

VALENS SECURITIES

The Importance of ROA' and Asset' Growth

Professor Joel Litman
June 2016

Valens Securities, Inc. and The Institute of Strategy & Valuation
425 5th Avenue, New York, New York 10016 | PSE Centre, 2404-B, Pasig City, Philippines
joel.litman@valens-securities.com

PRIVATE AND CONFIDENTIAL: This document is confidential and contains proprietary information. Neither the document nor any of the information contained herein may be reproduced or disclosed to any person under any circumstances without express written permission.

The 8th Wonder of the World

Credited with calling it the *“most powerful force in the universe”*

Referring to **COMPOUND INTEREST**

\$100,000 @ 10% interest over 40 years, produces \$400,000

If interest is fully reinvested, and therefore compounds...

\$100,000 @ 10% interest over 40 years, produces \$4.5 Million

The importance of the interest rate

Companies with the most improvement in ROA's

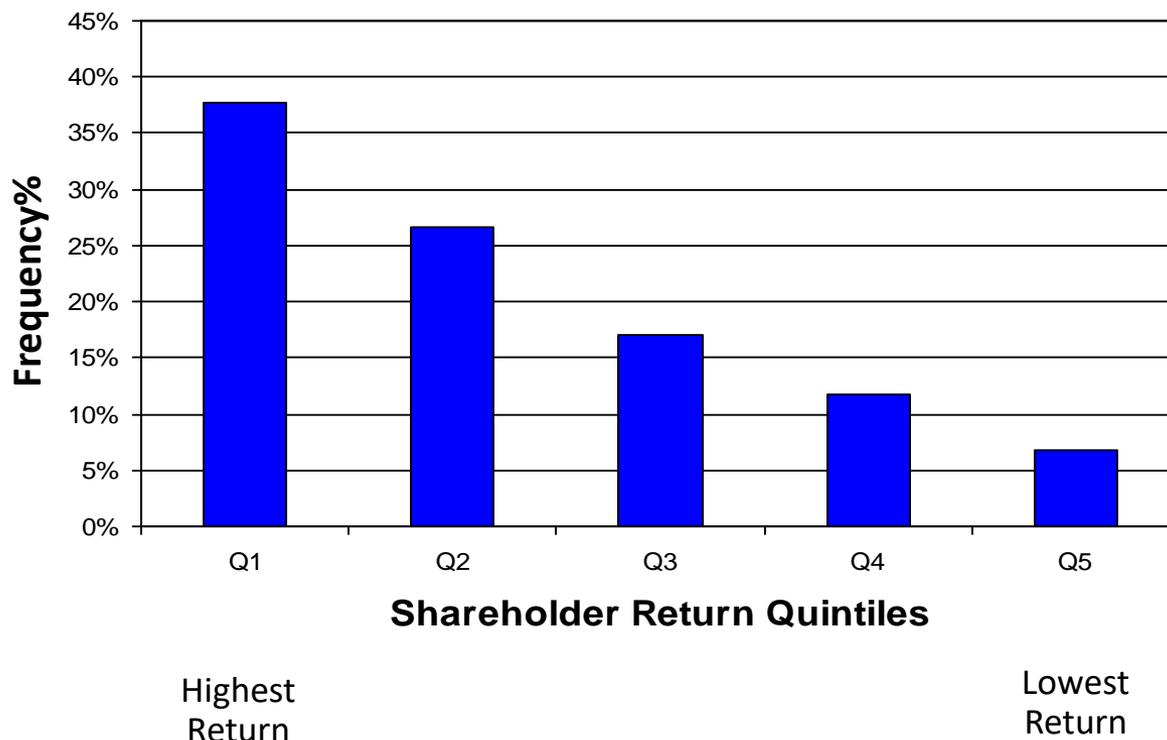
Take the largest 500 non-financials, rank order based on highest positive change in ROA'

What if one had bought the top 100 firms at the beginning of the period that was achieved?

Of the highest 20% of ROA' change companies, 38% were the best stock performers

1994-2002

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?



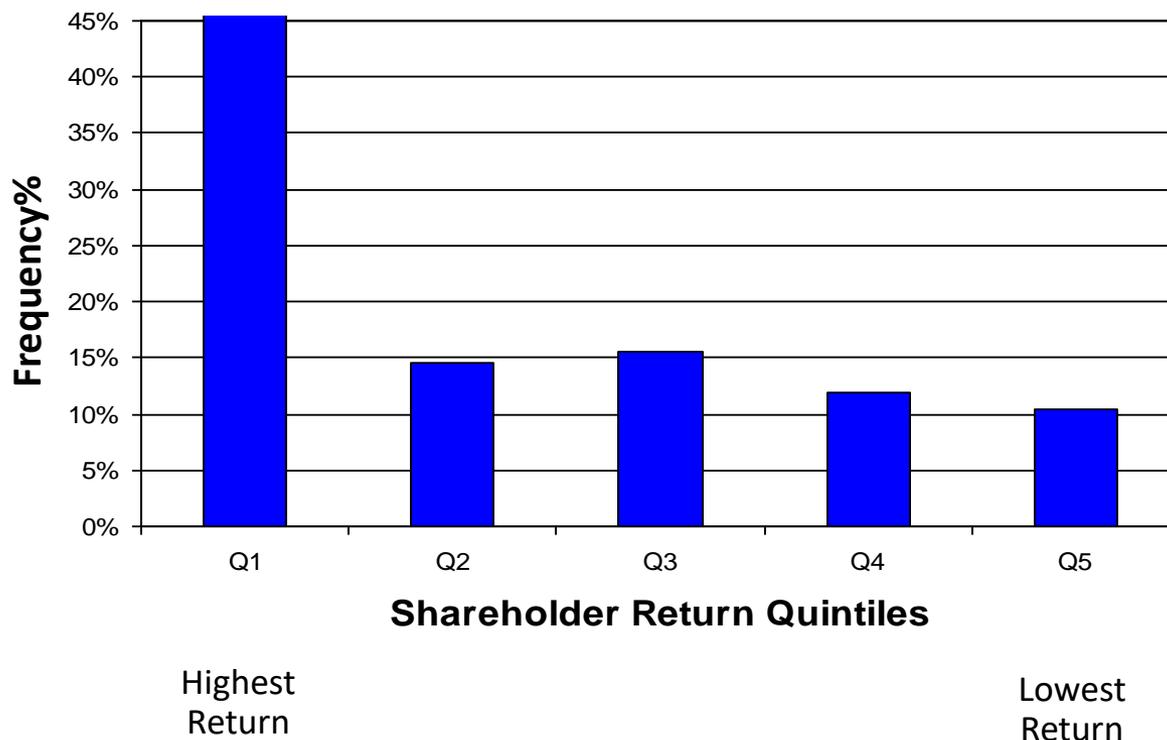
Source: Madden, Bartley J., Mauboussin, Michael J., Lagerman, John D., Eddins, Samuel T. "Business Strategy/Life-Cycle Framework." 22 April, 2003.

Does this hold true for other periods?

Of the highest 20% of ROA' change companies, 46% were the best stock performers

1988-1991

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?

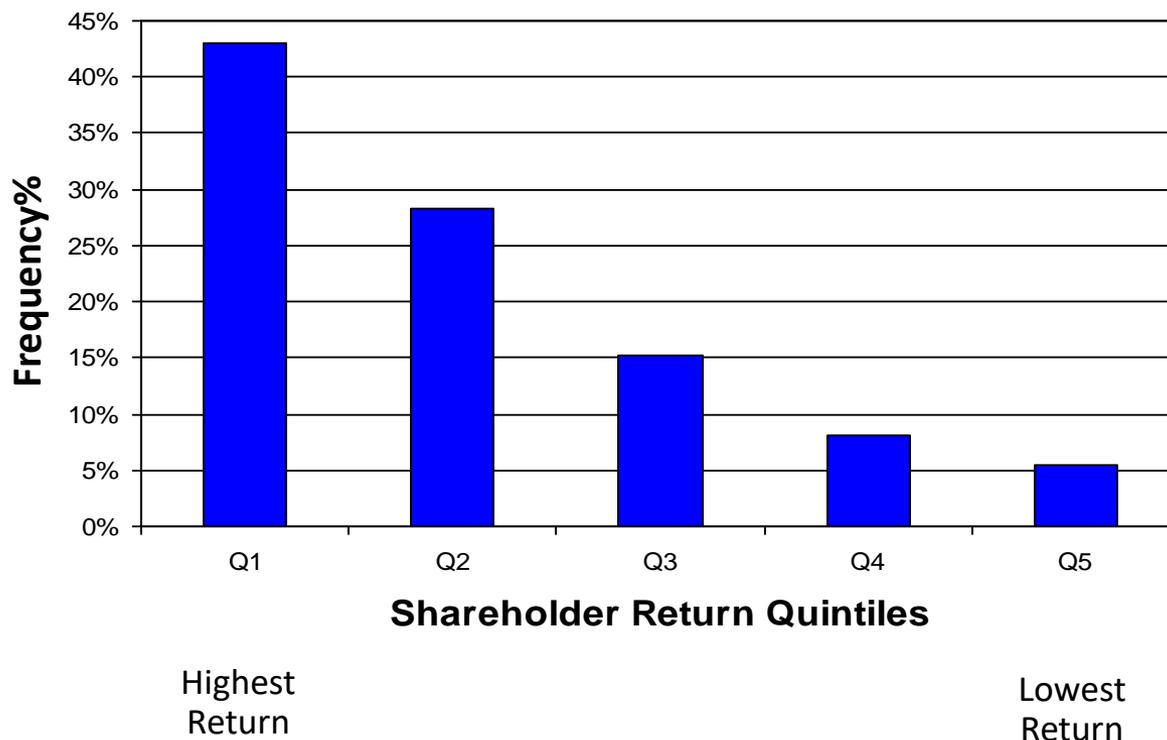


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of ROA' change companies, 43% were the best stock performers

1991-1994

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of ROA' change companies, 41% were the best stock performers

1994-1997

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?

