

LEVELLING THE GLOBAL PLAYING FIELD

Why understanding the key metrics of economic profit can lead to better global investing



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Executive summary

Economic profit – returns on investments generated in excess of a firm’s cost of capital – is a key indicator of a company’s effective deployment of capital. Commonly referred to as Economic-Value Added (EVA)¹, it incorporates both the cost of equity and debt capital to understand the value added by a firm. For a skilled investment manager, being able to properly assess economic profit standardizes a company’s effective deployment of capital across borders and serves as a more accurate form of analysis than solely relying on typical accounting metrics such as earnings per share (EPS). It is our belief that when applied, EVA concepts can identify the true value added by a company, which should ultimately translate into value for investors over time.

In this paper, we will examine some of the limitations of using standard accounting conventions to analyze global companies and how an EVA framework can help to level the playing field and better understand underlying business dynamics. We will also highlight key valuation concepts and metrics that are important when applying an EVA framework and how these metrics help lead us to companies that are more likely to create shareholder value. When EVA is combined with a disciplined approach to valuation, it can lead to better investment decisions.

Limitations of Generally Accepted Accounting Principles

All bottom-up fundamental analysis relies heavily upon financial statements and accounting data. In analyzing economic profit, one of the key issues is translating financial statements into data that actually reflects economic reality and allows comparability across varying time periods and countries. Typically, financial statements are created according to a set of rules referred to as Generally Accepted Accounting Principles (GAAP). These accounting rules can vary regionally and by industry and may not accurately express the economic reality or underlying business dynamics. When investing globally, these regional differences are highlighted in the treatment of items such as operating leases, currency translation, pensions, etc. Even in the same region, or between two companies operating in the same industry, accounting differences can be significant. Varying rates of inflation can also meaningfully impact financial statements over time and inhibit comparisons in different countries with different inflation rates.

¹ Trademark Stern & Stewart

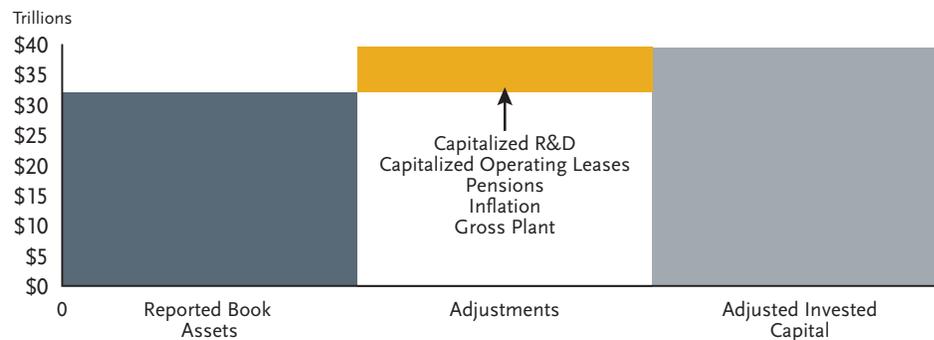
The AGF Global Equity team, led by Steve Way, has been using an EVA-based approach to investing for over a decade. The team has found that this framework helps to adjust for the inherent shortcomings in GAAP financial statements, allowing for a better understanding of the sustainability of a company’s franchise. To illustrate the difference between economic reality versus accounting convention, one can look at the issue of capital investment. In some accounting jurisdictions, GAAP requires companies to expense research and development (R&D) costs in the year made. However, from an economic standpoint, all cash outlays that are expected to contribute to future earnings should be considered capital investment. Therefore we believe R&D costs should be capitalized on the balance sheet and subsequently written off or amortized over time because they represent an investment in future products or processes that will generate potential earnings. The difference between expensing R&D and capitalizing R&D can result in significant differences to the same balance sheet, which will distort ratios such as return on capital. For example, expensing R&D may result in a relatively higher return on capital.

As another example, when comparing two retail companies, where one leases its stores and another owns its stores, the balance sheets will be difficult to compare. The company that had expensed its lease would have an unfairly higher return on capital compared to the one that is depreciating its stores, everything else being equal, making it necessary to make adjustments for an accurate apples-to-apples comparison.

To improve analysis and comparability, analysts must also take into account the amount of management discretion present in financial statements, particularly on accounting items that are exposed to subjectivity. Accounting returns can be improved by off-balance-sheet accounting items, increasing leverage. Detailed analysis of accounting items is required, particularly where exposed to management discretion and subjectivity. As can be seen in Figure 1, all these adjustments can impact the investment decision significantly. Over US\$7 trillion in adjustments was made to approximately US\$32 trillion in reported book assets. An EVA-based approach considers a more realistic invested capital by adjusting accounting assets for things like capitalized R&D, capitalized operating leases and inflation.

