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 when selecting stocks. This month, I assess Discovery and IBM – two large caps from different sectors. 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).

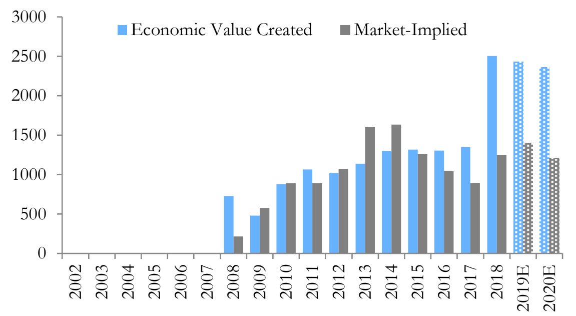
Discovery – Value creation arising from Scripps Networks still not fully priced-in

- Discovery provides non-fiction entertainment, operating a wide range of educational television channels and a portfolio of digital media services.
- The stock is traded at the same accounting and economic Price-to-Earnings ratios. However, for the same price, **the economic profitability (Real Cash Return) is more than two-times higher than the accounting one** (RoE)! It means that a series of important economic corrections are needed to unveil the true value creation, especially after the Scripps acquisition. In other words, to price-in **the upside potential from an economic, not accounting perspective.**
- Indeed, the RoE takes into account $13bn goodwill and $9bn goodwill-like *"customer relationships"* and *"trademarks"* stemming from acquisitions. The former is not operational, so it must not take part in any economic profitability measure; the latter reflects the *market value* of intangible assets, not their *replacement value* (original cash invested to build them).

Discovery COMMUNICATIONS

United States	
Entertainment	
Market Cap.	$ 18,4bn
Accounting RoE	13.3%
Economic RCR	**31.8%**
Accounting PE	11.4x
Economic PE	**11.7x**

Economic Value Created & Market-Implied $m



Source: VIA AM – Data as of March 24th 2019

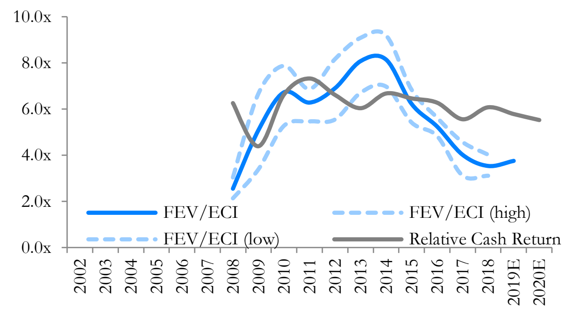
From Profitability…

- In practice, the **replacement value** of *"trademarks"* and *"customer relationships"* must be estimated economically based on investments that Discovery *and* Scripps have made in **advertising**. We value them to add $3bn to the Economic Capital Invested, captured through the RCR – *quite far from the reported $9bn!*
- Besides, the ECI increases by $1bn due to off-balance sheet leased assets and deferred revenues. In fact, the *"Equity"* part of the RoE **excludes crucial economic assets and includes non-operating ones.**

…to Valuation.

- From $13bn goodwill, $6bn relates to Scripps, paid in cash and stocks. Although goodwill is not in the ECI, the cash used and stocks issued to pay for it are certainly captured by the Full Enterprise Value. Hence **reflected in valuation, not in profitability.**
- The ECI went up 70% post-Scripps acquisition, while the RCR remained above 30%, thus setting conditions for substantial value creation, not yet priced-in. The relative cash return is well above the economic asset multiple (rhs chart), suggesting a 50% upside potential.

Economic Asset Multiple vs. Relative Cash Return



Source: VIA AM – Data as of March 24th 2019

IBM – a practical example on Why We Do What We Do

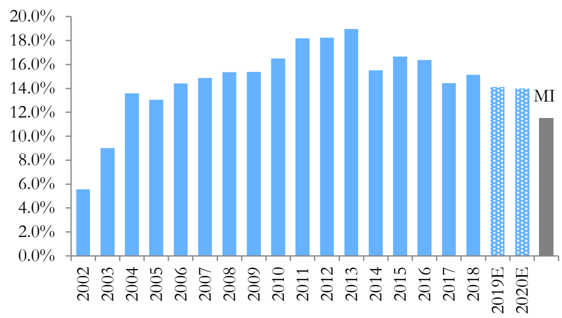
United States	
IT Services	
Market Cap.	$ 125bn
Accounting RoE	48.3%
Economic RCR	**14.1%**
Accounting PE	11.5x
Economic PE	**14.8x**

- IBM provides computer solutions: application, technology consulting and support, process design and operations, cloud, digital workplace, hardware...
- We have argued that the accounting normalization practice aims at **detecting, re-treating, and including elements that are not obvious at first sight** (*far from it!*), to get to the economic reality of corporates on a comparable basis. In this context, IBM has no shortage of items to be included or re-treated, materially affecting profitability and valuation: a finance division, pension and post-retirement benefits, deferred revenues, off-balance sheet leased assets, research and development, advertising, stock options, financial provisions, tax credits, product warranties, goodwill…
- Digging into the notes of IBM's 154-page 2018 annual report is key to understand controversial elements, and concretely decide how to include or re-treat them. In other words, **how to organize the data** to substantiate the Full Enterprise Value, Economic Capital Invested, and Real Cash Return.

