What is the Value Proposition?

Value Investors love numbers.

Ratios, financial statements and discounted cash flows are our bread and butter.

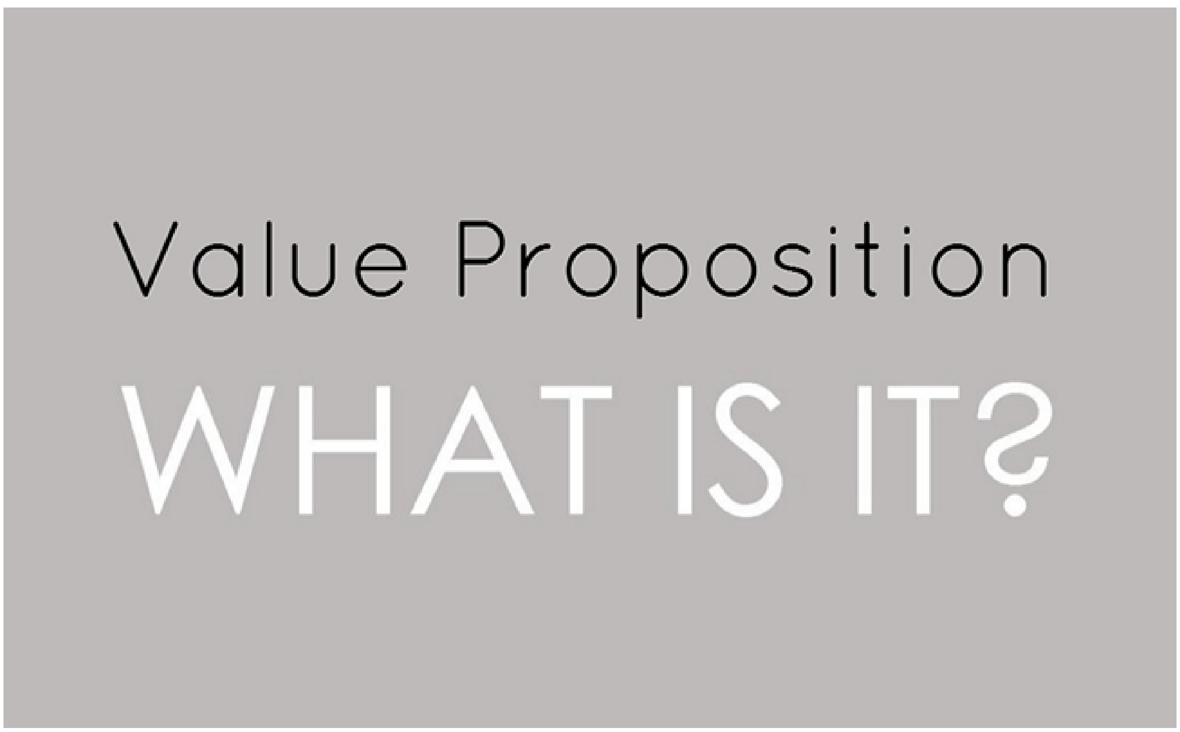
It is our edge in the market.

Numbers are safe to us.

We can justify our decisions with cold hard facts.

While I believe that numbers are a huge part of the equation, there is another part, the qualitative part of the business that cannot be ignored. This is what its called the "Value Proposition".

What is a "Value Proposition"?



Plainly, a Value Proposition is pitch to the customers, or clients, on why you should do something for them instead of doing it on their own.

It is the value you provide to them.

How I Heard this Term

Back in 2011, I was at my company's annual sales kickoff meeting.

It's a time where all the sales people from across the country get together and reflect on the successes of the year and what to expect for the upcoming year.

Towards the end, our CEO got up and talked to us. He opened with a question:

Why do our customer's do business with us?

There was silence for a bit, which is scary for a sales force.

Then the answers started coming.

"Our people"

"We are a good company"

"We do good work"

All were (and still are) true. That wasn't what he was looking for. I raised my hand and said:

Because we're cheaper

This got his attention and he asked me to elaborate.

Now I work in an infrastructure industry where we provide shared infrastructure and lease it to companies over many year.

I went on:

The customers do not have to lay out a large sum in capital up front and they can deploy that capital elsewhere. Also, by sharing the infrastructure, we spread the capital cost across many customers and it is thus cheaper for each individual customer.

Bingo!

This is our "Value Proposition".

This is the reason they do business with us. We provide something they need at a better price than they could do it themselves.

They are economically better off by having us do it instead of doing it themselves. In addition, we do it cheaper than our competitors

What Does "Cheaper" Mean?

Cheaper isn't about price necessarily.

It is about cost.

These two are as different as Income is to Cash Flow. Our whole economy is based upon someone else doing something cheaper than I could.

