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Mauricio's Monthly Letter

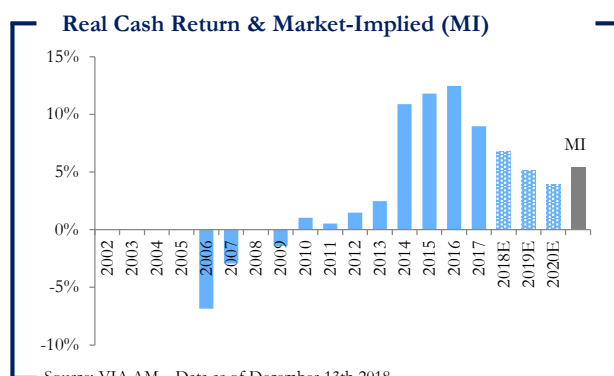
In these letters, I intend to raise awareness of problems, mistakes, and limitations in using accounting data when selecting stocks. This month, I assess Deutsche Wohnen and Mastercard – two large caps from different countries, sectors, and accounting norms. These two cases are meant to illustrate the 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).

Deutsche Wohnen – Properties do not last forever! Debt has nothing to do with returns!

- Deutsche Wohnen invests in, develops and manages residential and commercial properties (163,100 residential and 2,600 commercial units).
- We have argued that accounting profitability metrics such as the Return on Equity or the Return on Assets disregard the fact that a company's assets have predominantly *finite lives*. Hence, instead of using ratios we prefer to apply an **internal rate of return (IRR) method**, limiting the number of annual cash inflows to reflect the average economic life of the assets that are generating those inflows in the first place.
- Following this rationale, we don't see any reason why Real Estate companies may be treated differently, just for being part of the broad financials sector. At the end of the day, **the underlying assets that generate their cash are properties**, which have finite, though long-term, economic lives. Therefore the return of a Real Estate company can be worked out similarly to that of a long-term bond.



Germany	
Real Estate	
Market Cap.	EUR 15.4bn
Accounting RoE	15.7%
Economic RCR	6.8%
Accounting PE	8.9x
Economic PE	14.6x

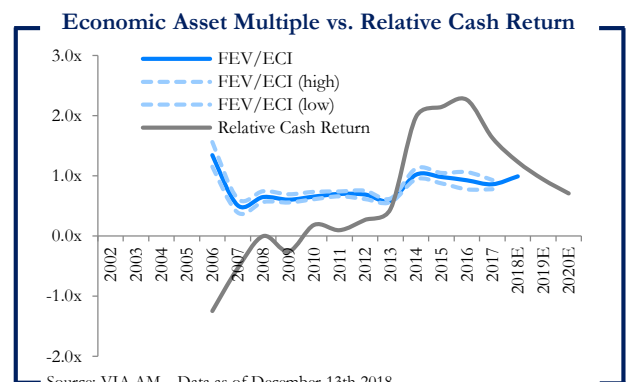


From Profitability...

- Deutsche Wohnen's Real Cash Return is then no exception. The main difference to industrials though is the fact that **unrealized properties' value gains and losses are treated economically as operating**, as they arise from the very core of Real Estate activities (+€1.4bn 2018E; +€2.4bn 2017).
- Equity results from total assets less total obligations, *debt included*. Because Equity is thus reduced by debt (€8bn), RoE goes up significantly as the denominator plunges, explaining the disparity with the RCR.

...to Valuation.

- The current €8bn debt has nothing to do with profitability, obviously. **It has to do with valuation!** And that's why the Full Enterprise Value is 140% the market capitalization. The group has €1.7bn *convertible debt*, which has a distinct impact on valuation (see [letter #18](#) for more details).
- The FEV also includes €340m GSW minorities. The gap in returns and debt explain the difference between Ec. and Acc. PE. The stock is traded at a slight discount - rel. return above the asset multiple (*chart*).



Mastercard – Are credit card companies financials or technology?



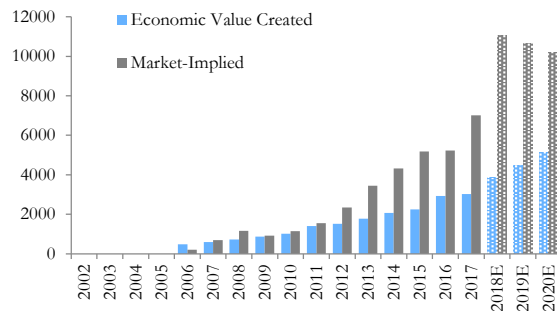
United States	
Credit Card	
Market Cap.	\$ 212.1bn
Accounting RoE	91.9%
Economic RCR	50.3%
Accounting PE	32.6x
Economic PE	48.0x

- Mastercard provides financial transaction processing services, in particular through credit and debit cards and ATMs.
- Just as Real Estate, Credit card companies are commonly seen as part of a “financials” sub-sector, hence fairly different from industrials or services groups when it comes to transforming accounting data into **corporate economic data**. However, the accounting normalization practice pursues the economic reality through the understanding of the true business model, regardless of the sector the business is officially classified in.
- In fact, Mastercard, Visa, American Express, Cielo...are primarily technology data processing companies. In general, **their most important operating assets are finite-lived intangibles (not financial)** on and off-balance sheet. Mastercard’s Economic Capital Invested is mainly composed of software and brands (10% and 71% of the total respectively). But the latter was declared as only \$1m following accounting standards!

