

Marakon

commentary

Growing Intrinsic Value in the New Normal

April 2010 by Jim McTaggart and Ron Langford

Last year, Bill Gross of Pimco coined the phrase “new normal” to describe what economic life might be like as the global economy recovers from one of the worst economic storms since the 1930s. While there is considerable uncertainty around what the new normal will look like, it is likely to be a world where:

Profitability is lower across almost all markets – margins have come down significantly and are unlikely to recover fully for quite a while, the amount of capital per dollar of revenue has risen as revenue has fallen, and nearly all companies are reducing financial leverage. As a result, the sustainable return on equity for the economy as a whole has declined from its pre-recession norm in the mid-teens and is now expected to be in the low-teens post-recovery.

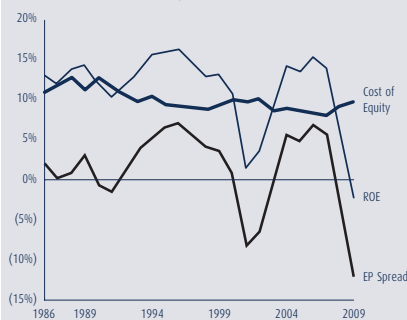
Growth is returning at a slower pace than in past recoveries – the recession caused a steep decline in global demand, and the climb back out looks like it will take longer as corporate and household balance sheets rebuild slowly and unemployment remains high. In addition, there has been a “reset” in consumers’ willingness to pay (referred to as the age of frugality) that has caused major shifts in demand across markets; and

Risk is fundamentally higher – both the level of volatility has increased (it skyrocketed during the meltdown and has since settled into a range 20-30% higher than before) and the price of risk has increased (the cost of equity capital is now near 10% vs. 8% pre-recession). This has caused the expected spread between ROE and the cost of equity to fall sharply into negative territory, even worse than the dot-com bust in the early 2000s, as shown in Exhibit 1.

Since the intrinsic value¹ of a company is driven by profitability, growth and risk, growing intrinsic value will face significant headwinds. These headwinds can be overcome if management focuses on value in a different way and adopts new practices that drive changes in the firm’s management model, strategy choices and operating practices.

Exhibit 1

Annual US Market Spreads Over Time



Source: FactSet US Market Aggregate.

2009 estimate based on data from Q4 2008 through Q3 2009; cost of equity is based on Bloomberg MRP.

Exhibit 2

Total Shareholder Return vs. EPS Growth

Total Shareholder Returns (1999-2009)

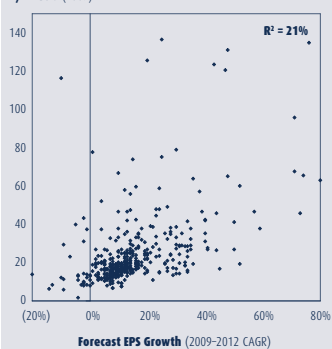


Sample includes S&P 500 companies; Total Shareholder Returns represent the total returns to common stock shareholders, including share price appreciation and dividend yield.

Exhibit 3

P/E vs. EPS Growth Forecasts

P/E Ratio (2009)



Source: Thomson analyst consensus estimates. Sample includes S&P 500 companies.

Traditional Approach to Growing Shareholder Value

Most senior executives accept that it's their fiduciary duty to provide reasonable, if not superior, returns to shareholders. They also recognize that if they are unable to do so, corporate boards or the market for corporate control are likely to act, placing their jobs or the company's independence in jeopardy.

With a few notable exceptions, most management teams try to grow shareholder value by growing earnings with the hope that the earnings multiple will either stay constant or increase over time. For publicly traded companies, most management teams focus on reported earnings per share (EPS) as the measure of earnings and use the price/earnings (P/E) multiple to determine value and stock price. In recent years, as the private equity industry has grown, some companies have adopted a slightly more complex approach that uses EBITDA² as the measure of earnings and applies a multiple defined as enterprise value divided by EBITDA (the EV/E multiple) and then subtracts debt to determine equity value and stock price.

