VIA AM

#20 – January 2019

Mauricio's Monthly Letter

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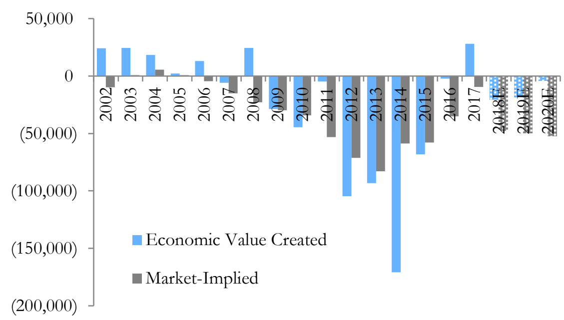
In these letters, I intend to raise awareness of problems, mistakes, and limitations in using accounting data when selecting stocks. This month, I assess Indian Oil and Allergan – two large caps from different countries, sectors, and accounting norms. These two cases are meant to illustrate the importance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

Indian Oil – watch out for the transition from local GAAP to IFRS

- Indian Oil is India's number 1 crude oil refiner. The company also owns an extensive downstream pipeline and a chain of gas stations across India.
- The transition from Indian GAAP to Ind AS must not be overlooked. **India is converging to IFRS in a phased manner** starting from annual periods beginning on or after April 1st 2016. The IFRS converged standards are known as Indian Accounting Standards (Ind AS) and contains numerous features from IFRS, which are seen as a positive move.
- However, there is a great deal of flexibility during this transition and one of the main concerns (from an economic perspective) is called **"deemed cost"**, because the entity is given the option to revalue its property, plant and equipment (PPE), and intangible assets. Indian Oil opted to *"continue with the carrying value for all PPE"*, but in reality both economic profitability (Real Cash Return) and Economic Capital Invested become inaccurate if both PPE Gross and Net are not treated consistently.

India	
Oil & Gas	
Market Cap.	INR 1,340bn
Accounting RoE	12.9%
Economic RCR	**4.8%**
Accounting PE	8.3x
Economic PE	**14.7x**

Economic Value Created & Market-Implied INRm



Source: VIA AM – Data as of January 18th 2019

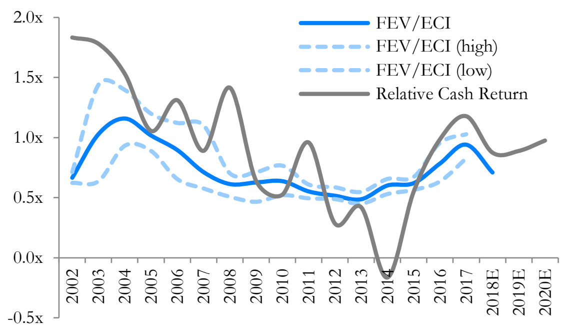
From Profitability…

- One of the main conditions to reach the true profitability is to inflation-adjust the ECI, **free from revaluation**, based on its original cost - reflected in the Gross PPE, not the Net. The "accumulated depreciation" is the Gross minus the Net.
- Before and after Ind AS adoption, the **Net PPE was nearly the same at INR 1,279bn, but the Gross went down by 30%!** So it's necessary to add-back the acc. depreciation that was written-off artificially. This broadly explains the gap between RCR and RoE.

…to Valuation.

- The stock is traded at a significant discount according to the accounting PE, but nearly at fair value according to the economic PE, on the back of a normalised profitability predominantly **within value destruction territory** (see chart above).
- Also contributing to explain the big mismatch between acc. and ec. PE is the full debt, which includes **long & short term financial provisions**, pension deficit and operating leases, making the Full Enterprise Value 60% above the market cap.

Economic Asset Multiple vs. Relative Cash Return



Source: VIA AM – Data as of January 18th 2019

Allergan – patents arising from acquisitions must be carefully valued

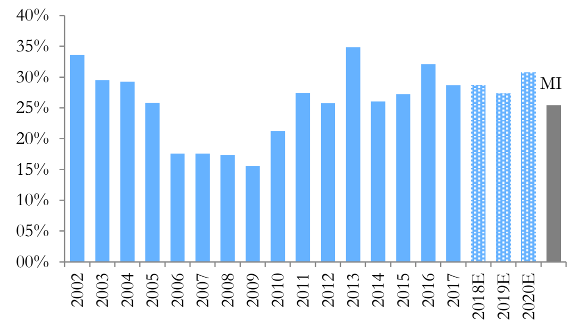
Allergan	
United States	
Pharma.	
Market Cap.	$ 54bn
Accounting RoE	-0.4%
Economic RCR	27.3%
Accounting PE	NM
Economic PE	16.9x

