and it is evident that the author has enjoyed writing it.

The structure of the text is very, well... structured. Damodaran tells you that he will combine narratives and numbers, he describes the basics of one of those, then he describes the basics of the other one, he merges them and finally discusses the consequences. The author who describes himself as a "teacher first" gives us short but thorough accounts of the two components before merging them into a greater whole. And to clarify, the narrative referred to in this book is the fundamental story of long-term value creation drivers for the company, not the flimsy, often biased and constantly shifting stories that always surround listed companies on the stock exchange. All the way through the book we get to follow the

described process through the case studies and there are further several illuminating pictures giving good oversights of the reasoning.

The advocated valuation process is to:

1. develop a narrative for the business,
2. test the narrative to see if it is possible, plausible and probable,
3. convert the narrative into drivers of value,
4. connect the drivers of value to a valuation and
5. keep the feedback loop open.

Interestingly the author calculates one value of the company as a going concern and one liquidation value and then estimates the probabilities of each life-or-death scenario. I very much appreciate the 3P test in stage 2 and the openness for change in stage 5 importantly tries to ensure that the narratives are reasonable and don't become stale and outdated in the light of changes. Damodaran's arguing for the importance of having enough humility to alter one's opinion brings to mind similar arguments from George Soros.

My main caveat is that the process doesn't explicitly enough ensure a combination of an inside view and an outside view when developing the story. When forming a narrative it is very easy to focus on the uniqueness and thrill of the situation at hand and extrapolate from the recent history. Often this leads to too high expectations and bottom-up sell side analyst estimates are partly due to this almost always too optimistic. The outside view treats the situation statistically and takes into account the outcome of many similar historical situations. In business where success is governed by both skill and luck both viewpoints have merit.

To make good forecasts narratives must meet numbers. Without the verbal structuring of the fundamental business story of a company it isn't even possible to understand the numbers to start with. Damodaran shows that good decisions benefit from several points of view such as the numerical and the verbal and I fully agree.

Mats Larsson, March 03, 2017