The problem with both multiple models is that very few managers have a detailed understanding of what actually drives the company's P/E or EV/E (see Sidebar: What Drives a Company's Multiple). When making a decision at a point in time, most managers assume the current multiple will stay constant so that any increase in earnings will increase value proportionately. And when evaluating opportunities that play out over time, most managers either assume the current multiple will stay the same or may well expand, especially if earnings are growing at a good rate. Thus, the thinking goes, if a company can manage to grow earnings at a healthy and preferably steady rate, shareholders (and management) will reap large rewards.

Unfortunately, the linkage between earnings growth and shareholder value growth is not reliable. The correlation between earnings (EPS) and shareholder returns (looking historically) as well as EPS growth forecasts and P/E ratios is in general less than 50%, and the correlation appears to have decreased during the great recession. What investors appear to be saying is that earnings "quality" (as manifest by the company's multiple) matters as much or more than earnings "quantity."

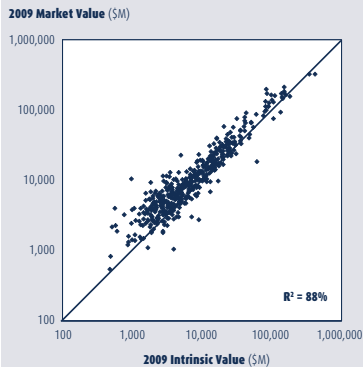
An Alternative Approach

An alternative to the "earnings growth" approach is to focus explicitly on growing intrinsic value, with the underlying assumption that market values will follow intrinsic values over time. Warren Buffett is the most famous practitioner of this approach and stated early in his tenure at Berkshire Hathaway that "our long-term economic goal...is to maximize Berkshire's average annual rate of gain in intrinsic business value on a per-share basis."³ Fundamentally, growing intrinsic value is achieved by investing as much capital as possible at rates of return that exceed the cost of the capital.

Empirically over time, we have found the correlation between intrinsic value and shareholder value to be very high. As shown in Exhibit 4, the current correlation is above 85%. Given this, why don't more management teams focus on growing intrinsic value?

There are two perceived problems with this approach. The first is practicality: intrinsic value is not objectively measurable because it's based on future forecasts of profitability, growth and risk. Also, it's often not practical for management to estimate intrinsic value for a broad range of the decisions they make on a daily basis. A second perceived problem is the potential disconnect between earnings growth and intrinsic value growth; actions that

Exhibit 4
Intrinsic Values vs. Market Values



Source: Thomson One analyst consensus estimates through 2012; cost of equity based off of Bloomberg MRP. Sample includes S&P 500 companies; all figures as of end of last reported fiscal year (2009) for each company; Intrinsic value assumes 2012 ROE and 2009-12 revenue growth sustained for 8 years for all companies, then zero incremental value creation.

grow intrinsic value may reduce near-term earnings and actions that grow near-term earnings may reduce intrinsic value. When these disconnects exist, it takes strong conviction and leadership to choose the higher intrinsic value path rather than the higher earnings path.

Managing the Drivers of Intrinsic Value

So what can management do to get the best of each approach and overcome the problems inherent in each? We believe there are three things management should do:

1. Manage both earnings 'quality' and 'quantity'

First, management needs to recognize that managing EPS alone won't work. Growing intrinsic value requires managing both the quantity and the quality of

earnings, where the company's multiple is the best proxy available for earnings quality. By earnings quality, we're referring to earnings that (1) can be consistently generated over time using minimal capital, (2) are likely to recur year after year rather than coming from one-off transactions, and (3) are perceived as less risky – the three financial drivers that are produced by the company's overall strategic position. So, growing value requires that managers find the optimal combination of earnings quantity and quality over time.

This means that management can gain the confidence that investing to improve the company's strategic position (entering more attractive markets, building advantages) no longer needs to be held hostage to current earnings. This is not to suggest that executives are free to

So What Drives a Company's Multiple?

In fact, the drivers of a company's multiple and the drivers of intrinsic value are identical. By decomposing the model that computes intrinsic value in "steady state", the drivers of P/E and EV/E can be easily identified. There are three primary financial drivers of P/E and EV/E multiples:

1. The company's profitability as measured by its return on equity capital (ROE) and its return on investment (ROI);
2. The growth rate of the company's capital, which reflects growth in revenue and, for a given ROE and ROI, drives earnings growth; and
3. The company's cost of capital – its cost of equity (the return shareholders demand for investing in the company – which consists of the risk-free interest rate and a risk premium) and its weighted average cost of debt and equity capital.