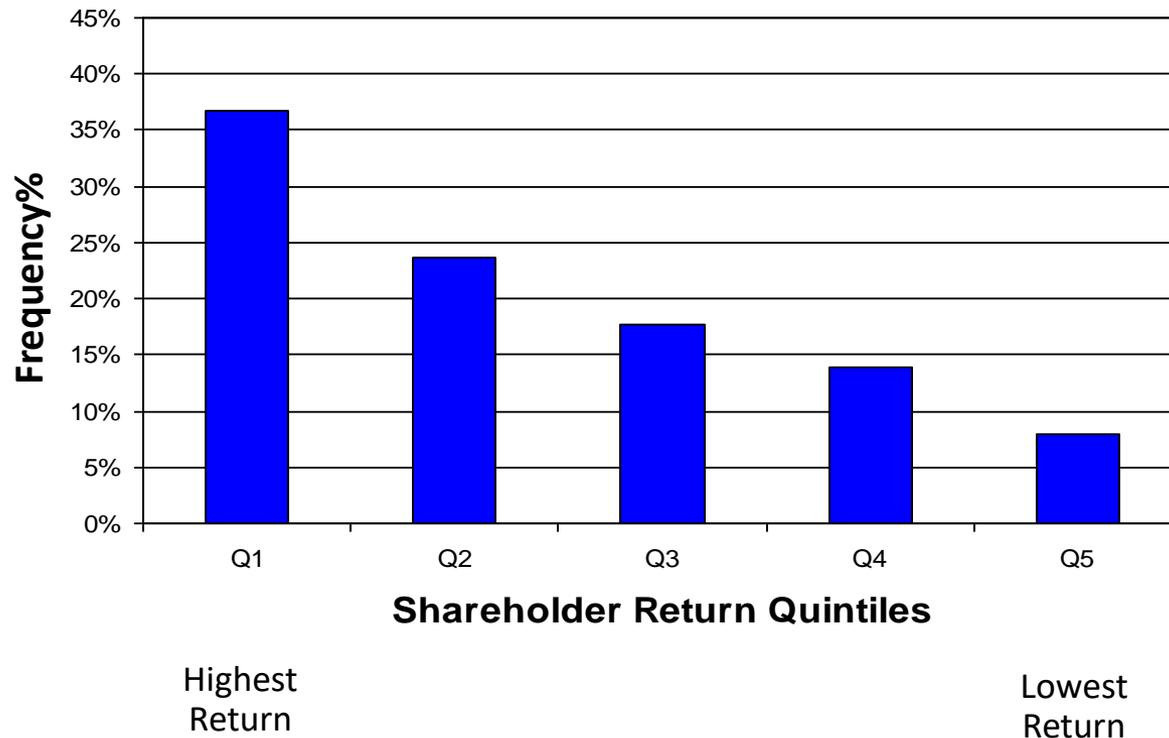


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of ROA' change companies, 37% were the best stock performers

1997-2000

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of ROA' change companies, 36% were the best stock performers

2000-2003

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?

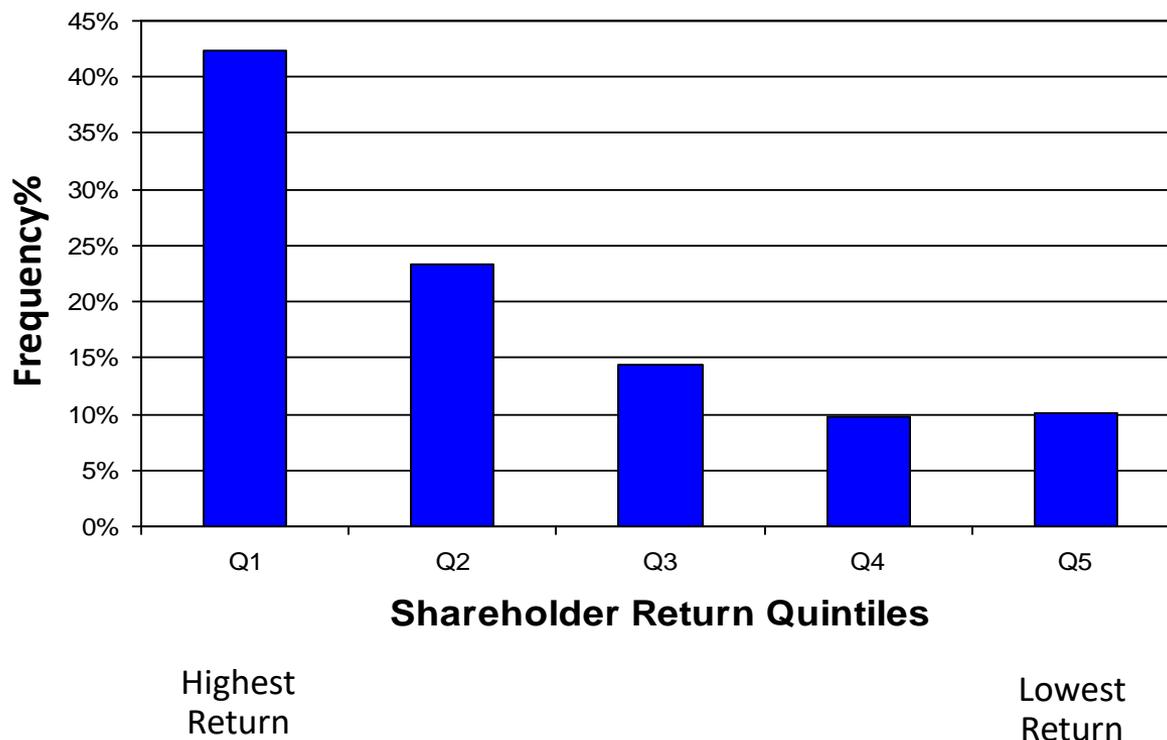


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of ROA' change companies, 42% were the best stock performers

2002-2005

Of Highest
"ROA' Change"
companies,
what percent
achieved each
level of
shareholder
return?



Source: ValueSearch™7. Data Date: December 31, 2006.

The importance of the bank balance

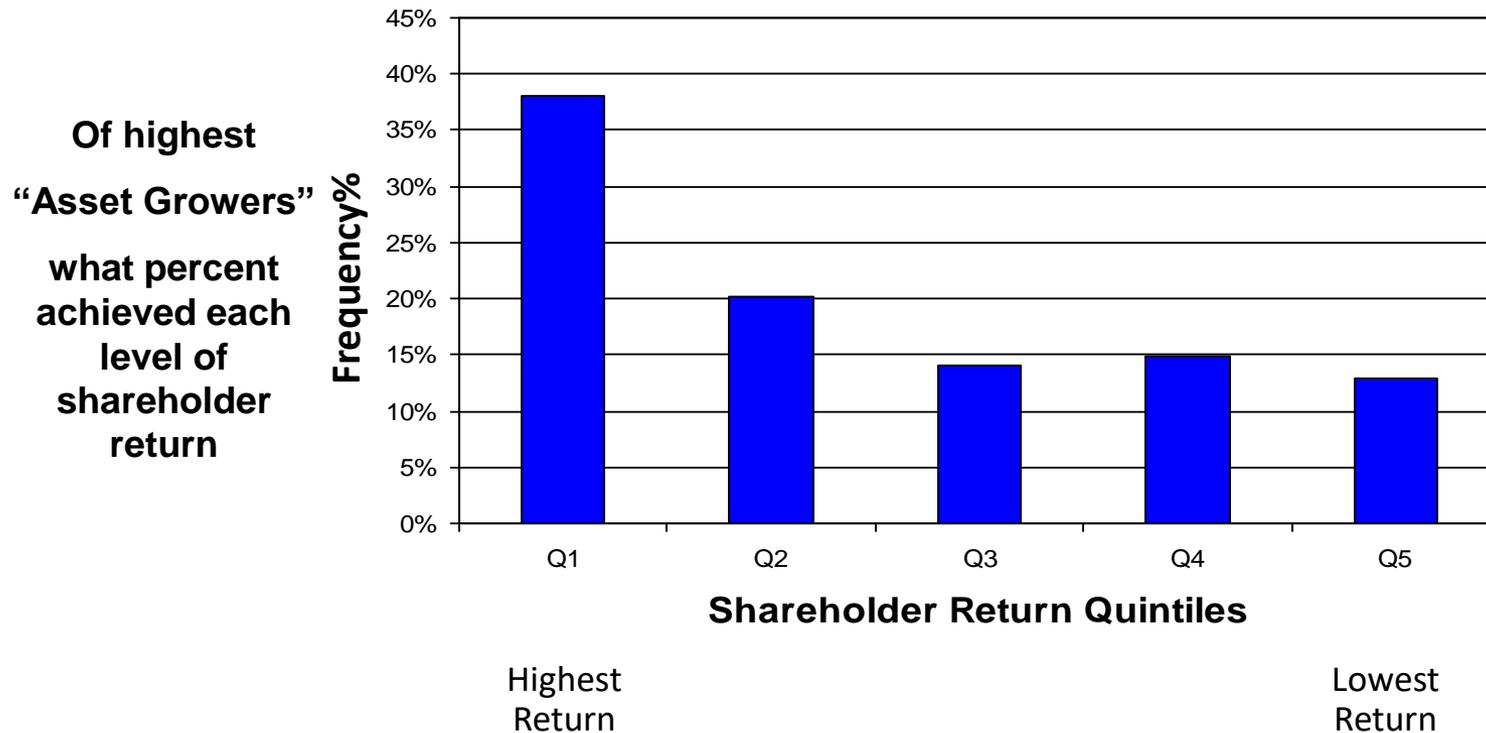
**Companies with highest “Adjusted Asset” growth
(highest increase in capital invested)**

**Take the largest 500 non-financials, rank order based on
highest asset growth**

**What if one had bought the top 100 firms at the beginning
of the period that was achieved?**

Of the highest 20% of Adjusted Asset growers, 38% were the highest stock performers

