ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

> ***It's tough to make predictions, especially about the future.***
> *Yogi Berra*

Friday, 3 July 2020

In this week's Investment Insight

When buying rich is good value
A common reason for many investors not to invest in high-quality, high growth-companies is that the shares of these companies usually command high valuation multiples and, consequently, almost always look expensive. To see whether these ostensibly high multiples are justified or not, investors need to carefully consider the different underlying drivers of equity value that are obscured by the use of a simple multiple. In the vast majority of cases high multiples can be justified and are a fair reflection of strong underlying business fundamentals. In *The Inside Track* we take a look.

At the wrong game?
Coronavirus has shaken up many business models and it will undoubtedly have a lasting impact on business models and corporate operations, especially in the area of remote working. However, while analysts continue to grapple with the implications of coronavirus – identifying the winners, avoiding the losers, rationalising the valuations, understanding how long the impacts will continue, etc., etc. – the real game is on at a different stadium. In this week's *Pic of the Week* we delve a little deeper.

Newswire
Some interesting nuggets from this week's newswires.

Market view
A visual snapshot of recent market performance

The Inside Track: When buying rich is good value

In a recent white paper Steef Bergakker, analyst at Robeco, examined the issue of valuation multiples and, in particular, the question of when paying a high multiple makes sense. Below is a synopsis of some of the key factors he identified.

Miller and Modigliani showed that the value of a firm can be usefully thought of as comprising two components: 1) the steady-state value of existing assets and 2) future value creation.

The appropriate steady-state multiple is the reciprocal of the equity cost of capital. The steady-state value assumes that the current assets in place, properly maintained, produce a level of normalized profits indefinitely into the future. This steady stream of future profits can be valued as a perpetuity; i.e. normalised profit divided by the cost of capital. The appropriate multiple to pay for the steady state value of a business therefore is the reciprocal of the cost of capital.

Three fundamental factors drive future value creation. By construct, the steady state describes a situation where incremental investments earn the cost of capital and, consequently, do not create economic value. Higher multiples than this steady-state multiple can only be justified by future value creation, which is determined by three fundamental factors:

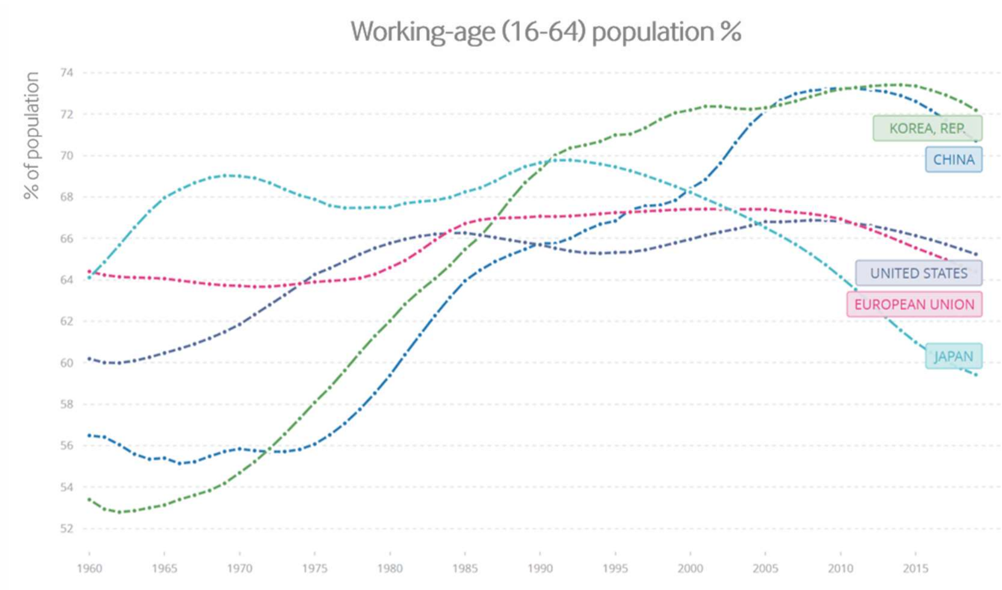
- investment returns that exceed the cost of capital (earn a positive spread);
- the relative size of profitable investment opportunities;
- the duration of competitive advantage.

