

Mini White Paper: Stock Evaluation Strategy for Long-Term Investors

Introduction:

Most retail investors rely on technical patterns like head & shoulders, flags, pennants, or double tops to time entries and exits. While these can work for short-term trades, they often ignore the core of long-term investing—business quality and financial health. This strategy combines two scoring models and forensic checks to evaluate a company's long-term investment potential. It is inspired by institutional methods used by firms such as Bridgewater, Bain Capital, and analysts trained in Buffett-style value investing.

Scoring Model 1: Value Investor Stock Stress-Test (100 Points)

This model analyzes key financial fundamentals to assess margin of safety.

1. Free Cash Flow (Max 25 Points)

Formula: Operating Cash Flow - Capital Expenditures (CapEx)

Meaning: Shows how much cash the company generates after maintaining or expanding assets.

Used by: All long-term investors and credit analysts.

Impact: Positive and stable FCF means high flexibility and value creation.

2. Balance Sheet Strength (Max 20 Points)

Formula: Debt-to-Equity Ratio & Interest Coverage ($\text{EBIT} \div \text{Interest Expense}$)

Meaning: Measures financial stability and debt risk.

Used by: Banks, credit rating agencies.

Impact: Lower debt = safer investment and less sensitive to rate hikes.

3. Moat Quality (Max 20 Points)

Input: Qualitative assessment—brand, IP, switching costs, network effects.

Meaning: Protects profitability from competition.

Used by: Private equity firms, long-term institutional funds.

Impact: High moat = durable advantage and pricing power.

4. Valuation Discipline (Max 20 Points)

Formula: Favorable P/E Ratio, $EV/EBITDA < 10$, Price-to-Sales < 3

Meaning: Measures how expensive the stock is vs. fundamentals.

Used by: Hedge funds, value managers.

Impact: Lower valuation = higher upside, lower downside.

5. Rate Sensitivity (Max 15 Points)

Input: Debt maturity, variable vs. fixed interest mix, and CapEx dependency.

Meaning: Determines how rising rates affect profits or funding.

Used by: Fixed income analysts, macro investors.

Impact: Lower sensitivity = more resilient in rate hikes.

Score Interpretation:

- 80–100: Strong, possibly undervalued
- 60–79: Fair, needs deeper analysis
- Below 60: Caution — low margin of safety

Scoring Model 2: Business Quality Framework (40 Points)

Assesses business durability and ability to scale.

1. Revenue Quality (Max 10 Points)

Input: Recurring revenue %, concentration, contract length.

Meaning: Predictability of income.

Impact: More stable earnings and planning power.

2. Operating Leverage (Max 10 Points)

Formula: $\text{Operating Income} \div \text{Revenue growth}$

Meaning: Measures scalability of the business.

Impact: High leverage = growing profits faster than revenue.

3. Capital Efficiency (Max 10 Points)

Formula: Return on Invested Capital (ROIC)

Meaning: How efficiently capital turns into profit.

Impact: Higher ROIC = superior long-term performance.

4. Management & Culture (Max 10 Points)

Input: Insider ownership, capital allocation history, compensation structure.

Meaning: Aligns leadership with shareholder value.

Impact: Better decisions and sustainable success.

Forensic Accounting Red Flags

Purpose: Identify manipulation or unsustainable trends

1. Stock-Based Compensation vs. FCF

High dilution with negative cash flow is a red flag.

2. Receivables Growing Faster than Revenue

Could mean aggressive revenue recognition.

3. Declining CapEx with Rising Revenue

Might indicate underinvestment or accounting tricks.

4. Legal/Audit Risk

Look for restatements, ongoing investigations, or weak auditor opinions.

How to Use This Strategy:

1. Run both scores and flag any forensic issues.
2. Combine with industry trends, macro context, and management commentary.
3. Only invest when business quality + valuation + forensic results align positively.