1994-2002

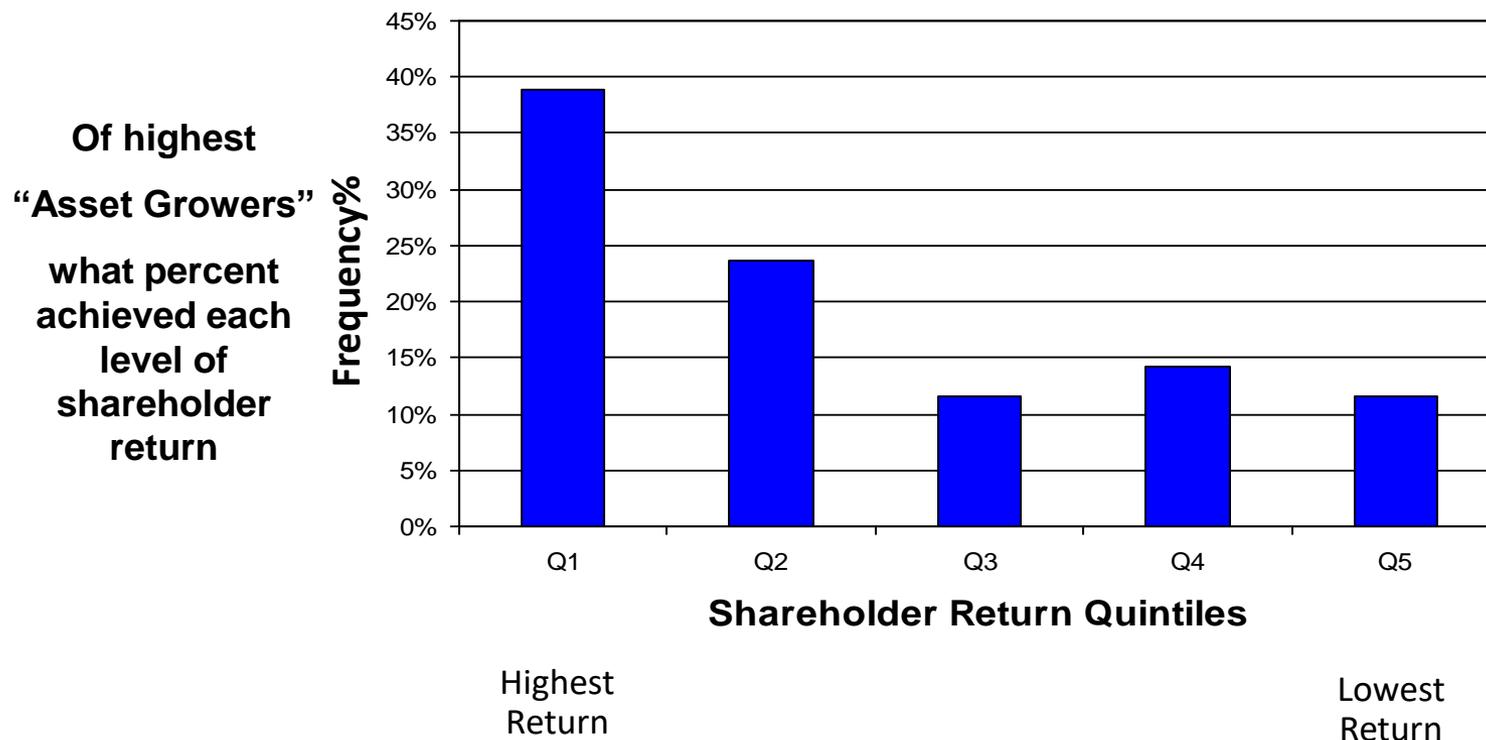


Source: Madden, Bartley J., Mauboussin, Michael J., Lagerman, John D., Eddins, Samuel T. "Business Strategy/Life-Cycle Framework." 22 April, 2003.

Does this hold true for other periods?

Of the highest 20% of Adjusted Asset growers, 39% were the highest stock performers

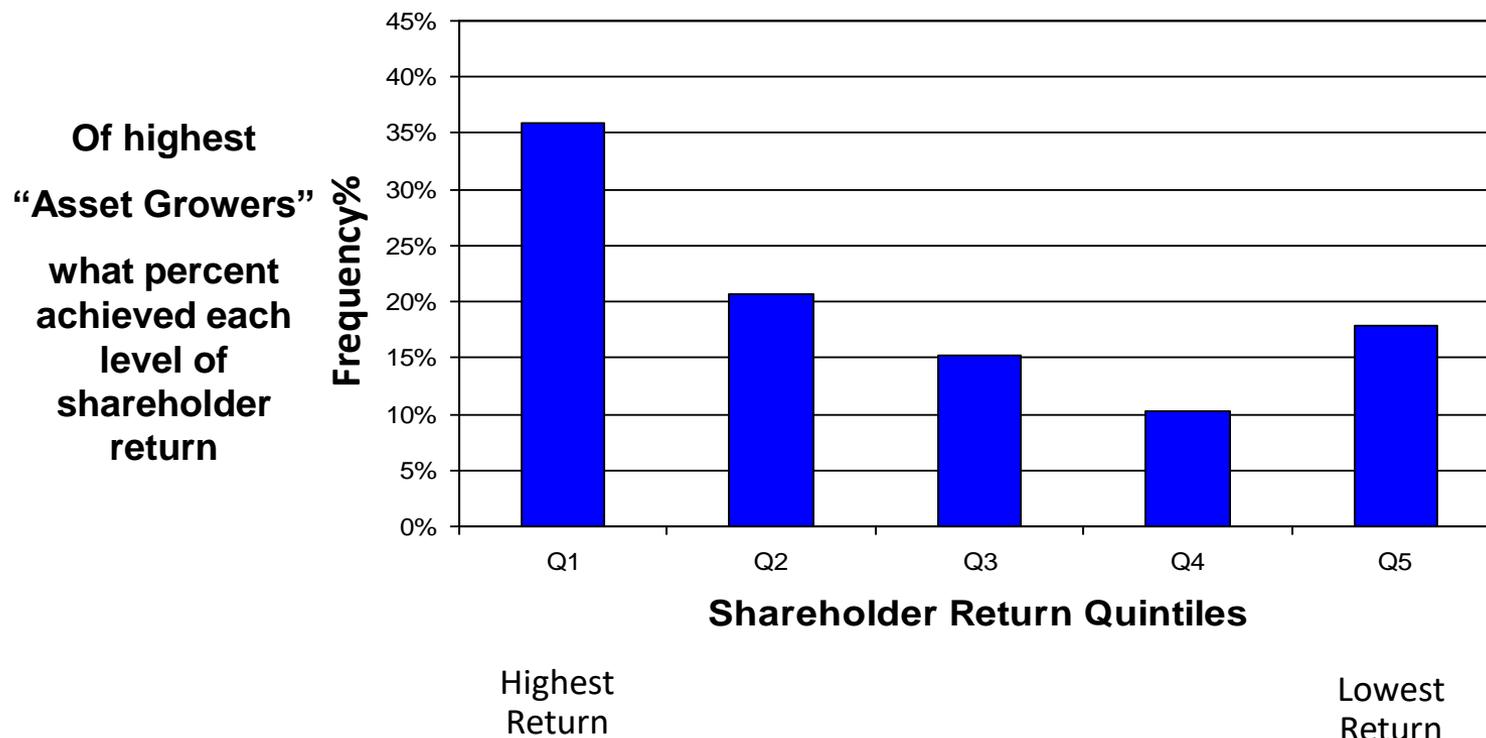
1988-1991



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of Adjusted Asset growers, 36% were the highest stock performers

