

Digging Into Valuation

Capital Area Chapter
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William F. Mahoney



Some Principles:

- Market Determines Stock Price.
- Prices Are Based on Market Expectations.
- Current Price Reflects Analysis of Future.
- Multiple Factors Drive Market Sentiment & Expectations:
 - Macro -- Industry -- Company.
- Market Is Highly Complex.

Methods Used by the Market Are Complex

- They Involve Numerous Investment Approaches/Methods.
- It's Highly-Valuable to Understand Them.
- That's the Basis to Know How/What to Communicate.

Market Is Highly Complex

- Numerous Investing Approaches & Styles
 - Passive/Active
 - Quant/Fundamental
 - Pattern/Causality
 - Top Down/Bottom Up
 - Growth/Value
 - Contrarians
 - Multifactor
 - Hedging
 - Behavioral

Valuation Has 3 Dimensions

- Prime: What Is the Company Worth
- Market-Based:
 - Methods Used by Investors/What Is the Company Worth.
 - How Is the Company Valuing the Stock.
- Internal:
 - A Value-Based Management Framework.

Vital: Understand the Investment Process

- Two Primary Market Methods:
 - Calculate Intrinsic Worth.
 - Comparables Method.

Foundation: Calculate Intrinsic Value

- A Definition:
- The present value of expected future cash flows to investors over the remaining life of the business.
- Uses Economic, or Discounted Cash Flows Method.
 - Essence: Calculate Cash Flows, Growth Rates, Discount Rates.

Many Investors Use This Method

- Economic Analysis, or Cash Flow, Seen as More Reliable Way to Truly Understand the Business.
- Analysts and Investors Calculate Discount Rate, Want to Know if Company is Earning Returns on New Investments and Existing Assets Above Cost of Capital.

3 Components of DCF Analysis

- Cash Flows from Given Asset/Investment (Before Debt Service and Dividends).
- Time Period Cash Flows Are Expected to be Generated (Terminal Value).
- Discount Rate, or Cost of Capital.
(Risk Factor Adjustment to Account for Uncertainty).

Intrinsic Value Is a Foundation of Investing

- Is Fundamental Analysis.
 - Basis of Sell Side Analysis.
 - Basis of Analysis Used in Portfolio Management.
- Forms a Foundation: Investors Cannot Ignore Ongoing Behavior of Market.
- Daily Market Behavior Is Driven More by the Comparables Method.

The Comparables Method

- Pure (Intrinsic Value) Investors Define as a 'Shortcut.'
- Highly Popular with Investors Today.
- Depends on Market Behavior.
- Primarily Uses Market Ratios to Track Market (Price to Earnings, Sales, Cash Flow, Book Value).

Comparables Model

- A Definition:
- “The principle concept is to compute a ratio from a company-generated metric (i.e., earnings) and a market-generated metric (price of the stock) and then compare the result with other comparable companies or to itself.
- Most Popular:
 - Price/Earnings Ratio.
 - Price/EBITDA Ratio.
 - Price/Sales Ratio.

Habits of the Buy Side

- Institutional Analysts and Investors Use:
- DCF Analysis.
- Cash Flows (Seeking to Understand Economic Profit).
- Growth Rate (Sustainability of Cash Flows).
- Discount Rate (Uncertainty of Future Cash Flows).
- Variations (EVA, CFROI, Enterprise Value).
- Comparables Method.

Hard-Working Portfolio Managers

- Essentially Working Their Investment Models.
- Incorporating Research from Multiple Sources.
- Evaluating Market Factors:
 - Funds Flows.
 - Charts and Technical Metrics.
 - Competitors.

Investment Styles Come Into Play

- Every Professional Investor Has a Fine-Tuned Model, Incorporating Various Factors. (No Two Models Are Likely to be Exactly Alike.)
- Approaches/Styles Are Highly Diverse:
- Passive (Indexing, Enhanced Indexing, Quant).
- Active (Growth, Value, GARP, Income).
- Technical/Behavioral.

Most Investors Use Multifactor Models

- Most Incorporate a Handful of Factors.
- Some Use Dozens of Factors.
- Factors Weighted by Their Expected Impact.
- Goal: Create the Best-Possible Predictive Model.

Thus, Investor Behavior Drives the Market

- Foundation of Intrinsic Value Analysis, Based on Economics/Cash Flow.
- Daily Action Driven by Thousands of Very Bright People Working Their Models to Try to Outperform the Market and Each Other.
- Revenues, Earnings, Margins, Cash Flow, New Capital Investment, Cost Reduction and More All Come into Play.
- It's Not Simply a Question of Whether Earnings or Cash Flow Drive the Market. They Both Are at Work in a Complex Modeling Process.

Factors Leading the Market Continually Change Over Time

- 17 Leading Factors Driving Institutional Portfolios.
- Weights of These Factors Are Constantly Changing, Reflecting Investor Efforts to Predict Market Behavior and Evaluate Future Performance of Companies.
- Also, at Certain Times, Certain Models Work Very Well and Don't Work Well At All.

