

# CORPORATE VALUATION

FOR PORTFOLIO INVESTMENT

ANALYZING ASSETS,  
EARNINGS, CASH FLOW,  
STOCK PRICE, GOVERNANCE,  
AND SPECIAL SITUATIONS

ROBERT A. G. MONKS  
ALEXANDRA REED LAJOUX

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Analyzing Assets, Earnings,  
Cash Flow, Stock Price, Governance,  
and Special Situations

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*To John P. M. Higgins, who has for a half century explored  
with me the challenges of valuation.*

—RAGM

*To Stella Swingle Reed, who taught me the value of  
perseverance.*

—ARL

# Foreword

A SMALL FRACTION of cohorts who lived through the age of the Nifty 50 still tackle important problems. We don't know that the torch has been passed, as an earlier president reminded us. We forgo shuffleboard and leisure suits for writing and mounting platforms on issues that we believe to be important—where we can bring our personal experiences to bear and where our voices will remind others that we bring personal history, energy, and foresight to vexing problems. Bob Monks is the archetype of the group.

We will get to his capabilities shortly, but let us first examine Bob's courage to tackle a really big topic: the valuation of securities. It is as big a subject as they come, running in multidimensions from qualitative to psychological, from static to dynamic, from one dominant measure to a complex soup, and using measures that range from those that are internal to the observer to those determined by the markets. He categorizes the enduring tussles between momentum speculators and fundamental investors (as they often label themselves) and bravely wades into academe and critically tackles anyone, from Nobels to postdocs. Nothing escapes his attention.

Many investors aspire to universal skills, often proclaiming to be rotating specialized investors in the changing days of one valuation mode to another. In truth, most of us adopt a valuation scheme that is suited to the nature of our psyche. We search for nomenclature that proclaims its wisdom; we quest for indices that illustrate our brilliance; and we market . . . oh, we really market.

In *Corporate Valuation for Portfolio Investment*, Bob and his worthy coauthor (more later) cover the full range of

valuation methods. We are reminded how narrow most of our outlooks really are. Our normal style as investors in public securities, usually as fiduciaries investing for others, is to examine, select, implement, measure, and report . . . with some ingredient of hope and justification. But Bob's stamp on this book is clear. As in life, so in this book he goes to a rare and important next step. He adds the active behavior of someone who behaves as if he owns the entire business and sends a message to institutional shareholders who tend to rely on buying or selling to express their views to management.

He and I reached the same conclusion independently at about the same time, he as assistant secretary of labor for ERISA [Employee Retirement Income Security Act], and I while chairing a governance committee at the Securities and Exchange Commission. Back in the private sector we shared valuation insights, models, and spreadsheets. I went the next step in aggressively voting against directors who supported protective measures against shareholders and announced our actions—practices unheard of at the time. Bob started an investment management enterprise, the Lens Fund, to invest in potential target companies, announcing plans for some to improve their accountability to owners. Whereas institutional investors typically vote proxy statements with management, without even knowing the individual positions of directors receiving their endorsement, Bob makes his views known. He lays out a clear program.

He is an active investor in large publicly traded securities that need, but normally fail to get, attention from investors who take a position and then aggressively attempt to change companies in directions of greater value. Thus, his focus on valuation is a natural complement to his governance activities. He has to know how to start at a low enough price to provide a cushion for the time it takes to



implement his approach. He is usually attracted to a yield sufficient to finance his efforts. He has to develop a cogent program that has not been adopted by the directors charged with just that job. And, finally, he has to have the credibility to make it work. The list of major companies who have felt his attention looks like a typical high-quality list, but the members of that list are better now in hindsight than when Bob and his staff first visited them.