From Profitability...

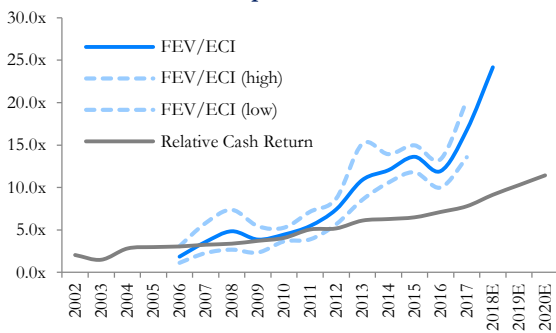
- The reconstruction of the capital invested **following an economic framework** becomes crucial as a result. Mastercard has invested around \$850m p.a. in advertising to strengthen its brands to boost revenues. So each year’s advertising “expenses” must be capitalized, not expensed. Logically, the amounts expensed must be added-back to the norm. EBITDA.
- The gap between RCR and RoE is then primarily explained by the fact that the full replacement value of the Mastercard brand is *missing* in the RoE *denominator*.

Economic Value Created & Market-Implied \$m



Source: VIA AM – Data as of December 13th 2018

Economic Asset Multiple vs. Relative Cash Return



Source: VIA AM – Data as of December 13th 2018

...to Valuation.

- The group is not financially leveraged, has low pension fund deficit, post-retirement obligations, and litigation provisions. Its FEV is nearly identical to its market cap. as a consequence, the gap between economic and accounting PE is attributed to profitability. Still, the RCR reaches 50% and the value creation is substantial (*see chart above*).
- But that comes with a price. The *LHS chart* shows the **valuation premium growing exponentially**: the economic asset mult. is well above the rel. 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	17.1%	18.0%	15.9	17.4
European Universe	12.6%	14.5%	12.9	16.2
World Universe	13.6%	16.6%	13.8	16.0

*Sources: VIA AM, Bloomberg – universe fundamentals as of November 30th 2018
To be noted that the three universes exclude financials.

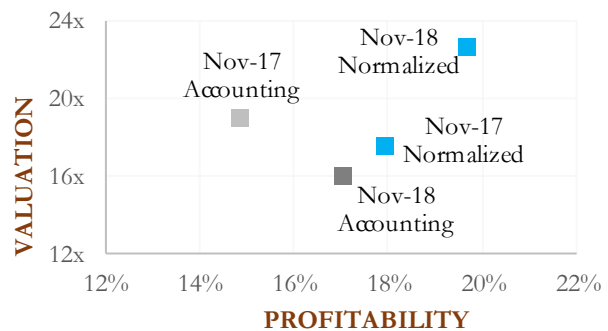
Notes

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

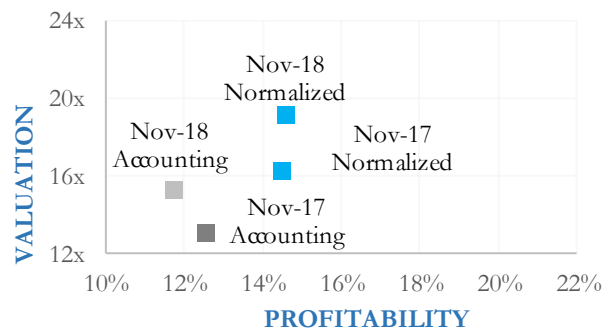
US UNIVERSE

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



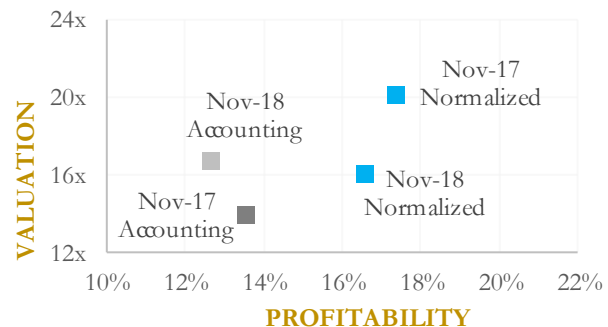
EUROPEAN UNIVERSE

- 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 3,100 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 November 30th 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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