VIA AM

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# Mauricio's Monthly Letter

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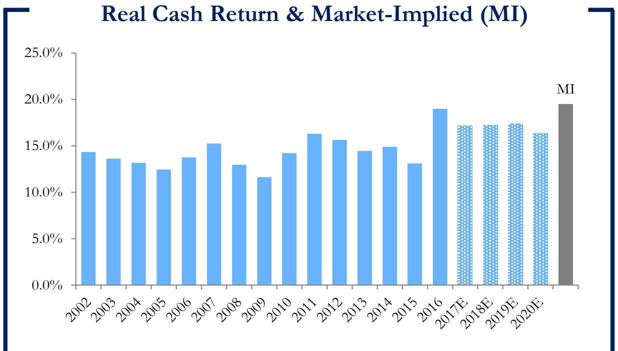
In these letters, I intend to raise awareness of problems, mistakes, and limitations in using accounting data while selecting stocks. This month, I assess Christian Dior and Salvatore Ferragamo – two luxury goods companies. These two cases are meant to illustrate the importance of using corporate economic data instead, which definitely lead to very different conclusions. I'll also detail VIA's current fundamental statistics on our main investment universes (US, Europe & World).

## Christian Dior – Yes, "minority interests" do matter. A lot, by the way

- Christian Dior engages in the production, distribution, and retail of fashion and leather goods, perfumes, footwear, watches and jewellery.
- Dior has major non-controlling interests or minorities, which are basically the portion of the equity of all the subsidiaries that the company does not own. **It is therefore the slice of the pie that is not owned by Dior shareholders.**
- More precisely, **Christian Dior owns 41.4% of LVMH, consolidating its accounts in the financial statements**. When analyzing Dior's latest balance sheet, we see that out of €30.8bn in total equity, €18.5bn actually belongs to minority interests (58.6% of LVMH). So what are the implications on valuation? 3 big ones: i) Minority interests are not part of accounting valuation multiples; ii) The traditional EV may take into account their book value, which is seriously flawed, and **iii) Only the Full EV captures €70.7bn (not €18.5bn), their correct *market value*.**

Dior

| | |
|---|---|
| France | |
| Luxury Goods | |
| Market Cap. | €50.3 bn. |
| Accounting RoE | 6.5% |
| Economic RCR | 17.2% |
| Accounting PE | 24.9x |
| Economic PE | 20.6x |



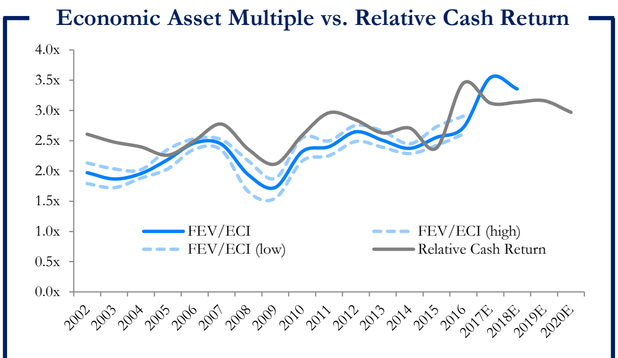

Source: VIA AM – Data as of October 17th 2017

### From Profitability…

- There are consequences in neglecting minority interests in the profitability measure. **The un-retreated RoE for example *could not be more wrong!*** The numerator is post-minorities whereas the denominator includes them.
- Even if this is addressed there are other missing parts such as the contribution of key intangible assets. Solution: **Dior's RCR includes both LVMH's cash flows and ECI** among other operational cash flows and investments associated with its brands.

### …to Valuation.

- The inclusion of minority interests in the FEV (market value of assets), *and* the economic consolidation of LVMH in the ECI (replacement value of assets) and RCR (return on those assets) are crucial. Only by then **it will be possible to assess and compare the valuation of Dior to those of peers globally.**
- More attractive economic than accounting valuation may have played a role in Semyrhamis' decision to acquire an **additional 25.7% stake in Dior**, as re-treated multiples are used in corporate finance.




Source: VIA AM – Data as of October 17th 2017

# Salvatore Ferragamo – Half of the capital invested is simply invisible

Salvatore Ferragamo

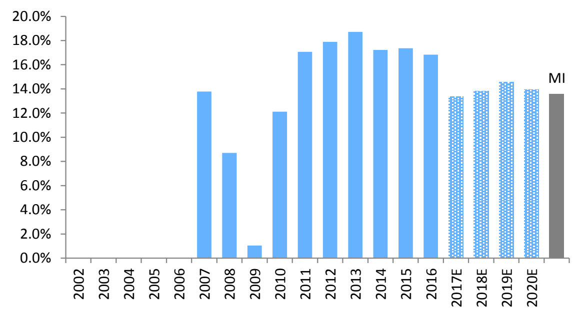
| | |
|---|---|
| Italia | |
| Luxury Goods | |
| Market Cap. | €3.9 bn. |
| Accounting RoE | 20.4% |
| Economic RCR | 13.4% |
| Accounting PE | 23.5x |
| Economic PE | 18.4x |