Rarely do companies welcome the interference from someone who proposes to alter their clubby atmosphere. But his investment record is a clue that his ideas, when implemented, work. From its founding in 1992 until it became part of the Hermes Pensions Management group in 2000, activities of the Lens Fund were followed by such august publications as *Barron's* and the *New York Times*. As noted in the *Times*: "Lens's investing style pays. In six years of operation, through Dec. 30, 1998, it returned 25.1 percent a year, on average, compared with 20.5 percent for the Standard & Poor's 500-stock index." Well-known shareholder activists like Boone Pickens and Carl Icahn are disruptive and make their intentions to fire managements well-known. It is not surprising they would be met by vigorous objection. Bob Monks, on the other hand, comes in with a plan that can be implemented by the existing management. His proposal is more about accountability than disruption. He too meets with objection but less so than others storming the corporate gates with devastating firepower.

Bob's colleague in this endeavor, Dr. Alexandra Reed Lajoux, brings her own long history to the quest for better approaches to corporate valuation. Alex, who has served as editor of a variety of influential business periodicals, is the lead author of *The Art of M&A* series of books and, through these and her many other writings, is an ardent proponent

of the overarching principle of stewardship and long-term sustainable value creation.

Bob and Alex wrote in the Preface: “We wrote this book to advance world prosperity by explaining how to determine the value of corporate equity securities for the purpose of portfolio investment.” Together, with records of success improving corporate accountability in their hip pockets, they are ready to storm—tactfully—the barriers to full understanding of what constitutes sustainable value.

DEAN LEBARON  
Adventure Capitalist

BOSTON AND ZURICH  
[DeanLeBaron.com](http://DeanLeBaron.com)

# Preface

WE WROTE THIS BOOK to advance world prosperity by explaining how to determine the value of corporate equity securities for the purpose of portfolio investment.

A number of recent changes have made this subject lava hot: international accounting conundrums, massive transformations making both forward and backward comparisons meaningless, low inflation with rumors of deflation, and—now—government-created assets and earnings! These volcanic trends have brought equity valuation nearly to a meltdown. Yet certain truths remain.

Equity capital provides two main benefits: a flexible funding option for companies and superior returns to investors compared to debt. But unless an investor can buy every stock and hold all stocks for decades, the long-term, general superiority of equity over debt is of little use. To take advantage of equity's power, investors must learn how to put *a precise value on a specific stock for a specific investment period*.

This book advocates a multidimensional approach to equity value, asserting that value exists only in specific temporal and situational contexts. This said, the “default setting” for investment appropriately remains an intelligent investor considering public equity securities as a choice among alternatives.

Corporate valuation for portfolio investment means determining the present value of future worth. There are two main sources of information about the worth of a stock: financial reports and the stock's current trading price.

Financial reports contain riddles that must be decoded by the valuation-minded investor. The first step in valuation for investment is to bridge the gap between current valuation in financial reports and the future value of the company for investment purposes. Despite the work of numerous groups to reform generally accepted accounting principles (GAAP) and their global equivalent, international financial reporting standards (IFRS), financial reports remain only dim mirrors of company value. Sources of complexity in GAAP/IFRS accounting include variation in accounting models, scope exceptions, mixed attributes, and bright line standards.

All this requires reading between the lines. And the main message is that equity securities are difficult to value in part because both companies and the markets that trade in their equity are living human systems prone to self-deceptive traits that militate against pure valuation logic.

Paradoxically, however, human nature, which makes the valuation of equity so difficult, is also the fundamental reason for the superiority of equity. Value-minded investors can put a financial value on the greatest contributor to securities' value: long-term corporate action based on vision. To do so, however, requires a multifaceted approach to valuation, including both respect for quantitative fundamentals and an appreciation for qualitative complexity.

This book, intended for the professional investor building an investment portfolio that includes equity, takes the reader through a range of approaches, including those primarily based in assets, earnings, cash flow, and securities prices, as well as hybrid approaches. It also discusses the importance of qualitative measures that we call "governance" (going well beyond GAAP/IFRS) and addresses a variety of special situations in the life cycle of businesses, ranging from initial public offerings to bankruptcies.