In short, both P/E and EV/E multiples are a product of profitability, growth and risk. In general, when investors believe that a company will produce above average profitability and growth, with below average risk, they bid up the stock price relative to earnings. For example, a constant ROE of 20% and growth of 5%, and a risk premium pegged at 80% of the market average produces a P/E of 20. In contrast, a constant ROE of 10% and growth of 3%, and a risk premium of 120% produces a P/E of 6.

There is a fourth, **strategic driver** of multiples which is very important: sustainability. The highest P/Es are awarded to those companies where investors believe high profitability and growth, and moderate or low risk, will be sustained for long periods. In the previous P/E examples, the steady-state model assumes that ROE, growth and risk will persist for all time, a situation that one seldom sees in the real world. We all know that high returns and growth attract competition, and competition drives returns down toward the cost of capital and erodes growth rates. We also know that high-risk companies almost always take steps to reduce risk over time. To provide an idea of the impact of duration, if investors woke up one day and decided that the company with a constant ROE of 20%, growth of 5% and risk premium of 80% of market could only hold those rates for five years, after which its ROE would fall to 10% and growth to 3%, the warranted P/E falls from 20 to 10. In short, 50% of the multiple comes from ability to sustain ROE and growth past the 5th year into perpetuity.

So what drives sustainability? It depends on the economic attractiveness of the markets in which management chooses to participate and how the company competes to create and maintain advantage in those markets. Buffett has often referred to the combination of attractive market economics and competitive advantage with a

medieval metaphor: "I look for economic castles protected by unbreachable moats".⁴

To illustrate the drivers of a P/E multiple, let's examine two familiar companies in today's landscape, Amazon and Wal-Mart. Analysts are expecting AMZN to earn an ROE averaging 23% over the next five years vs. a 20% ROE for WMT. For AMZN, however, analysts are expecting five year growth of 22% vs. WMT's growth of 4% (not too surprising given its scale). While WMT's high return is a testimony to the advantages it has built over time, AMZN's combination of a high return and high growth puts it in the pantheon of competitive advantage that has been created by its innovative business model and brand. It's not a surprise that AMZN is viewed as much riskier than WMT (beta of 1.0 vs. 0.5), but AMZN's average risk relative to the market might surprise some people. As for sustainability, the prices of both stocks are supported by an assumption that ROE will not fall to the cost of equity and growth to GDP rates for 19-20 years for both companies. The combination of these drivers produces a healthy P/E for WMT of 15 and an astounding P/E for AMZN of 65. In other words, investors are betting that AMZN's competitive advantages are so strong that they can be sustained from their current very high levels for 19 years and on that basis, are willing to pay 65 times earnings for AMZN's stock.

Exhibit 5
Alignment of Managerial Drivers and Intrinsic Value

Management Model
"How We Align Behavior with Value"



Strategy Choices
"How We Position the Business for the Future"



Operating Practices
"How We Efficiently Deliver Customer Benefit"



Financial Performance and Value
"The Value We Create For Our Owners"

chase rainbows – all decisions that call for near-term sacrifice must be subjected to a rigorous analysis that clearly demonstrates likelihood of long-term value creation, including a healthy respect for the forces of competition to erode advantages. What it does suggest is that value can be pursued more aggressively even if it causes a decline in current earnings with confidence that investors won't tank the company's shares.

2. Create and manage to a 'suite' of performance measures linked to value

Growing intrinsic value is the primary objective that management should seek to achieve, but intrinsic value is not the only measure on which management should focus. Objective measures of growth, returns and risk that are explicitly linked to intrinsic value should be defined and used. Managing growth, returns and risk – and, most importantly, the linkages between them – is what is required to achieve consistently superior intrinsic value growth.

