OUTCOMES BEYOND PERFORMANCE

EQUITORIAL

Valuation, not value.

When paying a higher price can be justified.

Hermes Global Equities
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For professional investors only

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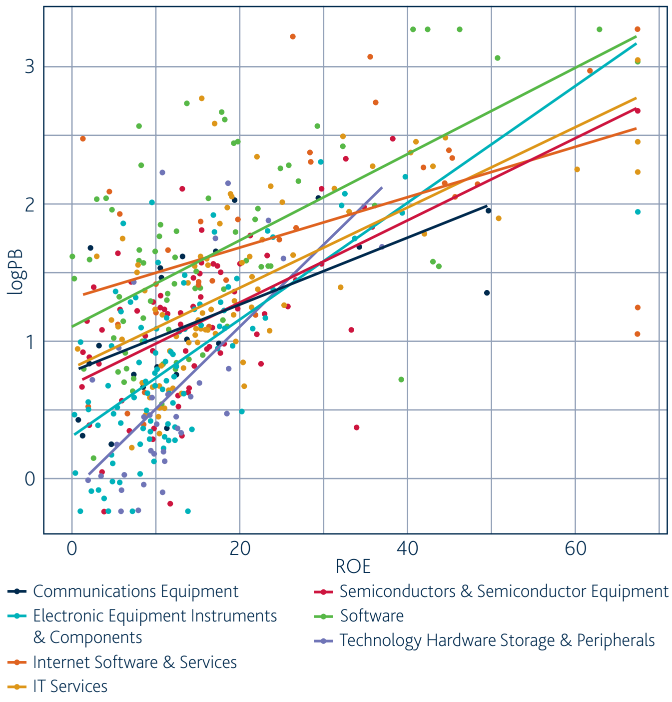
HERMES
INVESTMENT MANAGEMENT

We assess a company's value based on a wide range of characteristics: from growth and profitability, to capital structure, corporate behaviour, ESG metrics, and market sentiment. Companies with an attractive valuation and a positive blend of these elements are what we look for when investing.

A simple way of thinking about how a company's characteristics interact with one another to create its ultimate value is to consider the relationship between a company's Price-to-Book (P/B) ratio, a valuation metric, and its Return on Equity (ROE), a measure of profitability.

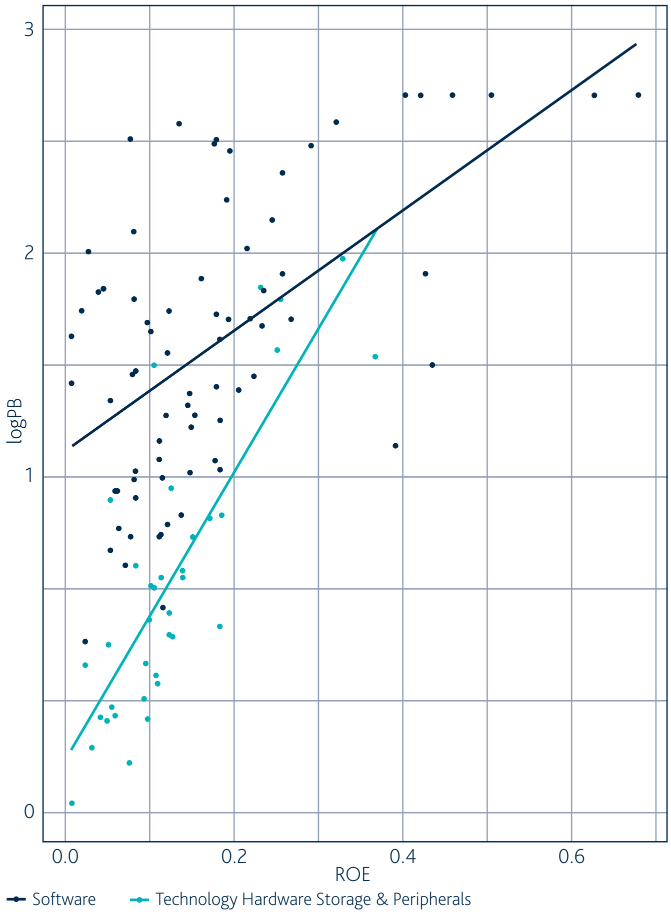
Broadly speaking, similar companies tend to display a persistent relationship between profitability and valuation: the higher the excess returns the company is expected to generate, the higher the valuation. Looking at figure 1, the lines show how different levels of profitability are valued in each industry group, with companies below the line for a given sector looking cheap and those above the line expensive. From the slope of the lines we can estimate the market's expectations of how long companies in each industry are expected to deliver excess returns. This is referred to as the market-implied competitive-advantage period for the peer group.

