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Mauricio's Monthly Letter

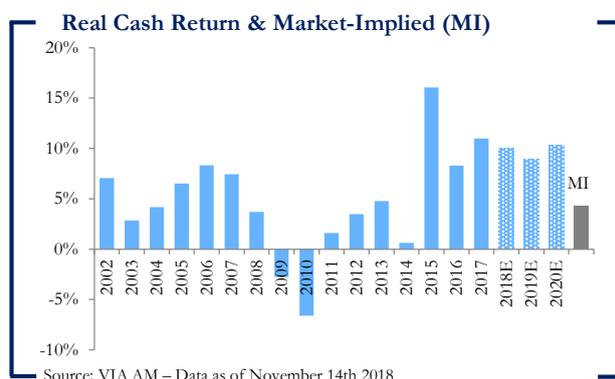
In these letters, I intend to raise awareness of problems, mistakes, and limitations in using accounting data while selecting stocks. This month, I assess SAS AB and Jardine Strategic – two large caps from different countries, sectors, and accounting norms. These two cases are meant to illustrate the importance of using corporate economic data instead, which definitely leads to very different conclusions. I'll also detail VIA's current fundamental statistics on our main investment universes (US, Europe & World).

SAS AB – Mind the gap! between basic and diluted number of shares

- SAS AB is an airline company, offering transportation services of passengers and cargo. Among others, it owns Scandinavian Airlines.
- **The market cap. is one of the most used valuation metrics worldwide**, an essential part of multiples such as the Price/Earnings ratio (PE), Price/Book (P/B), and yield variables as the free cash flow yield, the dividend yield, etc. **The main issue resides in its traditional calculation – (*basic number of shares * share price*)**. We defend that the **diluted number of shares** must be applied instead, to account for **in-the-money convertible debt** and the dilutive effect of stock options.
- SAS' Q3 2018 release makes it clear: “at the balance-sheet date, there was one convertible bond of SEK1,574, covering 66,329 shares”. The basic number of shares is 382,582 and the diluted is 66,329 higher at 448,911. So the true market cap is not SEK8.3bn but **SEK 9.9bn (+19%)** because **this debt can be converted into equity at any time!**



Sweden	
Airlines	
Market Cap.	SEK 9.9bn
Accounting RoE	13.1%
Economic RCR	8.9%
Accounting PE	5.7x
Economic PE	8.8x

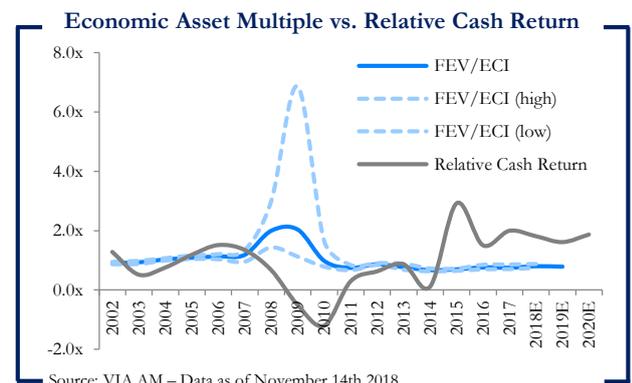


From Profitability...

- Although above the cost of capital, the Real Cash Return (RCR) is lower than the accounting version Return on Equity (RoE), because of **aircrafts and properties that are not on the balance sheet!** They represent **50% of the Economic Capital Invested (ECI)**, and their replacement value can be estimated based on operating lease commitments (AR note 33).
- Moreover, SAS has SEK5.3bn in “**Unearned transportation revenue**” which is added back to the ECI for being part of the economic working capital.

...to Valuation.

- The Full Enterprise Value (FEV) includes the net debt. Given that the dilutive effect of in-the-money convertible debt is reflected via the diluted number of shares, one must be careful not to duplicate the impact of it. Sometimes the **disparity between the dilutive effect of convertible debt can be material in relation to the convertible debt itself**.
- Operating lease obligations are also part of the FEV, (SEK18bn), just as “unearned revenues”, contributing to explain the gap between economic and acct. PE.



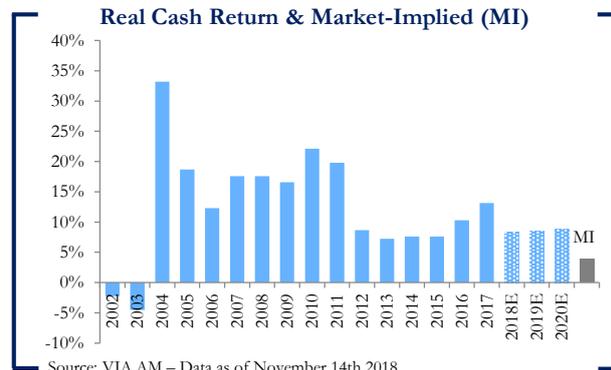
- Jardine Strategic - Mind the gap 2! between issued and outstanding number of shares

 Jardine Strategic	
Hong Kong	
Holdings Co.	
Market Cap.	\$ 21.2bn
Accounting RoE	5.6%
Economic RCR	8.4%
Accounting PE	11.9x
Economic PE	8.4x