Figure 1: Economic profits less likely to be manipulated

World Index – Reported Assets vs. HOLT Gross Investment (LFY)



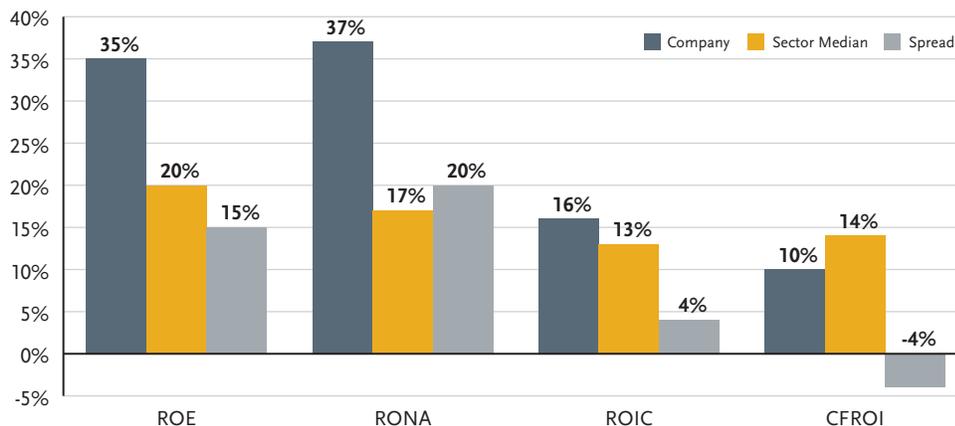
Source: HOLT ValueSearch, Universe World Index greater than \$500M cap (ex. REITS, Insurance and Financials); 6,000 companies. All data are in U.S. dollars and based on last fiscal year, as of Feb 2016.

Key metrics used to determine future value creation

There are a number of metrics used to analyze economic profit. One that we believe helps to accurately determine future value creation is CFROI², defined as cash flow return on investment. CFROI is a valuation metric that takes into account how much capital is required for the firm to generate each dollar of cash flow. It is the internal rate of return achieved on all past capital invested. However, this rate of return metric does not include the company's cost of capital. Thus by itself, CFROI does not tell us how much economic value a company has created or the future rate of value creation; however, the deconstruction of CFROI provides insight into valuation drivers. The stability of CFROI compared to the typical return on invested capital (ROIC) and other accounting metrics helps to improve forecasts and helps track the 'true' economic profit generation (see Figure 2). For non-financial firms, the main drivers of CFROI include sales, margins and asset turns. For financial firms, CFROE (cash flow return on equity) is a more appropriate metric, given the high use of leverage in the financial sector. Understanding the drivers of CFROI is key to analyzing a firm's ability to create value and arrive at an appropriate valuation.

Figure 2: The importance of EVA – different metrics = different results

Company ABC: CFROI vs. Accounting Returns



HOLT ValueSearch, as of February 2016; Hypothetical data shown for illustration purposes only. ROIC – return on invested capital; ROE – return on equity; CFROI – Cash Flow Return on Investment; RONA – return on assets

Another metric we incorporate into our analysis is a firm's weighted average cost of capital (WACC). This is primarily a function of three inputs: the cost of debt, the cost of equity and tax rates. These costs can vary according to different firms, regions and market conditions. For example, access to debt financing, interest rates and tax regimes vary widely across different countries. The WACC serves as the firm's hurdle rate, a minimum rate of return at which the company will break even in economic terms on its investments. Many firms tend to underestimate their total cost of capital by excluding the cost of equity, which can cause the firm to undertake seemingly earnings accretive projects that actually destroy economic value.

² Trademark HOLT

If a company generates CFROI in excess of its WACC, economic profits are produced. The past does not necessarily predict the future, so a further analysis of the sustainability of historical drivers of returns and the cost of capital is crucial. The spread between the CFROI and WACC also illustrates how resilient businesses can be in difficult economic times. If the spread is positive and expected to persist even during an economic downturn, albeit at a lower level, the company could continue to create future economic value for its shareholders by aggressively reinvesting into the business and gaining market share.

The vital importance of management's ability to allocate capital

With a well thought out and properly implemented economic profit framework, skilled management can provide strategic direction for companies as well as recognize and respond to game-changing themes to add economic value. If a firm operates with a focus on economic profit measures, their financial results may differ from firms that focus on accounting profit measures.

When deciding to make capital expenditures, managers must value projects and make decisions that are tied to the firm's internal measures of performance. Tying these performance measures to accounting metrics may not reflect economic reality or the true value that has been added. An understanding and implementation of economic profit measures allows managers to identify the possible return on an investment and the cost of capital to undertake this investment.