From Profitability…

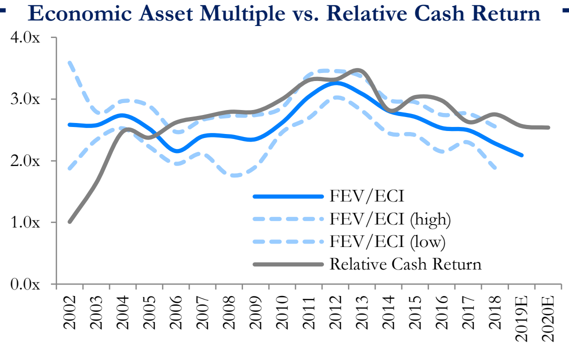
- There is no sole reason why the economic profitability (RCR) is so lower than the accounting version (RoE). The explanation rather lies in a number of inclusions in the ECI that are disregarded in the accounting book value: the brand IBM, the economic developed technology, contract liabilities, product guaranties, operating leased assets...or **$62bn altogether!**
- In the accounting measure, the book value is even reduced by a $27bn net-debt, mostly coming from its finance division, having **nothing to do with returns!**

Real Cash Return & Market-Implied (MI)



Source: VIA AM – Data as of March 24th 2019

Economic Asset Multiple vs. Relative Cash Return



Source: VIA AM – Data as of March 24th 2019

…to Valuation.

- In the same way that accounting distortions are dealt with in profitability, valuation must include all elements ignored by the traditional P/E ratio, **or $54bn worth of total economic debt and obligations.**
- In addition to the net debt, which is highly visible and already in the traditional EV, it's also necessary to revisit the notes of the annual report to find $20bn pension deficit and post retirement obligations; and $12bn provisions on restructuring, tax, employee, etc.

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%**	16.5	**19.7**
European Universe	12.3%	**14.3%**	13.5	**16.6**
World Universe	13.9%	**17.8%**	15.1	**17.7**

Sources: VIA AM, Bloomberg – universe fundamentals as of February 28th 2019
To be noted that the three universes exclude financials.

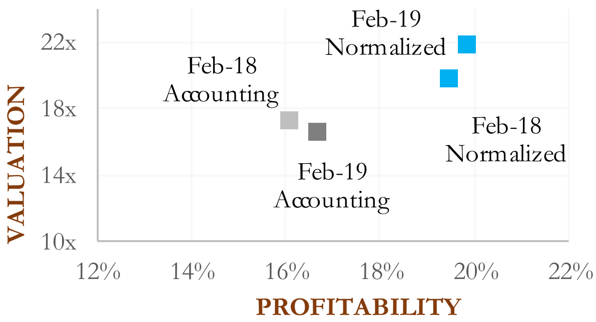
- Notes

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

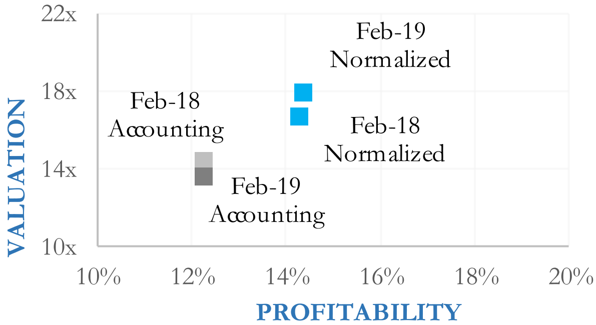
US UNIVERSE

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



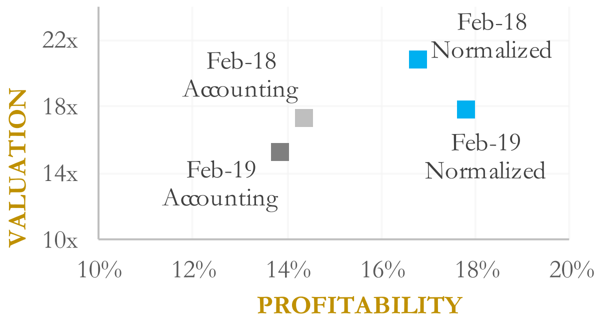
EUROPEAN UNIVERSE

- 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 3,050 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 February 28th 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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