- Salvatore Ferragamo creates, produces, and sells luxury goods, offering footwear, leather goods, apparel, fragrances, eyewear, and watches.
- The company has **only a fraction of the value of brands on balance sheet**. That's because the investment to make them more memorable and generate cash through greater customer responsiveness **is seen as expense in the accounting world**. We estimate that around 5% of revenues is allocated to strengthen the brands and seek product innovation. This core investment is reflected in the ECI accordingly.
- Warren Buffett once said "*Accounting is the language of business and it's an imperfect language, but* ***unless you are willing to put in the effort to learn accounting*** *– how to read and interpret financial statements –* ***you really shouldn't select stocks yourself***". This quote implies that one must address the problems, limitations, and mistakes **to pursue the economic reality.** Hence the critical role of accounting normalization!

## From Profitability…

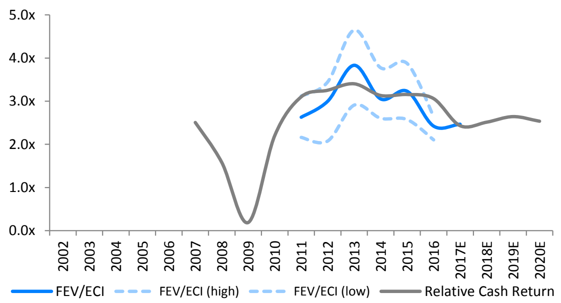
- Not only brands are part of the invisible capital invested, but also operating lease commitments, which are associated with core distribution and retail assets, but off-balance sheet. Altogether, **half of Ferragamo's operational assets are missing in traditional accounting measures of profitability.**
- Ferragamo will be comparable to Dior or to any other company only upon completion of the normalization process. Ferragamo's RCR is 3.8 pp lower than that of Dior due to inferior return on the invisible capital.

**Real Cash Return & Market-Implied (MI)**




Source: VIA AM – Data as of October 17th 2017

**Economic Asset Multiple vs. Relative Cash Return**




Source: VIA AM – Data as of October 17th 2017

## …to Valuation.

- Once again, because the economic capital invested captures 100% of operational assets, **the economic asset multiple is nearly half that of the accounting version** (FEV/ECI 2.5x vs 4.8x P/Bk). When compared to Dior's 3.5x FEV/ECI for example, it means that Ferragamo's shares are not traded at such a premium paid for value creation.
- In fact, they are currently traded at fair value, as indicated in the left-hand chart, where the economic asset multiple meets the relative cash return.

The conclusions in both cases are contradictory indeed. It does not necessarily mean that the transformation from accounting to corporate economic data will lead to such differences for each and every case. However, in "agglomeration", the spreads linked to fundamentals are wide, as shown in the following section.

# Universe Statistics

## UNIVERSES FUNDAMENTALS*

| | PROFITABILITY[2] | | VALUATION[3] | |
|---|---|---|---|---|
| | Accounting | **Normalized[1]** | Accounting | **Normalized[1]** |
| **US Universe** | 14.0% | **19.6%** | 18 | **21.5** |
| **European Universe** | 11.7% | **14.6%** | 14.9 | **18.9** |
| **World Universe** | 12.3% | **17.4%** | 15.8 | **19.1** |

**Sources: VIA AM, Bloomberg – universe fundamentals as of September 29th 2017*
*To be noted that the three universes exclude financials.*

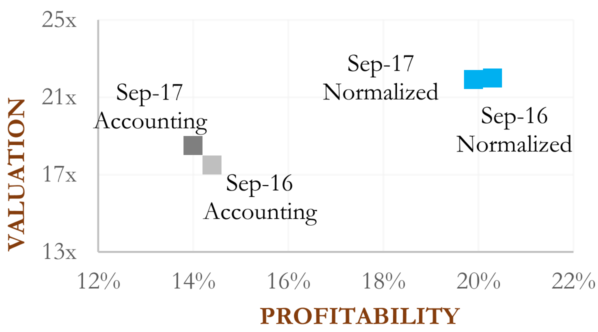
- Notes

1. Normalized Data aim to reflect the economic reality of corporates on a comparable basis
2. Normalized and accounting profitability is calculated using the Real Cash Return (RCR) and Return on Equity (RoE) resp.
3. Valuation is measured based on the economic and accounting Price to Earnings Ratio (P/E)

## PROFITABILITY/VALUATION – Today* vs. 1 year ago

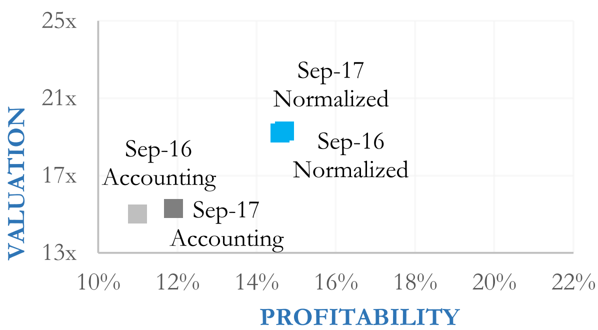
### US UNIVERSE

- The US Universe is composed of 1,150 US companies making up the VIA Smart Equity US fund selection universe, weighted by market cap