Figure 1. Bottom lines: how the market values profitability of different sectors



Source: Hermes as at June 2017.

Figure 2. Different strokes: the profitability of software companies is valued differently to that of technology hardware vendors



Source: Hermes as at June 2017.

In industries with high barriers to entry, such as Technology Hardware, companies are expected to keep generating superior returns for longer. As such, we may see a pronounced difference in the valuation of two near-identical companies which have a small difference in ROE.

However, for industries with low barriers to entry, such as Internet Software, the relationship between valuation and ROE is much flatter. Although a higher ROE is more attractive, the excess returns will be generated for a shorter period and therefore there is no pronounced difference in valuation.

WHEN A HIGHER PRICE IS JUSTIFIED

We are therefore happy to pay a higher price for companies expected to earn excess returns for a longer period of time. To illustrate this, let's look at Delta Airlines, a holding in our portfolio, and Harley Davidson. If we consider Delta Airlines to be attractively valued, surely Harley Davidson, which delivers slightly lower ROE at **double** the multiple, is expensive?

No. The competitive advantage period for autos is much longer than that of airlines, because much of their value comes from brand equity. Airlines, on the other hand, have become commoditised, and the focus of most airlines is on cost-cutting in order to drive down prices for increasingly cost-conscious consumers. It is therefore much harder for them to earn consistent superior returns than it is for autos, and we are less willing to pay a higher price for a higher ROE since we fully expect the excess return to rapidly revert to its historical mean. Therefore,

Amazon: valuing a game changer

While the technology giants have challenged and transformed the multitude of industries in which they operate, they are now challenging the traditional methods of stock valuation. Amazon, for example, has changed both consumer and competitor behaviour. The business may appear overvalued according to the standard metrics, but its outlook is bright.

Over the last two decades, certain technology companies have transformed the way that consumers and companies behave, growing into spectacular behemoths in the process. According to historic metrics like P/B these companies look vastly overpriced, yet it would appear that their monopolies and growth prospects represent valuable investment opportunities.

Six degrees of transformation

Amazon is a clear example of this paradox. The company has changed the way we live in many ways: the Kindle impacted our reading habits, Prime service altered the way we shop, and the Echo has started to change the way we manage our homes. Amazon has also challenged accepted business practices by offering a retail platform for small third-party suppliers, and by creating a new standard in logistics execution. The breadth of Amazon's operations means it cannot simply be considered a retail business: it is now a global leader in a number of industry sectors

Adapting to the environment

This multi-faceted business model allows Amazon to continuously innovate, providing strong future growth prospects. Instead of emphasising earnings, the business has pursued revenue growth and significant re-investment in order to consolidate its market positions.

This approach has been largely successful. Amazon's management has exhibited superior execution skills, investing in new business segments and often defeating competition from new contenders. While there have inevitably been some mistakes along the way, (such as the Fire Phone, which lost over $170 million[2]), the sheer scale of the company means these have been absorbed relatively painlessly. All of these factors combine to create expected annual revenue growth of roughly 20%, a healthy balance sheet, and phenomenal market sentiment.

Reframing value

Although Amazon has unquestionably been successful, the management's decision to pursue this model has impacted the business' backward-looking metrics. As previously stated, traditional measures like P/B ratio make Amazon look very expensive, but these analyses fail to take into account its future growth potential.