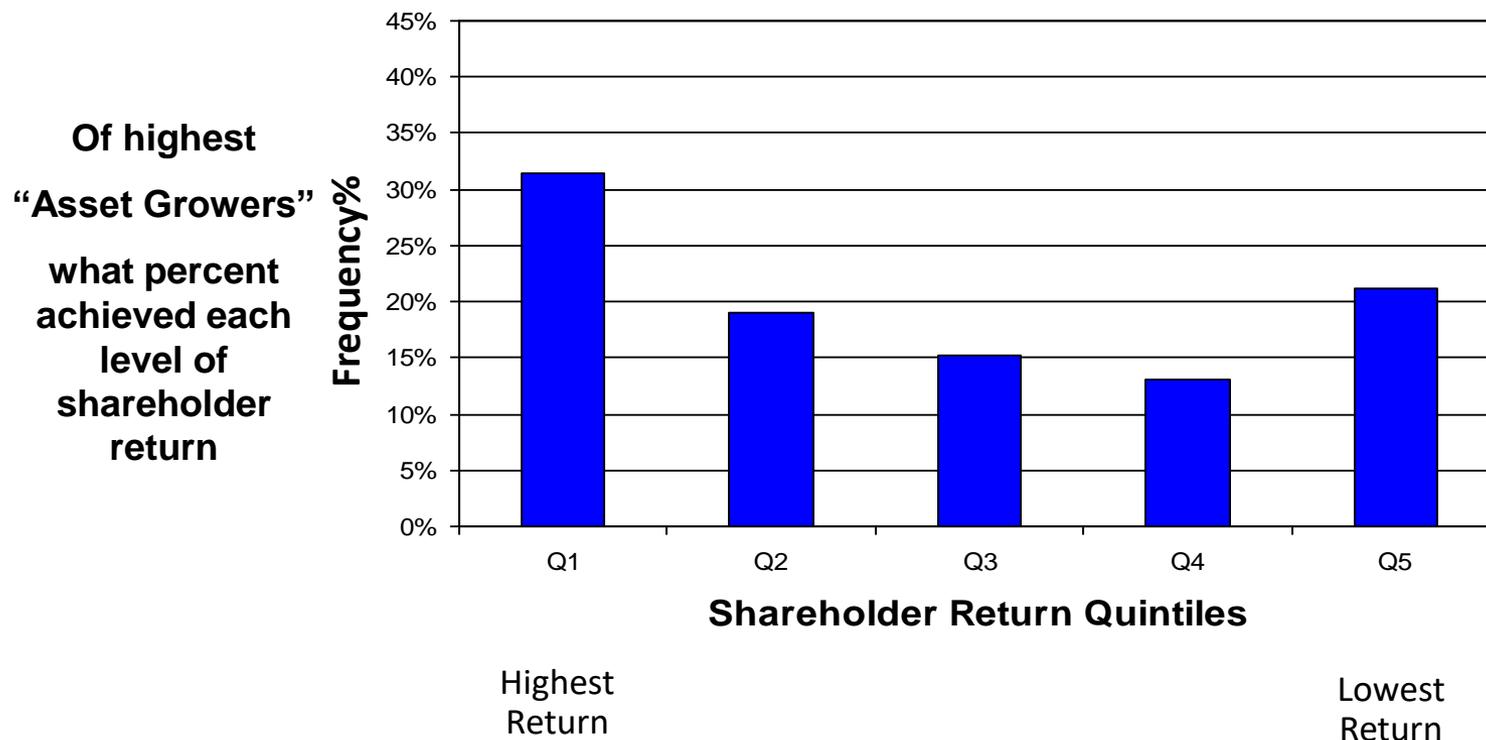
1991-1994



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of Adjusted Asset growers, 32% were the highest stock performers

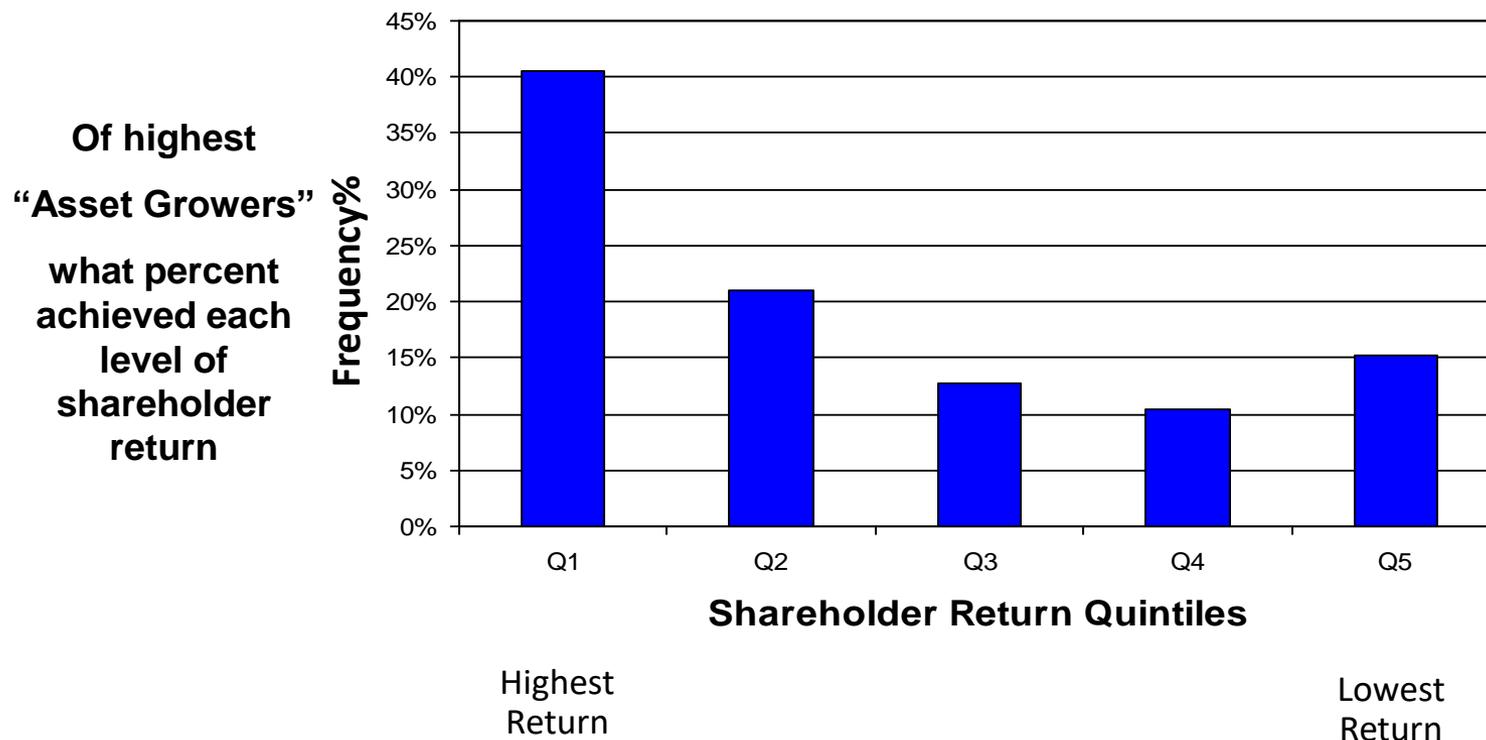
1994-1997



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of Adjusted Asset growers, 41% were the highest stock performers

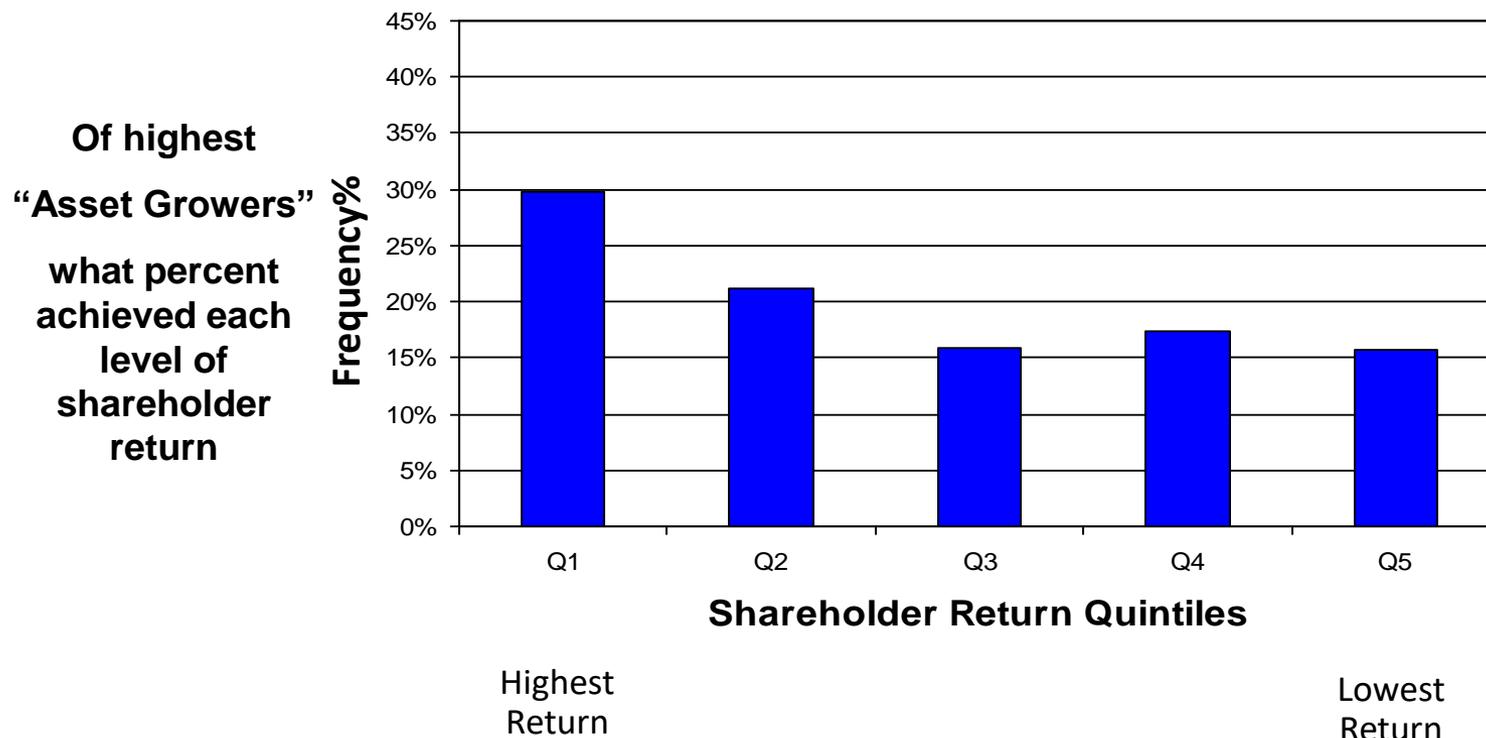
1997-2000



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of Adjusted Asset growers, 30% were the highest stock performers