If a company can create value above its cost of WACC, it has the potential to create value for its shareholders. For example, in a low interest rate environment, a large number of projects or acquisitions may seem earnings-accretive by accounting profit measures as the cost of new debt is low. However, this measure does not reflect the true cost of capital, which includes both equity capital and debt. In addition to this focus on financing costs, a company must also be able to understand and balance growth among projects that initially generate low economic value and have solid long-term potential (greenfields) and older projects with less current capital intensity but limited long-term growth potential (brownfields). Management should take a wholesome approach and evaluate each project from a perspective of economic returns, growth potential and the cost of capital involved.

Careful consideration of a firm's compensation practices and their alignment with performance evaluation metrics is also vital to understanding the possible value added by a firm's long-term strategic decisions. For example, Hannover Re Group (see Figure 3), one of the largest reinsurance groups in the world, uses an 'economic capital model' that aims to achieve a profit in excess of the cost of capital. This profit, referred to as Intrinsic Value Creation (IVC), is the key ratio used to manage its business activities³. This is tied to the company's profit and growth targets as well as its risk management and capital allocation. Business group bonuses are also tied to this concept.

³ Hannover Re Group, strategy at a glance, May 31, 2013

Figure 3: Hannover Re Stock Performance⁴

Calendar year, cumulative total return (USD)

To end of 2015	3 yr.	5 yr.	10 yr.
Hannover Re	70.4%	177.2%	398.3%
MSCI World Index	29.0%	39.8%	69.2%

Compensation structures that are more likely to be in line with long-term shareholder performance include option grants with long vesting periods. While there are a wide variety of compensation methods that have different benefits and downsides, we believe the optimal scenario would include methods that are tied to economic profit measures.

Beating the fade – creating value over a company’s lifecycle

Paying attention to where a company is in the industry lifecycle is particularly important in our process as mid-cycle firms are likely to earn higher rates of return on their capital. This could be due to their competitive advantages such as high innovation, low competition or industry barriers to entry. However, over time, as the firm loses its competitive advantage, there is also a decline in its rate of return on investments. This is referred to as the ‘fade’ in CFROI. In order to avoid this fade, the company must make investment decisions that cause CFROI levels to remain above the long-term cost of capital for longer. Firms that operate below the cost of capital can actually destroy wealth and will eventually be forced to restructure, be acquired or face bankruptcy.

We look for companies that can ‘beat the fade’. These companies maintain positive EVA longer than the markets expect. This can be done by cutting costs to maintain margins, through value-accretive activities such as product segmentation or changing the product mix or through continuous innovation, which can help drive sales, margins and asset turnover (‘sweating the assets’). Additionally, companies can maintain positive EVA through strong branding, which allows for pricing power.

As an example, one of the most significant strategic transitions carried out by IBM was the company’s transformation into a software-focused company. More than a decade ago, IBM was primarily a capital intensive mainframe and computer hardware business but now derives the majority of its revenues from software and services where capital requirements are lower. Some of the strategic decisions that were carried out under CEO Samuel J. Palmisano included the 2002 acquisition of PricewaterhouseCoopers’ Consulting and the 2004 sale of its capital-intensive PC business to Lenovo⁵. These decisions allowed IBM to dramatically increase its margins, adding value to the services it provides to customers through software, consulting and analytics while at the same time decreasing the asset intensity of the business.

“The single most important decision in evaluating a business is pricing power. – Warren Buffett

⁴ Bloomberg, as of December 31, 2015

⁵ IBM investor relations, March 14, 2013

Key drivers of economic profit

In addition to understanding where a firm is in the industry lifecycle, we conduct in-depth analysis of the key drivers of economic profit to determine a firm’s future sources of value creation.

Key Drivers	Sample Factors	Sample Questions
Sales Growth	Pricing power Change in product mix Expansions, e.g., through mergers or acquisitions	Has sales growth been smooth or choppy? What is the impact on sales from global macroeconomic uncertainty? Has the company entered more cyclical lines of business?
Profit Margins	One-of-a-kind product, patents Low industry competition Low production costs Continuous innovation Price increases Diversified product lineup Regulatory impacts	How has the company been able to expand operating margins and from what business lines? Can the firm continue to raise the bar in the future?
Asset Turnover	Management efficiency Rising sales, e.g., through demographic trends Gains in market share Distribution channels Manufacturing efficiency Capex spending Working capital management	Has management been prudent in ensuring assets are being used efficiently? Is there potential to ‘sweat the assets’ further? Is Capex spending as cyclical as sales growth?

Conclusion

While there are a wide variety of methods available to evaluate companies and their financial statements, we believe that an economic profit framework most accurately reflects the economic reality faced by firms compared to traditional accounting measures. Several metrics exist to measure economic profit and we believe that an EVA-based approach with a focus on CFROI provides the most robust basis to measure a firm’s return on investment. It helps to remove accounting subjectivity and gives an idea of the firm’s historical value creation.