Many executives strive to increase returns on capital and growth, while also reducing risk, but too often they focus on only one of the three at a time and don't manage the connection between them. Typically, when profitability is under pressure, management launches a series of initiatives to restore margins (broad-based cost reduction) and reduce capital (plant shut downs, increasing working capital turns). As profitability returns, they discover that the growth engine has shut down so initiatives to restore growth are undertaken (focus on the customer, enter adjacencies, M&A). As growth kicks into gear, profitability often suffers and the cycle repeats.

Exemplars in growing intrinsic value typically focus on all three drivers at the same time and manage the connections and tradeoffs between them well.

For example, a financial services client recently launched an initiative to determine the intrinsic value of each customer segment and then drill down to find out what was causing the tremendous difference in value across the entire customer base. The results drove a significant redeployment of resources that generated both increased ROE and faster growth.

Another recent example was an industrial client that had a vertically integrated business chain that was subject to significant commodity price exposure. By changing their "long/short" positions through the chain and rethinking the risk exchange embedded in their contracts with suppliers and customers, they were able to increase return and reduce risk at the same time.

As these examples illustrate, getting the organization focused on managing the linkages between growth, returns and risk results in new insights and opportunities to grow intrinsic value.

3. Align managerial drivers with intrinsic value

There is, of course, more to this story. Managing the growth of intrinsic value over time requires aligning the organization along multiple dimensions. In the broadest terms, as we mentioned at the outset, we think of this alignment as encompassing the four boxes shown in Exhibit 5.

The bottom box puts the goal of growing intrinsic value firmly at the top of management's goal hierarchy. It also establishes financial metrics that tie to and drive value (growth, returns and risk) and provides the "math" that links all the variables together.

The top box sets the stage for growing value. Getting alignment and creating the right conditions in the organization

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are the necessary foundations for value growth. We use the short-hand “management model” to describe the behaviors the company needs to shape so that barriers to value-creating investments are eliminated or at least minimized. It is here that goals and constraints are agreed, structure is determined, management processes are synched up and talent is managed.

The second box down is where the company’s big bets are made. When the management model is finely tuned, strategy choices must be made about which markets and customers to serve, and how to compete in a manner that creates and sustains advantages. The company should support these choices by constructing an intrinsic value fact-base and making a determined effort to develop and evaluate strategic options.

The third box down provides the discipline to optimize the chosen strategies and convert plans into results. The focus in this box is on delivering benefits to the company’s customers in the most cost-effective way possible and managing the company’s finances and risk profile.

We believe this framework represents a fundamental change from current practices that can help management navigate the new normal economy and the value headwinds that are like to blow for at least the next few years. A deeper understanding of what drives the company’s multiple will enable management to focus on both earnings quantity and quality, and it will improve management’s confidence that making the right decisions for the business will be rewarded by investors. The platform described by the four boxes offers the possibility of change that can rejuvenate the company and put it on a pace to double value far faster than competitors.

About Marakon

Since its founding in 1978, Marakon has partnered with senior executives of the most respected companies to help them fundamentally increase and realize their potential to create value. Hundreds of companies from around the world have adopted our approach to helping them improve their business models, operating and management practices. One measure of our success is the long-standing relationships we have with many world-renowned companies and their continued outperformance.

Today, we are focused on helping companies in their pursuit of managing for value as they adapt to the new economic reality, when the need for business and management model innovation is greater than ever.

Marakon has never found that industry solutions and armies of consultants are the best way to have significant impact. The keys to helping business leaders unlock value are tailored solutions and constructive challenge. We provide a focused team of senior professionals to work in partnership with our clients to drive results and superior decisions.

Marakon is a Charles River Associates company.

1. A company’s intrinsic value reflects the underlying potential for future returns, growth and investment – both short-term and long-term – embodied in management’s current plans and initiatives. Intrinsic value is calculated as beginning book value of equity plus the sum of all future economic profit streams discounted at the cost of equity.
2. EBITDA is earnings before interest, taxes, depreciation, and amortization have been subtracted.
3. Warren Buffet, “An Owner’s Manual” [letter to Berkshire’s Class A and Class B shareholders]; 1996.
4. Warren Buffet, “Letter to Shareholders of Berkshire Hathaway Inc.”; 1995.

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