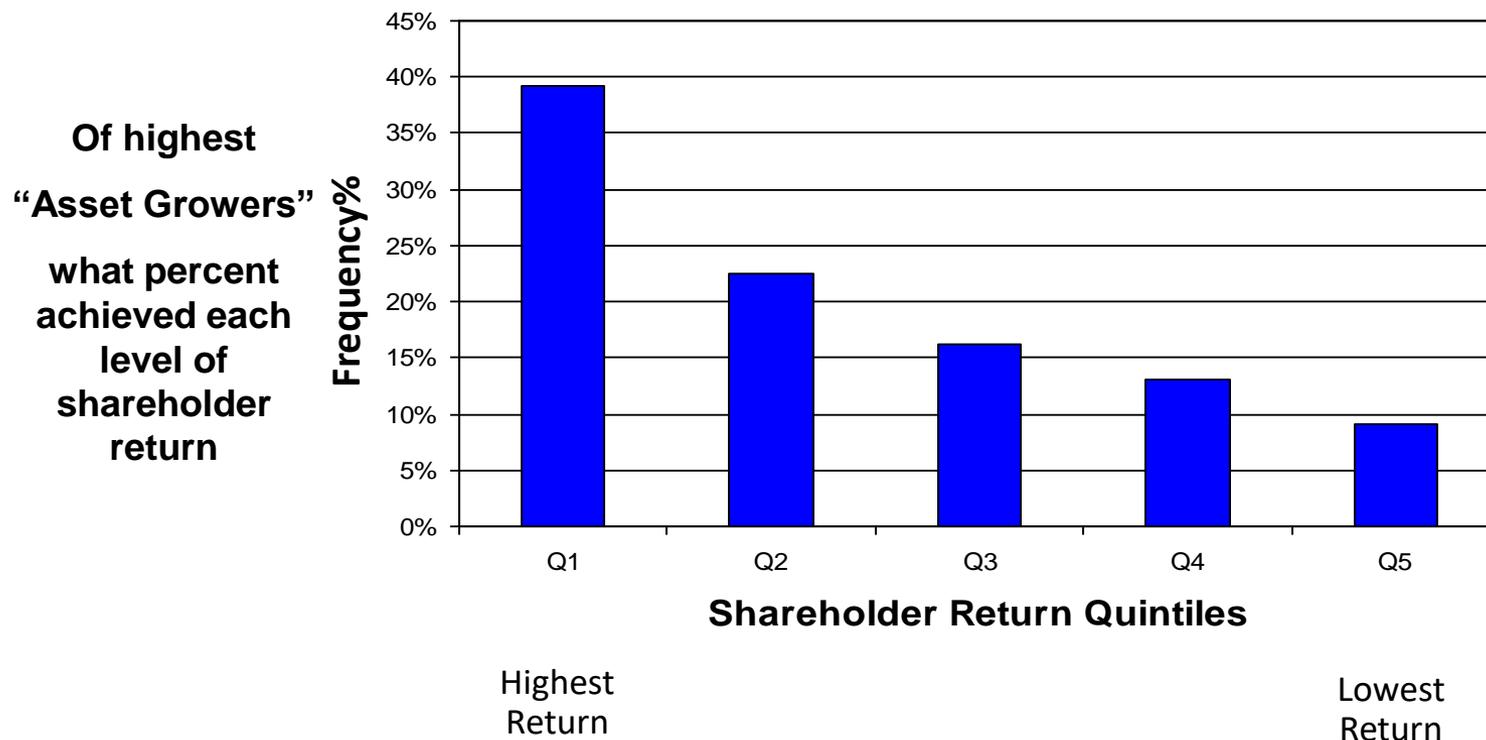
2000-2003



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the highest 20% of Adjusted Asset growers, 39% were the highest stock performers

2002-2005



Source: ValueSearch™7. Data Date: December 31, 2006.

The power of compound interest

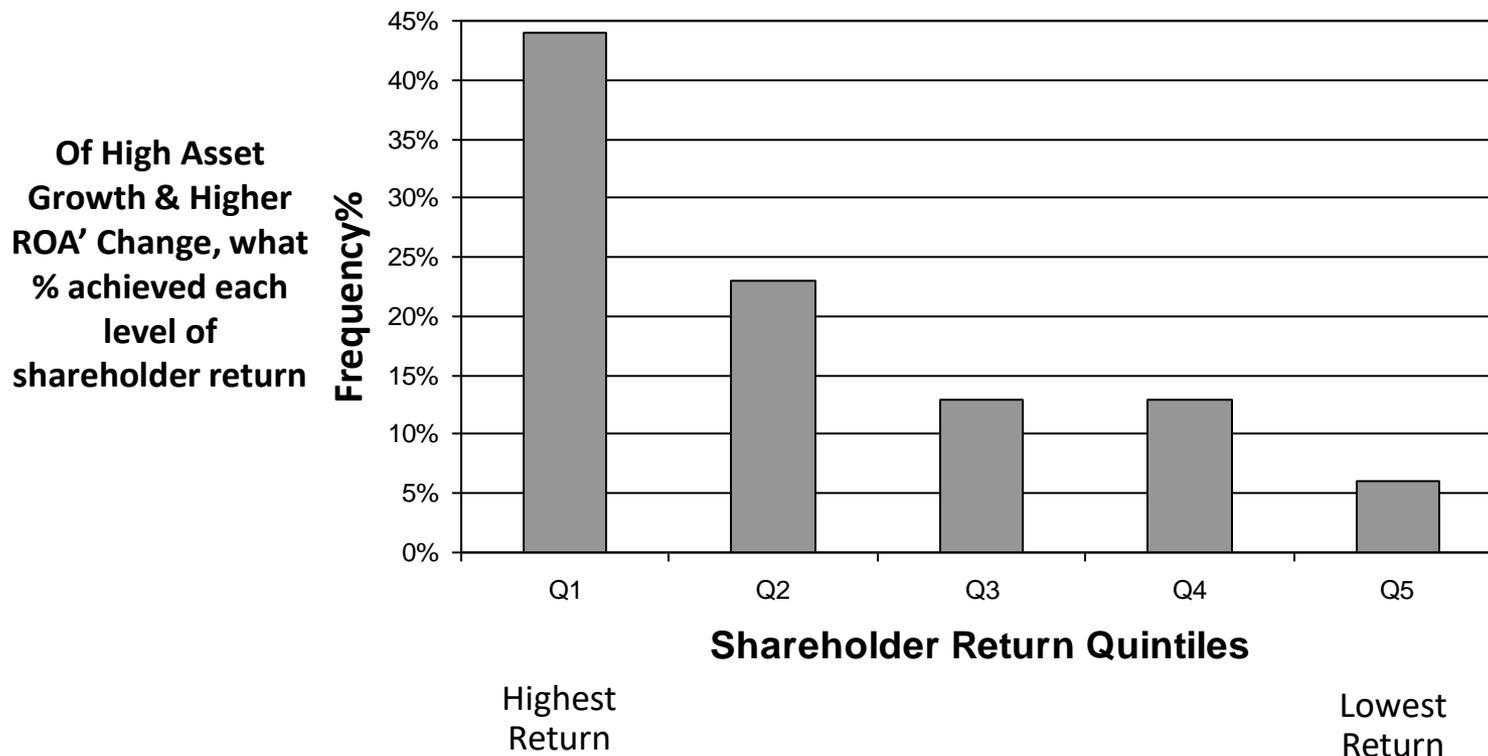
Highest ROA' increase AND Adjusted Asset growth

This time rank the 500 on a combination score of highest ROA' improvement and Asset' growth

What if one had bought the top 100 firms at the beginning of the period that was achieved?

Of the companies with highest Asset' growth & ROA' increase, 44% were top stock performers

1994-2002

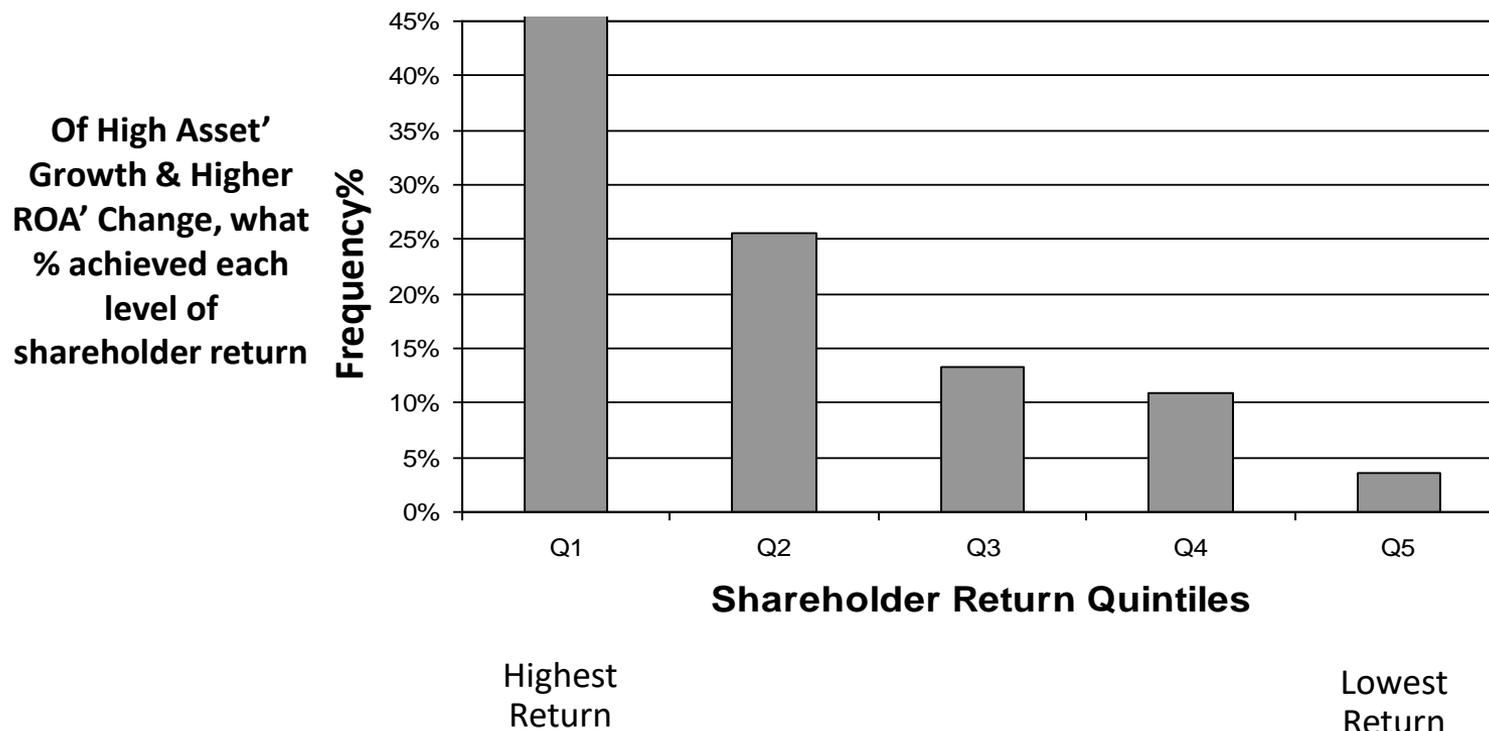


Source: Madden, Bartley J., Mauboussin, Michael J., Lagerman, John D., Eddins, Samuel T. "Business Strategy/Life-Cycle Framework." 22 April, 2003.