It is also vital to focus on where a company is relative to its industry lifecycle. In order to ‘beat the fade’, companies must make investment decisions that cause CFROI levels to remain above the long-term cost of capital for extended periods and lengthen their competitive advantage.

We believe that conducting detailed quantitative and qualitative analysis to understand a company’s key drivers, such as sales growth, margins and asset turnover, helps to form a projection of future economic profit creation. Through this process we gain deeper, improved insight into the companies we invest in, and, more importantly, how these companies will create future shareholder value.

Glossary of terms

Asset turnover – A measure of how much sales is generated per dollar of assets.

CFROE – Cash flow return on equity. A cash-flow-based metric that returns the implied internal rate of return (IRR) on equity, typically used to evaluate financial firms because of high leverage.

CFROI – Cash flow return on investment. A cash-flow-based metric that returns the implied internal rate of return (IRR) on investment, typically used to evaluate non-financial firms.

CFROI ‘fade’ – Empirically observed decline in CFROI over time due to maturity of industry. ‘Beat the fade’ – When a company can exceed the CFROI ‘fade’, which may be obtained through some internally-generated firm advantage.

EVA – Economic-Value-Added. A methodology used to evaluate the economic profit created by a firm, in excess of investors’ required return.

GAAP – Generally accepted accounting practices. Accounting guidelines that can differ by jurisdiction.

Profit margins – A measure of how much profit is generated per dollar of sales.

ROIC – Return on invested capital. A cash-flow-based metric that returns the rate of return on invested capital.

‘Sweating the assets’ – Maximizing asset efficiency.

WACC – Weighted average cost of capital. An estimate of a firm’s true cost of capital, which includes debt, equity capital, and tax rates.

About the author

Stephen Way leads AGF’s Global Equity team in Toronto and is lead manager of the Global Core Equity and Emerging Markets Equity strategies. Stephen, the architect of the EVA-based investment process used for these industry-leading mandates, is supported by a team that uses their collective industry experience and globally diversified cultural backgrounds to locate opportunities unrecognized by the market.

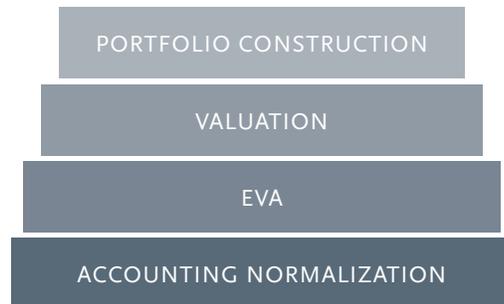
Stephen’s industry experience began when he joined AGF in 1987. In 1991, he established AGF’s wholly owned subsidiary AGF International Advisors Company Limited in Dublin, Ireland, and ran the operations as Managing Director until 1994. Stephen holds a BA in Administrative and Commercial Studies from the University of Western Ontario. He is a CFA charterholder and a member of the Toronto CFA Society.

About the AGF Global Equity team

The AGF Global Equity team conducts in-depth analysis of a company, its management and its competitive landscape in order to understand a company's drivers of return, which include sales growth, margins and asset turnover. Company management is scrutinized for their ability to add value, particularly their future plans to add value for shareholders, and understanding where the firm is in its life cycle helps determine the pace at which it will create value. When used in conjunction, the CFROI and WACC metrics form the starting point of the team's bottom-up analysis to help identify creators of economic profit. This is followed by rigorous analysis of the company's future drivers of economic profit to form a projection of the likelihood that a firm will create value. The team believes that a detailed analysis of a firm's drivers of economic profit will result in deeper insight into value creation.

AGF global equity investment process

The building blocks of our investment process begin with the normalization of worldwide accounting practices providing the ability to compare companies relative to their peers geographically and across historical time frames. Our focus on CFROI identifies high-quality companies with sound businesses. However, a solid company is not necessarily a good stock. Our valuation analysis leads us to stocks with attractive earnings power with greater than 15% upside potential. The last step is portfolio construction, where we seek to build a diversified portfolio with an attractive risk/return profile.



About AGF Investments

For over half a century, AGF has been providing asset management services to institutions and individuals around the globe. As an independent firm, we strive to help investors succeed by delivering excellence in investment management and providing an exceptional client experience.

Our suite of diverse investment solutions extends globally to a wide range of clients, including pension plans, corporate plans, sovereign wealth funds, endowments and foundations. Our investment management expertise is broad and well tested, with qualified individuals in each of our subsidiary firms: AGF Investments Inc., AGFIA Limited, Acuity Investment Management Inc. and Highstreet Asset Management Inc.

AGF has investment operations and client service teams on the ground in North America, Europe and Asia. This strong regional presence provides our clients with timely knowledge, insight and understanding of global markets – no matter where your organization is located.

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