I could go buy land, grow corn, harvest it and eat it. I could even save a lot of money on corn doing it this way.

However, there is a cost.

The time it takes me to do all those things could be spent doing other things, like writing articles for you here at OSV. In the time it took me to do all those things, I could have written several hundred articles and been better off.

Economists call this *comparative advantage*.

Cheaper means that my well being is higher because I had someone else do the work for me.

Being cheaper is not only about the end user not having to do it, but that your company does it cheaper, in the context above, than anyone else.

Most think of this as being the low price provider.

Not so.

It is being the low COST provider.

A company may low ball a bid, but if you have to constantly keep on them and monitor what they do, there is a huge cost to that.

They also may provide a lower quality product or service. That lower quality could cost you in lost revenue, having to buy another sooner or having to pay someone to fix the issue later.

The Value Proposition needs to incorporate all of this.

In my above example, our main driver is price. In addition, if the customers have difficulty tapping into the infrastructure or they are delayed, there is a lost revenue opportunity.

Predictability is also a value proposition.

If I know for sure I can get the product at a fair price at a certain place, I will go there first and just buy it. Even if another company has a better deal, the risk of time lost by hunting and pecking isn't worth the risk.

How many times do you hear "just go to Wal-Mart, I'm sure they'll have it". The value is in knowing that I won't waste time and I know that I will get what I expect.

Buffett's quote rings true here:

> *Price is what you pay, value is what you get.*

Value Proposition Examples

Let's look at a couple companies and see what their value propositions are.

It is important to note that the value proposition should be easy to understand and in laymen terms. If you can't describe your value in simple terms, you probably are not adding value to your customers.

McDonald's: They provide an inexpensive, reliable quality meal all over the country. When you go in to a McDonald's anywhere in the world, you know what you're going to get. The value is in the predictability of both price and quality.

Laymen's Terms: You could go to the street vendor for a burger, but are you willing to risk getting garbage.

Starbucks: They provide premium products that provide enjoyment to their customers. In addition to having a reliable product, Starbucks can charge more because people feel good about buying something with Starbucks' name on it. The air of superiority with the Starbucks customer is valuable. The customer is making themselves feel better about themselves because it is Starbucks.

Laymen's Terms: You could go to the gas station to get coffee, but will you feel hip and cool with a 7-Eleven coffee?

ExxonMobile: They provide a reliable source of oil at a lower price. Due to their large size and rights to natural resources, they can provide energy producing substances (oil, nat gas etc.) to their customers at a lower price. Also, their distribution system provides a sense of reliability that the customer's need.

Laymen's Terms: Go ahead and buy gas from the little guy. There is more risk that they won't deliver on time and you'll probably pay more.

Visa: Having a card with the Visa logo on it means that I can go just about anywhere and buy something without having to have cash on me. The convenience and security of only carrying a little card around makes customer willing to pay a premium for the service.

Laymen's Terms: Try buying something at Home Deport with a John Smith card.

Old School Value: You can download ten years of financial data in seconds. You save hours of time and have the data in an easy to interpret manner. In addition, you are able to make better investment decisions which will more than offset the cost. Also, you cannot find a product that is less expensive in the market.

Laymen's Terms: It's painful to enter COGS numbers by hand. That time spent will not make your decisions any clearer.

The last lines are a little snarky, but they are the laymen's way of illustrating the value proposition for each company.

A value proposition is not about what you do. It is about how what you do makes the customer's life better than the alternative.

Anyone can sell stuff, but it is the company that makes you better off that has a value proposition.

What Does this Have to do with Investing?

Everything.

Ask yourself what the value proposition is for the company you are investing in.

If you cannot explain the value the company is providing for the customer, then that company is probably not going to around for the long haul. If they aren't around for the long haul, you're playing the greater fool game of investing which usually doesn't end well.

A company that is just in the market and doesn't have a value proposition is never going to have the economic moat we all want.

They will have to compete on price and price alone.

When you are in a commodity business and you don't add value, you are subject to the whims of the consumer and outside economic conditions.

A Value Proposition gives the customer's a reason to choose YOU and not the competition. That is where repeat business comes from.

So before you invest, ask yourself what the Value Proposition is for the company.

If you can’t find out why anyone would buy from them over the rest, you have a huge red flag.

Also ask whether that Value Proposition is sustainable.

Could anyone come in and do what they do better, faster or cheaper?

Quality matters.

Qualitative analysis matters just as much as quantitative analysis.

Disclosure: Long Visa and an OSV member.

About Dan Myers

A converted value investor with a desire to hear as many ideas as possible on the subject of valuation. A believer that the best way to learn is to teach. You can follow his video's on YouTube as well as follow him on Twitter.