In the process, the book offers formulas, checklists, and models that we and others have found useful in making equity investments. As long as investors thoughtfully use a variety of tools to make their investments, corporate securities will continue to generate wealth for their owners and for society at large.

# Acknowledgments

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Alexandra thanks her family, friends, and colleagues past and present at the National Association of Corporate Directors.



# CHAPTER 1

## Corporate Valuation for Portfolio Investment A Philosophical Framework

EQUITY SHARES must be valued—but how? It may seem that sophisticated financiers have taken over valuation. The phrase “equity valuation” may conjure up visions of financial specialists feeding numbers into algorithmic programs, relentlessly making buy, sell, or hold decisions unrelated to the operating realities of businesses or to understandable economic concepts such as replacement value.<sup>1</sup>

A great deal of controversy surrounds the mathematicians and physicists (aka “quant jocks”) on Wall Street. Some blame them for the economic problems of the first decade, noting their complex trading programs that, once automated, accelerated doomsday events for markets.<sup>2</sup> Others say that the quant jocks boosted the overall intelligence of the market by introducing new and sensible ways of looking at risk and return, pointing out that they were among the first to warn against the crisis.<sup>3</sup> In fact, sophisticated trading programs do have a role to play, but the programs must be based on sound principles. Sophisticated trading activities are the symptom, not the substance, of stock valuation.

In fact, valuation begins from the hour a company’s leaders find equity investors who believe so strongly in the company’s economic prospects that they are willing to provide capital for it, no strings attached. This belief in a company’s future—in a word, *hope*—is what makes the

value of the stock something more than the current value of all its assets, if sold in a fire sale. Combined with the investor's own time horizon for a return, hope is the key to securities valuation. Vision and time are the alpha and omega.

*Valuable vision* is what propels a company's stock into the marketplace; it is what preserves the value of the stock in spite of market chaos. Understanding this concept requires an integrated theory of valuation that includes consideration of assets offset by liabilities, of income, of cash (liquidity), of securities market dynamics, and of comparable pricing. Understanding also requires consideration of what we call *stories*—meaningful information beyond the financial statements and market prices. This book is structured accordingly.

Of course, not all investors base their trades on such an integrated framework for valuation. Some are index investors, some are algorithmic traders, and some are fund managers who buy assets based on classes of risk. In fact, fewer than half of all investors actually choose an investment based on the quality of a particular company.<sup>4</sup> It is for these happy few volitional, value-minded investors that this book is intended.

### **Cost/Benefit of Information Gathering**

There is also the issue (which I found out in the S&P strat<sup>5</sup>) of the price of gathering data. One of the reasons such simple strats exist is the cost of gathering the information you need to implement them is fairly high compared to the payout. Would I be better off screen scraping all the livelong day to implement some lousy subjective strat with a low

Sharpe<sup>6</sup> anyway? Or would I be better off getting a job at a bank, making a lot of money, and buying bonds?”

—Posted by Scott Locklin at the Algorithmic Traders Discussion Board on [LinkedIn.com](https://www.linkedin.com), April 19, 2009.

## Valuation Defined

*Valuation* means determining a value for something. This book sets forth all the elements of a company that are to be valued and offers guidance on how to determine those values.

- *Corporate valuation* determines the worth of a corporation *today* (its present value); *valuation for portfolio investment* joins that present value with a future value. As Al Rappaport said so succinctly in *Expectations Investing*, the key to successful investing is “to estimate the level of expected performance embedded in the current stock price and then to assess the likelihood of a revision in expectations.”<sup>7</sup>
- *Expectation* is indeed a fitting word for the process of valuation for investment. “Valuation” comes from the Latin word *valere*—to be worth something in an exchange<sup>8</sup>. “Investment” derives from *vestire*—to clothe. It means exchanging money now for something that may offer more money in the future.