- Allergan manufactures specialty pharmaceuticals. The group develops, and distributes generic, brand, and OTC products.
- The Company has aggressively acquired many "product rights" holders since 2006. The main transaction was clinched in 2015 when Actavis Plc. acquired Allergan Inc. for $65bn in cash and stock, forming Allergan Plc. Various smaller acquisitions took place throughout its history: Warner Chilcott, Forest Laboratories, LifeCell, Zeltiq Aesthetics, Kythera, BonTi etc.
- Allergan reported $72bn as "product rights and other". That raises two questions from an economic standpoint: does it represent the *replacement value* of patents? No. Does it include in-house investments to create new drugs? No, again. It represents the *market value* of externally produced patents. But **what is relevant for the economic profitability (Real Cash Return) is how much cash each acquired company invested for creating their patents *plus* how much Allergan has invested in in-house R&D.**

From Profitability…

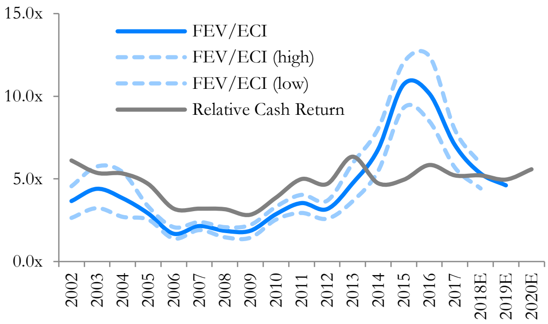
- The reconstruction of investments associated with patents **following an economic framework** becomes crucial for revealing the true profitability as a result. We estimate that all capitalized R&D, from acquired companies *plus* from in-house investments reached $24bn, or **67% lower than declared**.
- That's one reason for the high RCR and the low RoE. The others are the accounting amortization of patents ($7bn non-cash!), in-process R&D and impairments ($1.1bn non-cash) polluting the accounting version.

Real Cash Return & Market-Implied (MI)



Source: VIA AM – Data as of January 18th 2019

Economic Asset Multiple vs. Relative Cash Return



Source: VIA AM – Data as of January 18th 2019

…to Valuation.

- The correction of the profitability measure paves the way for a precise valuation. **The high productivity of internal and acquired R&D has granted strong cash flow generation**, which in turn has been used to trim the debt (1/3 reduction expected in 2019).
- Indeed, the significant improvement of accounting data allows investors to have an accurate valuation measure versus *non-meaningful or not available*. In this case, the conclusion is that the stock is traded at a slim discount, for the first time since 2013 (see LHS chart).

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	16.7%	**19.5%**	14.4	**17.8**
European Universe	12.5%	**14.5%**	12.1	**14.9**
World Universe	14.0%	**17.8%**	13.4	**16.6**

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

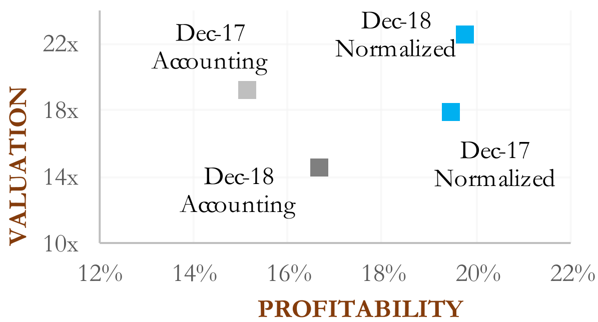
- Notes

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

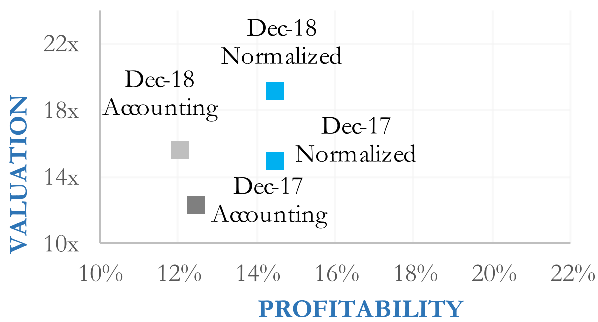
US UNIVERSE

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



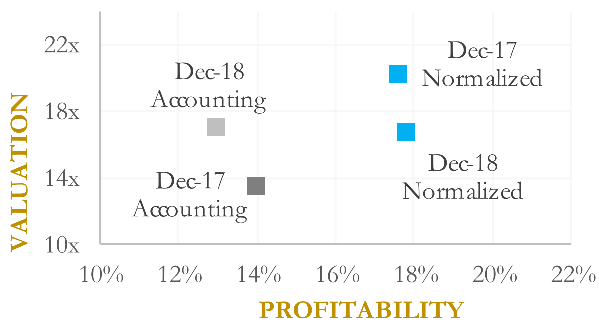
EUROPEAN UNIVERSE

- 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 3,100 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 December 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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