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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 Sony and Cleveland-Cliffs – two companies from different countries, sectors, sizes (large and small cap respectively), 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).

## Sony Corp. – the role of financial divisions is not always the same in non-financial groups

- Sony manufactures audio, home video game consoles (such as the PlayStation), communications, IT products, and provides financial services.
- Sony Financial Holdings or SFH (Sony Bank, Sony Insurance, and Sony Life) **account for 13% of total revenues, but 66% of total assets and 74% of total liabilities**. As opposed to GM or IBM for example, which have their financial divisions focused on providing loans to their customers to buy **core** products and services, Sony Financial doesn't attach banking and insurance activities to its consumer electronics and media businesses.
- So what are the implications? Quite significant. While financial divisions in the examples above are treated economically as consolidated - assets included in the Economic Capital Invested, and debt in the Full Enterprise Value - **Sony Financial is de-consolidated**, meaning that its total net of assets less liabilities reduces Sony's FEV, **just as we treat long term investments!**

### SONY

Japan	
Consumer Elec.	
Market Cap.	JPY 6,515bn
Accounting RoE	17.3%
Economic RCR	10.0%
Accounting PE	8.5x
Economic PE	11.7x

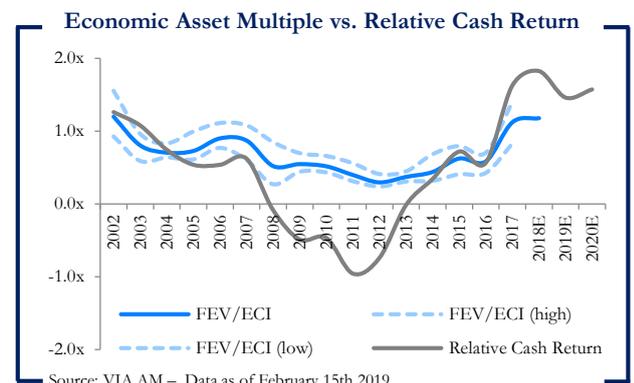


### From Profitability...

- By doing so, **it's possible to work out the Real Cash Return of core businesses only** (LHS chart) such as home entertainment, motion pictures and mobile communications, **while capturing the precise valuation of Sony Financial in the FEV**.
- RoE exceeds the RCR as net income includes volatile "gains on equity securities", and shareholders funds are 20% lower than the ECI, failing to reflect the replacement value of brands and technological innovation - reaching 11% of sales historically.

### ...to Valuation.

- Although the RCR is lower than the RoE, it has been well above the cost of capital since 2017, and value creation is set to continue if consensus forecasts prove to be right. By cleaning the accounts to reveal the true profitability of core businesses, **it's possible to reach an equally neat asset multiple (FEV/ECI)**.
- That's because Sony Financial is publicly listed, of which 65% is owned by Sony Corp. Therefore, ¥578bn is **exactly its market value**, decreasing Sony's FEV. The stock is traded at a 35% discount.



## Cleveland-Cliffs – deciphering the “tax losses carryforwards” jargon



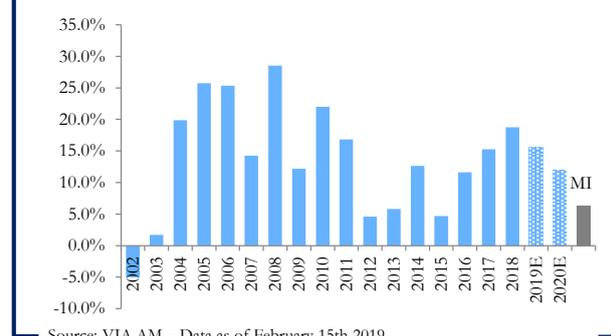
United States	
Mining	
Market Cap.	\$ 3.4bn
Accounting RoE	56.1%
Economic RCR	15.6%
Accounting PE	6.9x
Economic PE	7.3x

- Cleveland-Cliffs is primarily an iron ore mining company that supplies iron ore pellets, lumps and fines to blast furnaces in the global steel industry.
- In the recent 2018's 10K: “We had gross domestic and foreign net operating loss carryforwards of \$3.6 billion and \$6.6 billion, respectively, at Dec. 31, 2018 (...) The U.S. Federal net operating losses will begin to expire in 2034...The foreign net operating losses can be carried forward indefinitely...”. That’s mainly because Cliffs incurred **material non-cash impairment losses in 2014 - \$9bn** in Canadian/Asia Pacific iron ore and North American coal operations. **It simply means that those non-cash losses generated tax credits to be used in the future.**
- But how? Something called “**Deferred tax assets**” associated with tax losses carryforwards was specially created. An example can help illustrate this better. Say a company has accumulated carryforward losses of \$1 billion, hence using \$1 billion to offset \$1 billion in future gains at the tax rate of 21%. That made the deferred tax asset worth \$210 million.