Valuation alone is relatively simple; *corporate valuation for portfolio investment* is complex. Valuation alone says A is worth  $X$  today. But valuation *for investment* says A is

worth  $X$  today and *may be worth  $Y$  at a future date*. Valuation for investment means determining the present value of future worth.

Valuation is not a one-time event. It is a process. There is no one set of steps to value the stock of an existing public company, but it is generally agreed that the valuation journey proceeds with the following steps:

1. Select the item to be valued (the security).
2. Identify its current price (e.g., today's closing price).
3. Evaluate whether the current price is low, correct, or high.
4. Make a corresponding buy, hold, or sell decision based on the investor's own circumstances—including liquidity needs and the timing of those needs.

As part of step 3, the investor can adjust the values of price (step 2) based on six valuation matrices:

1. Time—Short term versus long term
2. Place—Market versus nonmarket
3. Slope—Level versus skewed playing field
4. Volition—Degree of willingness or unwillingness of the buyer or seller
5. Utility—Purpose (e.g., wealth versus liability collateral for a fund)
6. Quality—Level of certainty of return (high, medium, or low grade) based on investing standards

To get real value, one needs to pass each valuation through these six lenses. This paradigm appears throughout this book.

## **The Importance of Equity**

Few financial topics matter more than equity valuation. Without the possibility of placing a reasonably accurate

value on equity securities, there could be no equity marketplace. And without an equity marketplace, society would not have such a diversity of products and services. Some corporate undertakings are so long term and expensive that *only equity capital*—as opposed to operating capital or debt capital—can fund them.<sup>9</sup> Societal commitments such as payments made out of defined pension plans simply cannot be honored unless the obligated payor (the company or union offering the pension) has access to funding that can beat inflation at the level that equities have achieved historically.<sup>10</sup> It is no coincidence that these financial instruments are nicknamed “stock.” For an equity market to function, the economy at large must “put stock” (trust) in equities and continually “take stock of” (measure) their value.

The presence of the federal government as an investor (discussed in Chapter 2) raises new issues in equity valuation: as the holder of the shares, will a government entity’s focus be on financial return, as in the past, or on matters of broad social significance, such as jobs? There is some precedent for this concern at the state level. Public pension plans have at times made political rather than economic decisions.<sup>11</sup> In general, however, the equity investment decisions of pension plans are based on universally recognized financial principles. One of the purposes of this book is to articulate those principles so that equity valuation maintains its integrity as a discipline.

## **Equity Defined**

First invented by Dutch and English traders some 500 years ago, the term “equity” or “stock” as a form of corporate financing has been part of the business world for half a

millennium.<sup>12</sup> *Equity* is created when companies offer ownership stake to buyers, giving stock certificates in return for cash. The value of a company's equity (the number of shares times the current price per share) is its *market value*.

There is another kind of equity. It's the *accounting* kind, namely the dollar-value number remaining on the balance sheet after liabilities are subtracted from assets. This version of equity is also known as "net worth" or "book value." The accounting number is usually much lower than market value, but it can be used as a check on it because it is far less volatile.<sup>13</sup>

Regulators have done a good deal of hand-wringing over what equity is as opposed to debt. (See Appendix A.) In brief, equity represents ownership with potential for returns, while debt represents a claim entitling the holder to guaranteed payments.<sup>14</sup>

The issuance of equity securities brings two distinct values to an economy. For the company's management, the *sale* of equity securities can bring patient capital—funds that support growth without making fixed demands for return. To the company's investors, the *purchase* of securities can bring returns—a share in a company's total worth that grows in value as the company does.

Growth in share prices does not happen in each and every company, but it is common for all companies' stocks as a net total over any given 10-year period. Based on this general trend, Nobel Prize winners Franco Modigliani and Merton Miller asserted that the payment of dividends does not change the firm's market value: it changes only the mix of elements in the firm's financing. The Modigliani-Miller theorem has been true historically, but is it true today? If investors, over time, cannot count on share price