Does this hold true for other periods?

Of the companies with highest Asset' growth & ROA' increase, 46% were top stock performers

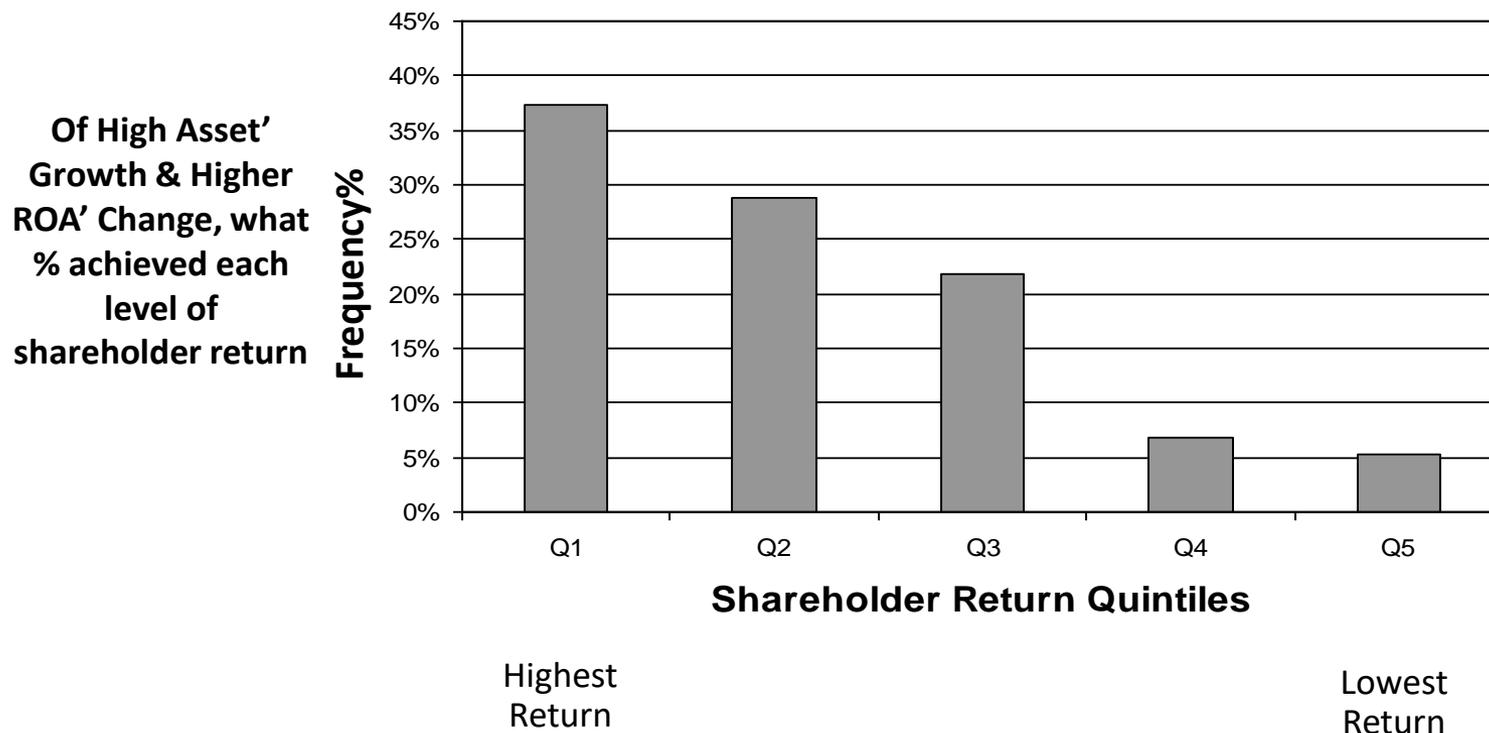
1988-1991



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with highest Asset' growth & ROA' increase, 37% were top stock performers

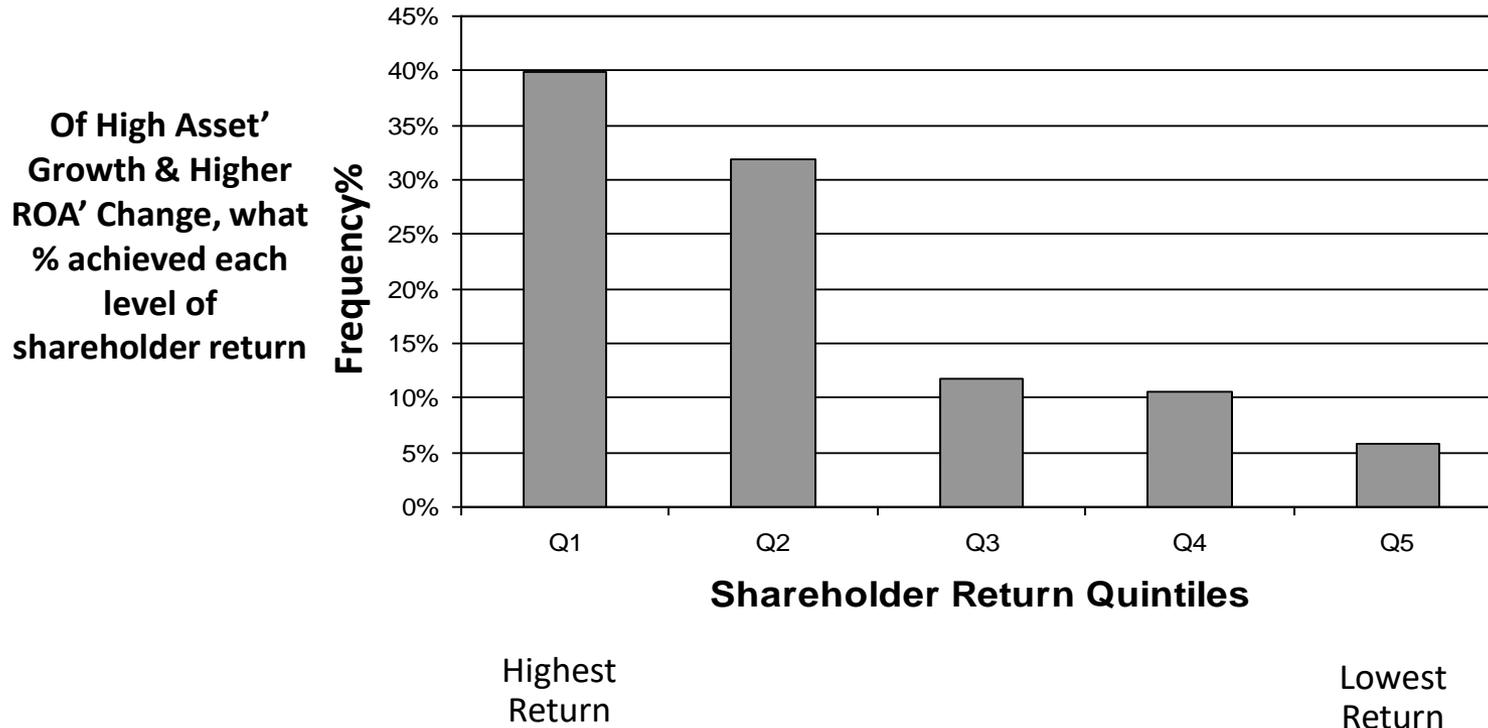
1991-1994



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with highest Asset' growth & ROA' increase, 40% were top stock performers