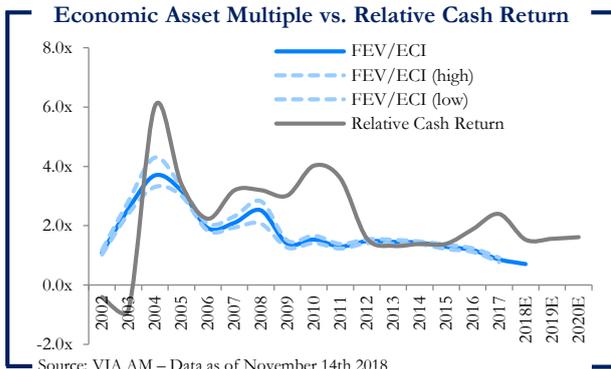
- Jardine Strategic is a conglomerate managing auto distribution, food and retailing, property investment and hotel operations.
- When looking at Jardine’s market capitalization through well known financial data providers, the figure commonly found is about **\$40.8bn**. **This is almost double the correct amount!** The root cause of this issue has a different nature from that of SAS, but also concerns the way the market cap must be calculated economically. In other words, based on the **number of shares outstanding**, not on the number of shares issued.
- So what is the difference between the two?* The number of outstanding shares is equal to issued shares *minus* treasury shares. Outstanding shares must be applied because they represent the **amount of stock on the open market**. Treasury shares are simply held by the company itself, directly or indirectly. For example, in H1 2018 release: Issued 1,108 – Treasury 537 (indirectly held through Jardine Matheson) = 571 outstanding shares.

From Profitability...

- The ownership structure of the Jardine Group is fairly complex, with Jardine Matheson acting as a holding company that controls 84% of Jardine Strategic, which in turn has 57% of JM...The bottom line is that **JS’ net income is significantly reduced by the 43% minority interests in earnings from JM**.
- Instead of using a common (post-minorities) net income, we opt for a refined post-tax EBITDA as the starting point for the Real Cash Return. Minority interests are dealt with, but in the FEV (see below).



Economic Asset Multiple vs. Relative Cash Return



...to Valuation.

- When analyzing JS’ latest balance sheet, we see that **out of \$58bn in total equity, \$27bn actually belongs to minority interests** (43% JM, 50% Hongkong Land, 22% Dairy Farm, etc.). However, the market value of minorities, which is added to the FEV, **is 22% lower at \$21bn**
- Logically, the market value of JM’s minority interest must be based on its outstanding number of shares: **728 Issued - 353 “Held by subsidiaries” = 375 Outstanding** (JM’s H1 2018 release).

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	17.0%	20.0%	15.9	19.6
European Universe	12.6%	14.8%	13	16.5
World Universe	14.3%	18.0%	14.8	17.4

*Sources: VIA AM, Bloomberg – universe fundamentals as of October 31st 2018
To be noted that the three universes exclude financials.

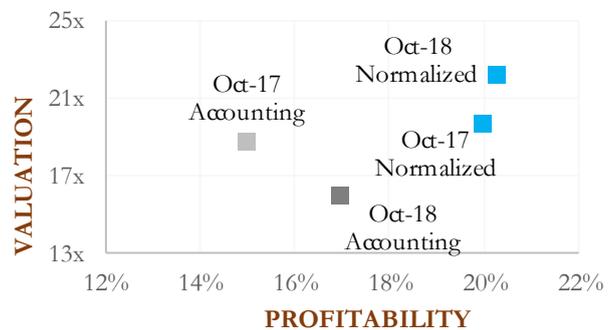
Notes

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

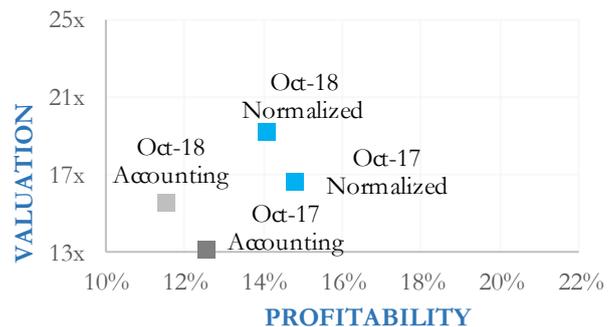
US UNIVERSE

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



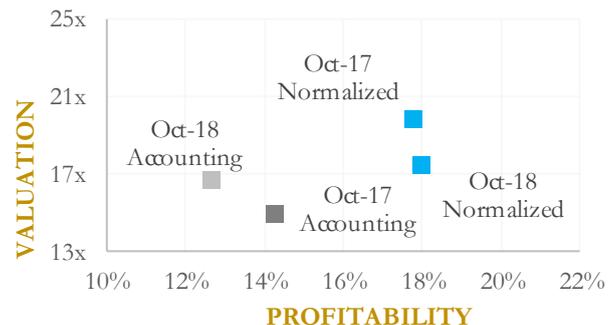
EUROPEAN UNIVERSE

- The European Universe is composed of 700 European companies making up the VIA Smart Equity European fund selection universe, weighted by market cap



WORLD UNIVERSE

- The World Universe is composed of 3,060 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 October 31st 2018

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	It is the discounted value of the cash that can be taken out of a business during its remaining life
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)

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