17 Leading Models (Factors)

- Size
- Cash Plowback
- Historical Earnings to Price
- Predicted Earnings to Price
- Yield (Dividend)
- Earnings Momentum
- Growth/Value
- Dividend Discount
- Historical Alpha
- Neglect

17 Factors

- Relative Strength
 - Residual Reversal
 - Estimate Revisions
 - Estimate Changes
 - Cash Flow to Price
 - Sector Momentum
 - Trading Activity
-
- (Source: Valuation Technologies)

Models Ranked Monthly on Total Extent of Use

- Based on Number of Portfolios.
- Based on Amount of Money Invested.
- Ranked At/Near the Top Most Months Are:
- Size, Neglect, Trading, Historical and Predicted Earnings to Price, Cash Flows.
- Earnings-based Factors Usually Rank in Middle or Lower Half.

Expectations Investing

- Title of Book by Alfred Rappaport and Michael Mauboussin.
- Shows Investors and Companies How to Anticipate Revisions in Market Expectations.
- Goal is to Anticipate Revisions to:
- (As Investor), Make New Portfolio Decisions.
- (As Company), Manage Strategies and Operations.

Key for Companies: Go About Your Business

- The Market Will Respond, Then Anticipate and Create a Set of Expectations.
- What's Vital:
 - Seek to Create Value.
 - Grow.
 - Continue to Sustain Growth.
 - Tell the Market What You're Doing (on an Ongoing Basis).

Value Creation

- The Fundamental Value Drive is Business Performance.
- Works from a Set of Financial Measures and Incorporates Intangible Value Drivers.
- Basis to Report Business Progress and Results.

Value Creation (Investor Perspective)

- Measures Combine Absolutes/Comparatives.

Absolutes: Revenue Growth, Operating Margins/Profitability, Cash Flow.

Returns: On Capital, Equity, Net Assets, Cash Flow, EVA, CFROI, etc.

Ratios: Stock Price to Earnings, Cash Flows, Sales, Book Value (Comparables).

Value Creation

- Purpose:
 - Measure Business Progress.
 - Compare Company with Market, Industry, Peers.
 - Give Analysts/Investors Yardsticks to Evaluate/Compare Business Performance.
- Ultimate Goal:
 - Use Current/Past Performance to Predict Future Performance.

Business Performance Driven

- Key Areas of Communication:
 - Vision and Mission.
 - Business Strategy.
 - Management Credibility.
 - Financial Measures.
 - Intangible Drivers of Value.

Focusing on the Intangibles

- Key: Identify, Prioritize and Report Fully On the Ones at Your Company.

Intangibles Most Important to Investors

- Vision and Business Strategy.
- Management Quality/Credibility.
- Customer Relationships.
- Market Position (Leadership).
- Intellectual Capital.
- Culture/Reputation.
- Innovation.
- Low Cost Supplier.
- Employee Productivity.

Key Notion

- Competitive Advantage.
- (Competitive Advantage Period).
- Core Competencies.
- The Intent Should Be to Identify, Fully Exploit and Report on Them.
- Purpose: Sustain Growth/Value.

Communications Goals

- Help Management Create Fair Value.
- Help Market/Stakeholder Groups Fully Understand the Company from a Value Framework.
- What Is the Business Worth?
- Is it Growing/How Will it Grow in the Future?

IR Function and Role: An Information Business

- Role: Information Conduit Between Management and the Market.
- Provide Best Information to Investors/Stakeholders
- Bring Best Information to Management/Help Them Use It Effectively.

IR Role

- Help Company Achieve Fair Value (Close Information Gap).
- Identify Information Important to the Market (Secure Agreement with Management.)
- Identify Company's Value Drivers.
- Communicate the Value Drivers Behind the Numbers (Intangibles).

Role of IR as Strategic Adviser to Management

- Resident Expert on How the Market Values Your Company.
- Adviser on:
 - Valuation Methods at Work in the Stock.
 - How the Market Is Reacting to the Vision, Business Strategy and Key Initiatives.
- Feedback Should Influence Strategies and Programs.

A Word About Value-Based Management

- Focuses on Economic Profit Instead of Accounting Earnings.
- Cash Flows and Free Cash Flows Are Essential.
- Value Is Created by Earning Returns on Assets and New Investments Above the Cost of Capital.
- Relies on Economic Profit, Economic Value Added, Risk-adjusted Return on Capital Employed and/or Cash Flow Return on Investment Frameworks and Metrics.
- Is Often Tied to Compensation.

Companies Using/Used Economic Profit Measures

- American Express
- Coca-Cola
- FMC
- Eli Lilly
- Boise Cascade
- Northrop-Grumman
- Georgia-Pacific
- Home Depot
- Nestle
- Unilever
- Olin
- Valmont Industries

Numerous Consultants Coaching Management on VBM Frameworks

- Marakon Associates
- BCG
- CSFB HOLT
- Vanguard Partners
- McKinsey
- Consulting Spin-offs of 'Big 4'
- LEK
- Stern-Stewart
- Helfert Associates

VBM Value to IROs

- Add Substantially to Your Knowledge and Expertise.
 - Value-Based Finance.
 - Economic Basis to Value Companies.
- Opportunity to Advise Management on Establishing VBM Framework.
 - Valmont Cross-Functional Team.