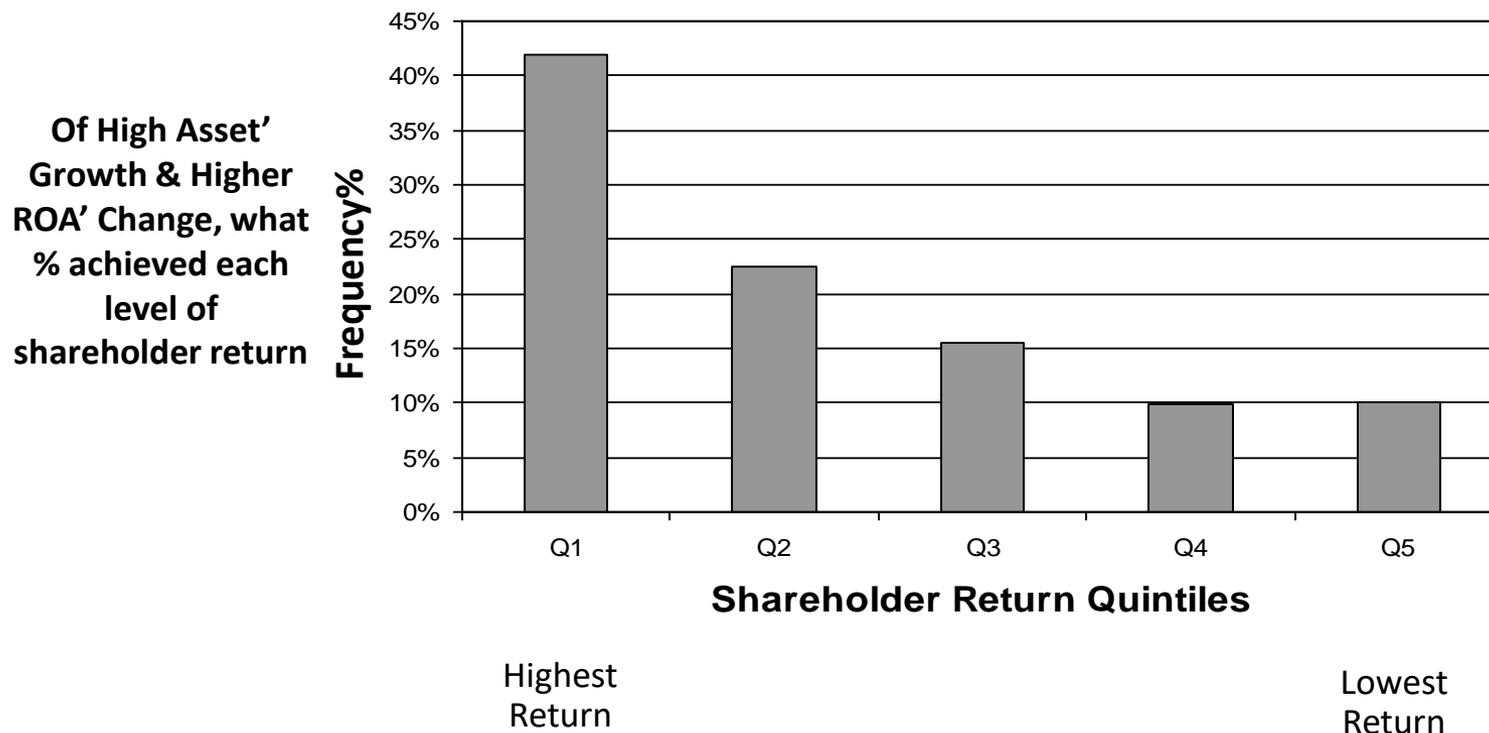
1994-1997



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with highest Asset' growth & ROA' increase, 42% were top stock performers

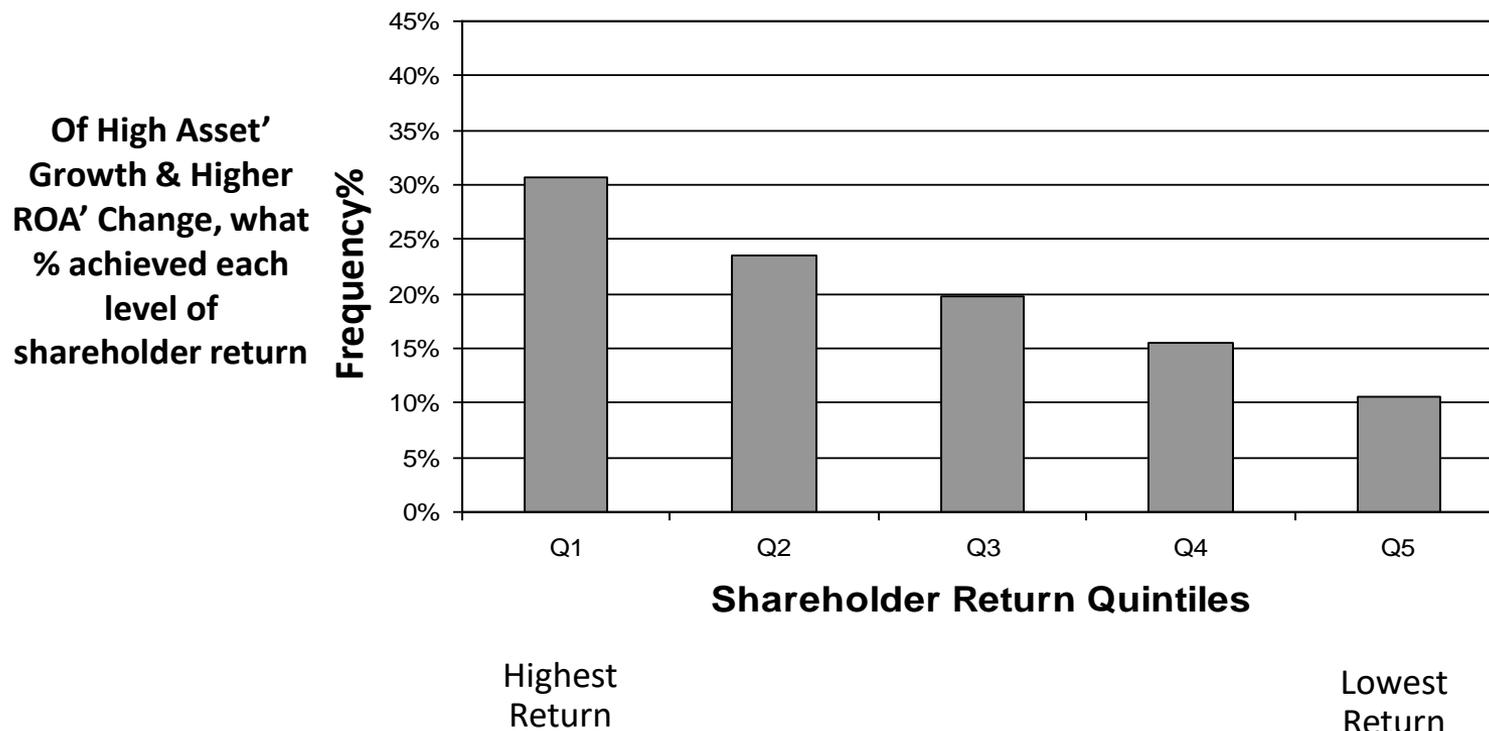
1997-2000



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with highest Asset' growth & ROA' increase, 31% were top stock performers

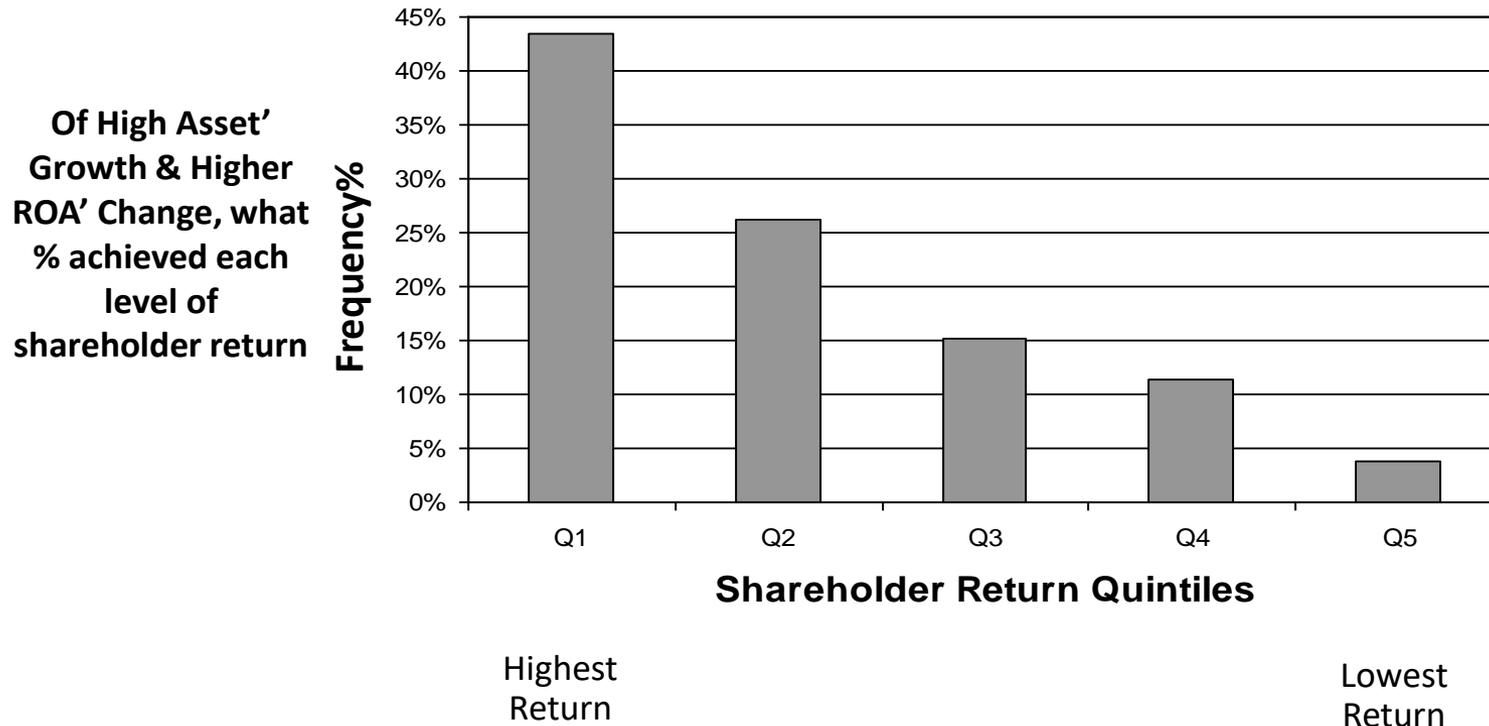
2000-2003



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with highest Asset' growth & ROA' increase, 43% were top stock performers