Assuming perfect foresight, investors should be willing to pay a seemingly astronomical multiple at the start of this company's life. The high multiple is justified by the prospect of years of profitable, value creating growth ahead. As the company moves through time and steadily consumes its growth opportunities the justified multiple slowly converges to the steady-state multiple reflecting the shrinking prospects for profitable growth ahead.

In next week's Inside Track we will expand the topic by examining some of the important factors that go towards determining what is the "right" valuation multiple.

Pic of the Week: At the wrong game

It is likely – indeed, we hope – that coronavirus will, in the fullness of time, go down in economic history as a short, sharp shock from which there was a quick and robust recovery. Ultimately we expect it to have a relatively short-lived impact on investments. What coronavirus has interrupted is investors' focus on an important long-term demographic trend - the fall across the developed world in the working-age population. As the chart illustrates, the growth rate of the working-age population (16- 64) has been slowing inexorably and will continue to do so during the coming decade. However, the trend is not limited to developed markets. China and Korea are also trending towards a notable decline in working age population, a phenomenon other emerging market economies are also experiencing. Aging demographics are associated with weaker real GDP growth, lower inflation, lower long-term nominal bond yields and reduced inflation. These are very powerful forces impacting the global economy. They were evident before coronavirus and they will be evident after it fades into economic history. Therefore, we can anticipate the likely continuance of stimulative central bank interventions and low long-term interest rates. This, in turn, should translate into a low volatility macro-financial environment with many of the key uncertainties emanating, as in recent years, from national and geo-politics. In the short-term coronavirus presents both opportunities and threats for investors. In the longer term, these secular trends are far more relevant.



Source: World Bank

Newswire

...on Monday

China's service sector expands at its fastest pace in 7 months in June.

...on Tuesday

Google postpones reopening of US offices until September due to a surge in coronavirus cases.

...on Wednesday

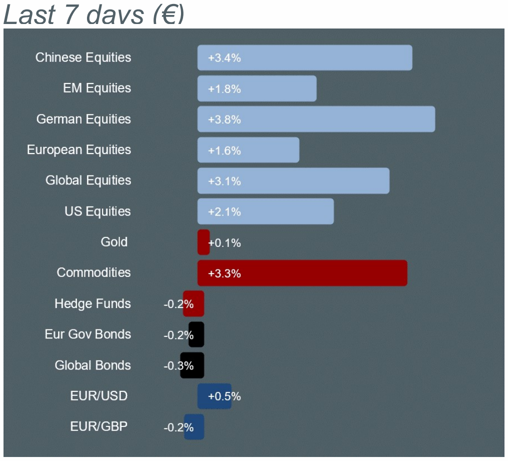
Tesla overtakes Toyota to become most valuable automaker in the world.

...on Thursday

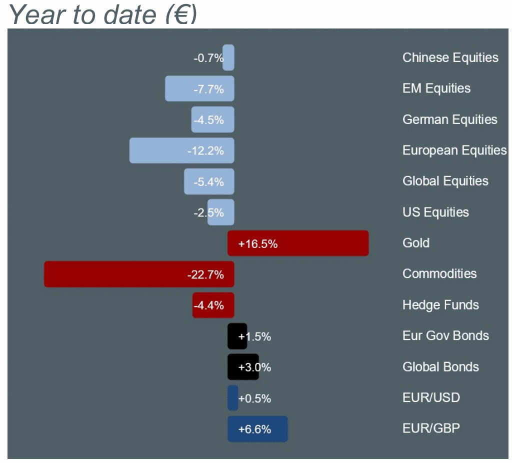
Stock markets react positively to news that the US economy beat the jobs forecast, adding 4.8 million

Market View

Last 7 days (€)



Year to date (€)



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