### From Profitability...

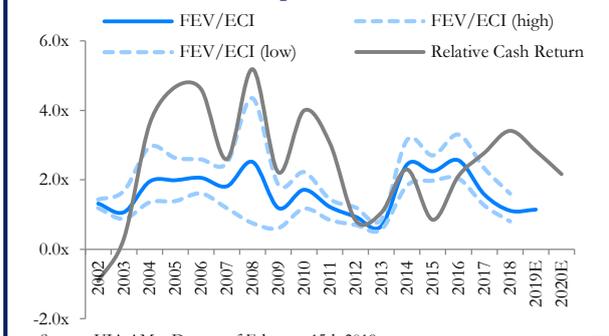
- Why does it matter? Because there is a substantial impact on both profitability *and* valuation. The Real Cash Return (RHS chart) is a post-tax measure, so it obviously goes up when the tax paid is close to zero.
- But not to the same extent as that of the Return on Equity, which benefited from a **negative tax expense of \$475.4m in 2018**, due to the effect of tax credits associated with past losses. In cash terms, there is no such a thing as a negative tax expense, so it must be removed from the economic profitability (RCR).

Real Cash Return & Market-Implied (MI)



Source: VIA AM – Data as of February 15th 2019

Economic Asset Multiple vs. Relative Cash Return



Source: VIA AM – Data as of February 15th 2019

### ...to Valuation.

- Following the same logic, because Cliffs has \$10bn of “operating loss carryforwards”, a corresponding \$2.1bn deferred tax asset was created. **It means that the company will not have an income tax cash outflow of up to \$2.1bn in the future because of it!**
- So around \$1.5bn can be estimated to reduce the FEV (a discount is applied to reflect the risk to Cliffs of not being allowed to use it - e.g. change in the tax law). That offsets the \$1.3 net debt, FEV and market cap converge producing a valuation discount (LHS chart).

The gap in acc. vs economic profitability in both cases is significant 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 <sup>2</sup>		VALUATION <sup>3</sup>	
	Accounting	Normalized <sup>1</sup>	Accounting	Normalized <sup>1</sup>
US Universe	16.7%	19.5%	16	18.9
European Universe	12.2%	14.1%	13	16
World Universe	13.6%	18.1%	14.5	16.8

\*Sources: VIA AM, Bloomberg – universe fundamentals as of January 31st 2019  
To be noted that the three universes exclude financials.

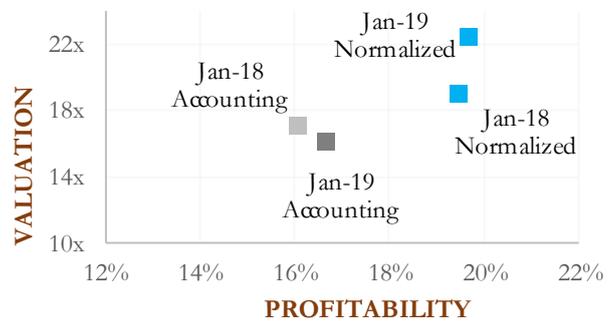
### Notes

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

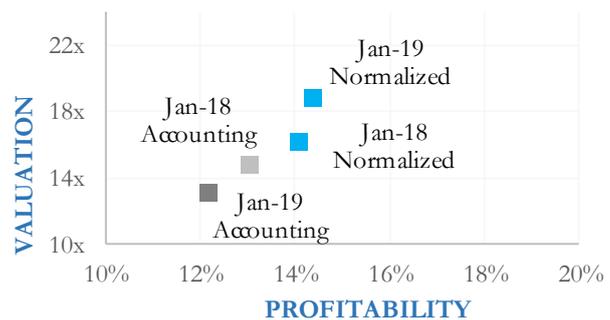
### US UNIVERSE

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



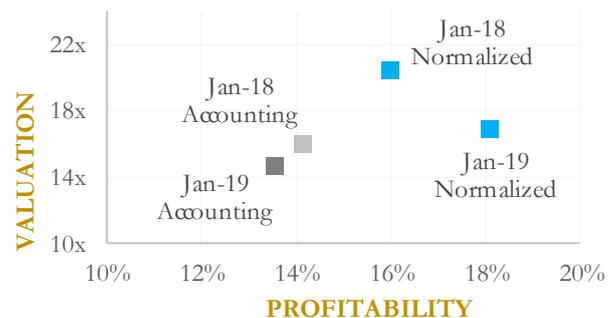
### EUROPEAN UNIVERSE

- 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 January 31st 2019

## 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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