In order to fully account for potential growth in a company's valuation, it is necessary therefore to value Amazon and similar businesses using our 'hyper-growth' model. This model allows us to place greater emphasis on forward expectations and market sentiment, and thus more accurately track the likely direction of a business' share price. Amazon is a textbook example of when applying the 'hyper-growth' model achieves a more realistic valuation.

while Delta Airlines and Harley Davidson have broadly similar levels of profitability, their strikingly different P/B ratios – 2.9[1] for Delta and 5.4 for Harley Davidson – can both be justified on the basis of their industry sector.

And if we reverse the maths, we can also look at the profitability required to justify a company's current valuation. As described above, we consider Harley Davidson's 5.4x P/B multiple justified given its ROE of 37%, but if the company were an airline with the associated short competitive advantage period, then this valuation would not be attractive. Instead, a valuation of 5.4x would require an ROE of around 71% to look fairly valued. It is therefore little wonder that we consider American Airlines to be expensive with its 6.3x P/B multiple and ROE of 57%.

Of course, this is just one method of assessing a company's value. For example, ASML, the global lithography company specialising in semiconductor manufacturing equipment, looks overpriced at first glance, with a P/B of 4.2x and an ROE of 15%. However, once adjusted to account for the company's market dominance, which amounts to a market share of 85%, the premium is justified.

There may also be times when this approach to valuation will be entirely ineffective. While it is an appropriate measure for mature and cyclical companies, for young, high-growth companies valuations should be focused on future returns and growth. For example, within the Internet Retailer sector there is a much less meaningful relationship between ROE and P/B, which reflects the diverse nature of the group. Netflix, Amazon and Start Today appear incredibly expensive at first glance, but these companies are breaking the industry trend of short-lived competitive advantages. It is therefore difficult to compare these companies with their peers.

We analyse companies with extreme valuations under an alternative lens: our 'hyper-growth' model. It identifies companies whose share prices are driven almost entirely by forward-looking metrics; these are often technologically disruptive companies which are reshaping their part of the industry. These companies frequently appear outrageously expensive, and enjoy overwhelmingly positive market sentiment. For these companies, metrics such as P/B and historic peer-relative numbers become less important, and we instead emphasise forward expectations and market sentiment.

MOVING THE VALUE GOALPOSTS

As technologically disruptive businesses change the way we live, they are also changing the way we as investors assess valuation. Their investment-intensive models are skewed traditional metrics, making these companies appear overpriced but actually highlighting the fact that the existing metrics can be ineffective. By giving weight to future-facing measures like growth forecasts and market sentiment, we can more accurately distinguish between those businesses which are simply exploiting a short lens scenario, and those which are fundamentally altering the established model – that is, those gaming the market, and those changing the game.

[1] All figures correct at time of issue (30 April 2017)

[2] Amazon is killing off the Fire Phone, Kia Kokalitcheva, Published by Fortune, http://fortune.com/2015/09/09/amazon-killing-fire-phone, September 2015.

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HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, Private Debt, Private Equity, Commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, and small and mid cap

Credit
Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | New York | Singapore

Why Hermes Global Equities?

Transparency
Our accessible investment process and analysis is based on clearly defined statistical and economic evidence. It is not a 'black box' and the drivers of returns can be clearly explained.

Expertise
Our bottom-up stock-selection model systematically analyses companies' financial statements and gauges investor sentiment to generate an optimal portfolio. The team draws on its deep investment experience to identify unquantifiable risks such as negative news flow and regulatory change.

Flexibility
We partner with clients to create portfolios addressing their needs, amending the risk profile, investment universe and benchmark, and portfolio characteristics such as dividend yield and ESG exposure as required.

Broad risk awareness
MultiFRAME, our proprietary risk modelling system, detects exposures to all quantifiable risks. The Hermes Investment Office performs independent risk management services for clients and sustainability risks are identified by our ESG Dashboard.

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