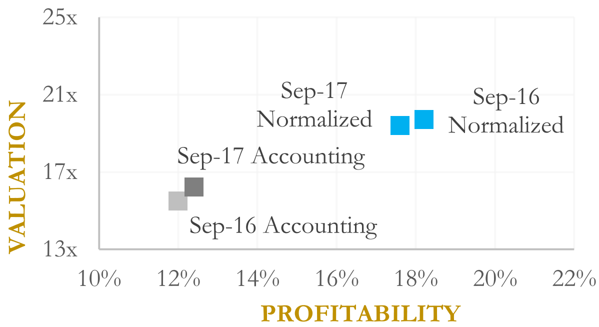

### EUROPEAN UNIVERSE

- The European Universe is composed of 680 European companies making up the VIA Smart Equity European fund selection universe, weighted by market cap




### WORLD UNIVERSE

- The World Universe is composed of 3,030 companies from developed and emerging economies worldwide making up the VIA Smart Equity World fund selection universe, weighted by market cap




*Source: VIA AM and Bloomberg*
**Data as of September 29th 2017*

## Glossary

| | |
|---|---|
| Accounting Asset multiple | Market Cap/Shareholders' Fund or Price/Book Value |
| Accounting Book Value (Bk) | Shareholders' Fund or Net Worth as given on the balance sheet |
| Accounting Enterprise Value (EV) | Market value of equity (market cap) and net-debt |
| Accounting Intangible Assets | Assets that are not physical in nature. Corporate intellectual property, patents, trademarks, copyrights, and goodwill are examples of intangible assets |
| Accounting PE | Market Cap/Net Income |
| Accounting Return on Equity (ROE) | Net Income/Shareholders' Fund |
| Book Value of Associates | Investment in affiliated companies as given on the balance sheet |
| Book Value of Minorities | Non-controlling interests as given on the balance sheet |
| Competitive advantage period (CAP) | Competitive advantage period (CAP) is the time during which a company is expected to generate returns on incremental investment that exceed its cost of capital |
| Corporate Economic Data | Outcome of VIA's accounting normalization process, whose aim is to unveil the companies' economic reality of profitability and valuation on a comparable basis |
| Cost of Capital (COC) | Real long term return of equity assets, estimated to be between 5.5% and 6.0% |
| Current Cost Accounting (CCA) | A method of accounting in which assets are valued on the basis of their current replacement cost, and increases in their value as a result of inflation. |
| Deferred Revenues | Deferred revenue, or unearned revenue, refers to advance payments for products or services that are to be delivered in the future. The recipient of such prepayment records unearned revenue as a liability on a balance sheet |
| Economic Asset Multiple | Full Enterprise Value/Economic Capital Invested (FEV/ECI) |
| Economic Capital Invested (ECI) | Replacement value of assets, including inflation-adjusted tangible assets, net working capital, other long term operational assets, and the "invisible capital invested" - or capitalised intangible assets such as investments in advertising, R&D, and operational leases |
| Economic Earnings | RCR x ECI. ECI is calculated in today's money |
| Economic PE | (FEV/ECI)/RCR |
| Economic Value Created | (RCR-COC) x ECI. If positive, value has been created, otherwise destroyed |
| Financial Leverage | Degree to which a company uses fixed-income securities such as debt and preferred equity. The more debt financing a company uses, the higher its financial leverage |
| Full Enterprise Value (FEV) | Market value of equity (market cap), net-debt, financial provisions, pension deficit (-) surplus, operational leases, market value of minorities less market value of associates |
| Historical Cost Accounting (HCA) | Record transactions appearing in both the balance sheet and the profit and loss account in monetary amounts which reflect their historical costs |
| Intrinsic Value | The actual value of a company or an asset based on an underlying perception of its true value including all aspects of the business, in terms of both tangible and intangible items. This value may or may not be the same as the current market value. |
| Invisible Capital Invested | Economically capitalised intangible assets such as investments in advertising, R&D, and operational leases |
| Market Value of Associates | Market value of investment in affiliated companies |
| Market Value of Minorities | Market value of non-controlling interests |
| Operational Gearing | Relationship between fixed and variable costs. Higher fixed costs mean greater operational gearing and vice versa |
| Real Cash Return (RCR) | Real cash return on the economic capital invested, calculated as an internal rate of return of inflation-adjusted capital invested and cash flow over the average economic life of depreciable assets |
| Relative Cash Return | Real Cash Return/Cost of Capital (RCR/COC) |

## Disclaimer