2002-2005

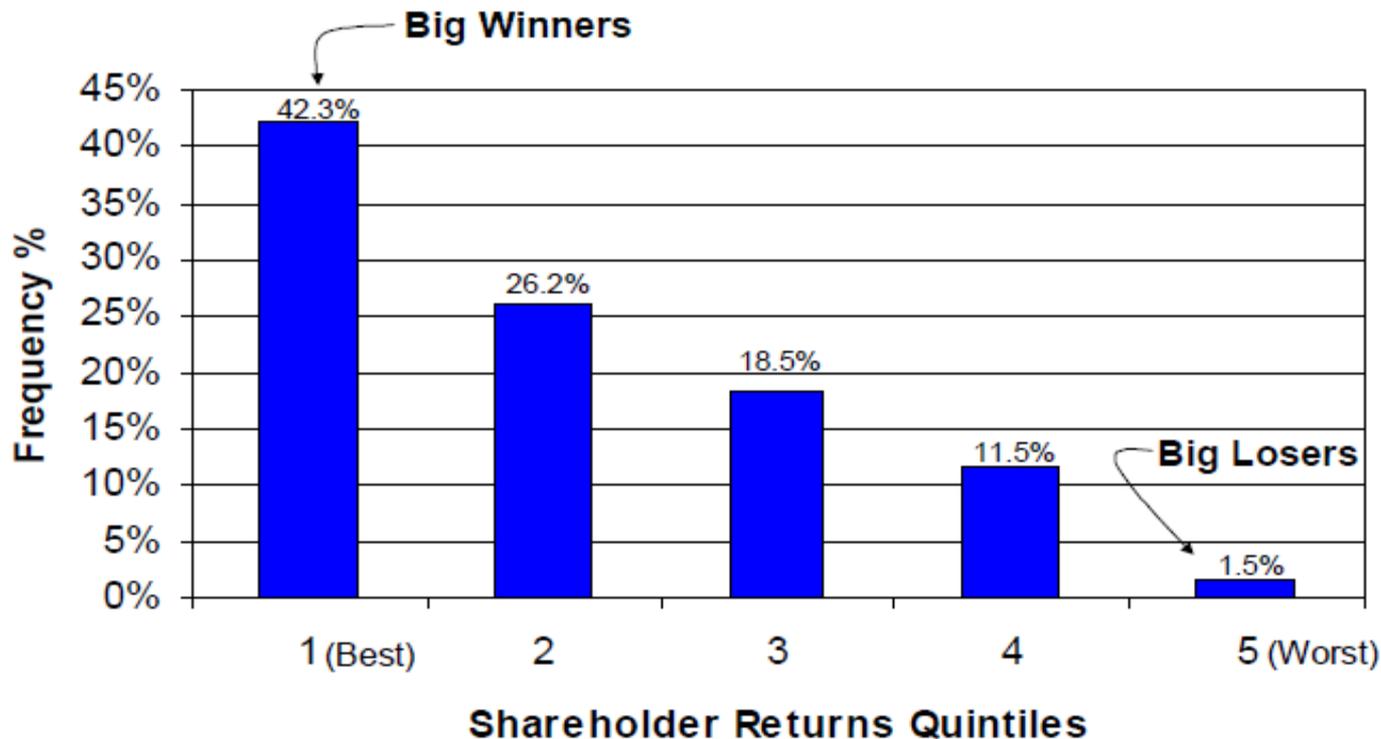


Source: ValueSearch™7. Data Date: December 31, 2006.

Does this hold true globally?

Of the companies with highest Asset' growth & ROA' increase, 42% were top stock performers

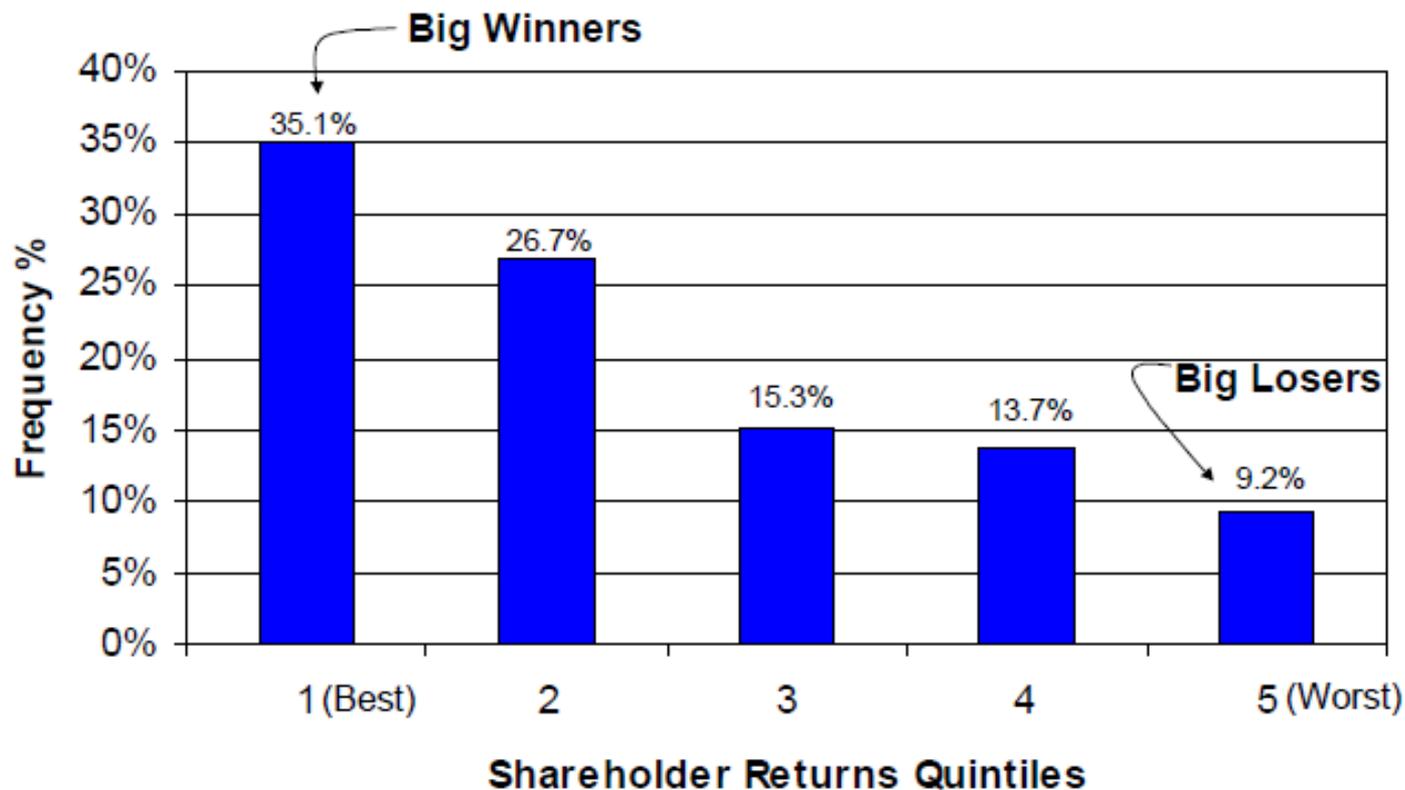
Europe



Source: CSFB HOLT Equity Research

Of the companies with highest Asset' growth & ROA' increase, 35% were top-quintile stock performers

Asia



Source: CSFB HOLT Equity Research

When interest does not compound

High ROA' improvement, but low Asset' growth

**Rank order the 500 companies based on combination score
of highest ROA' improvement while also lowest/negative
growth rates**

**What if one invested in the top 100 high ROA', low growth
firms at the beginning of the period?**

Of the companies with high ROA' increase that didn't grow their assets, only 16% were top performers

1994-2002

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?



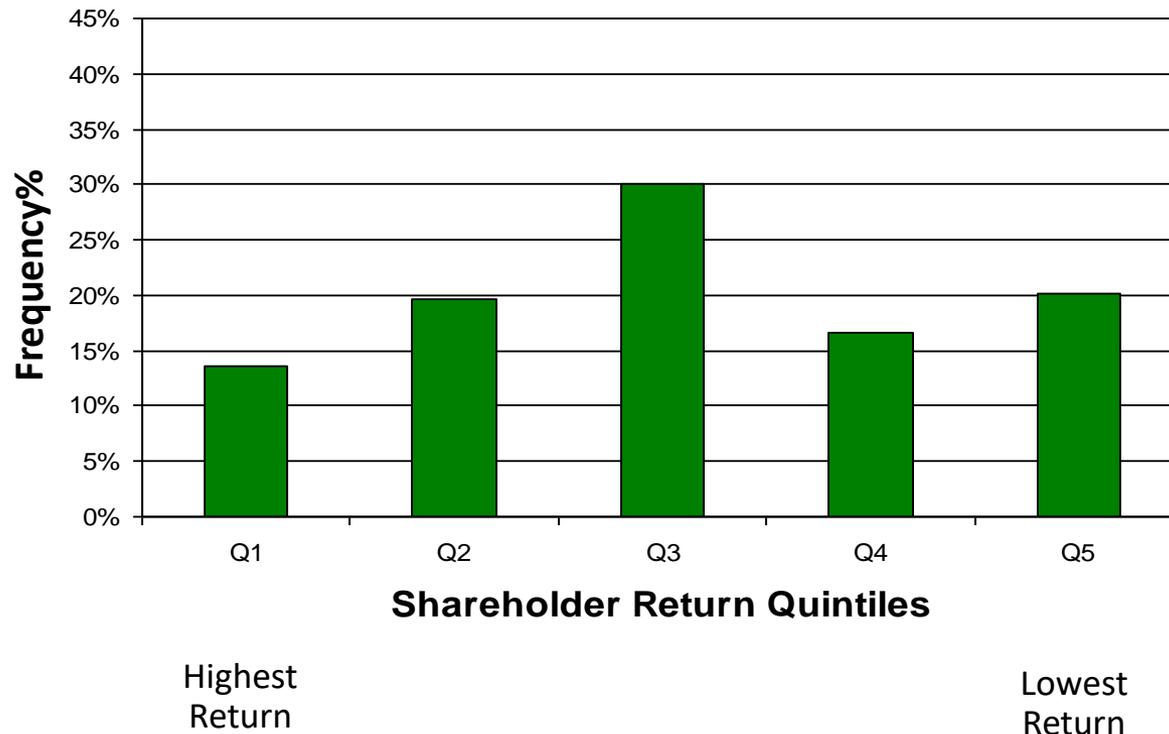
Source: Madden, Bartley J., Mauboussin, Michael J., Lagerman, John D., Eddins, Samuel T. "Business Strategy/Life-Cycle Framework." 22 April, 2003.

Does this hold true for other periods?

Of the companies with high ROA' increase that didn't grow their assets, only 13% were top performers

1988-1991

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?

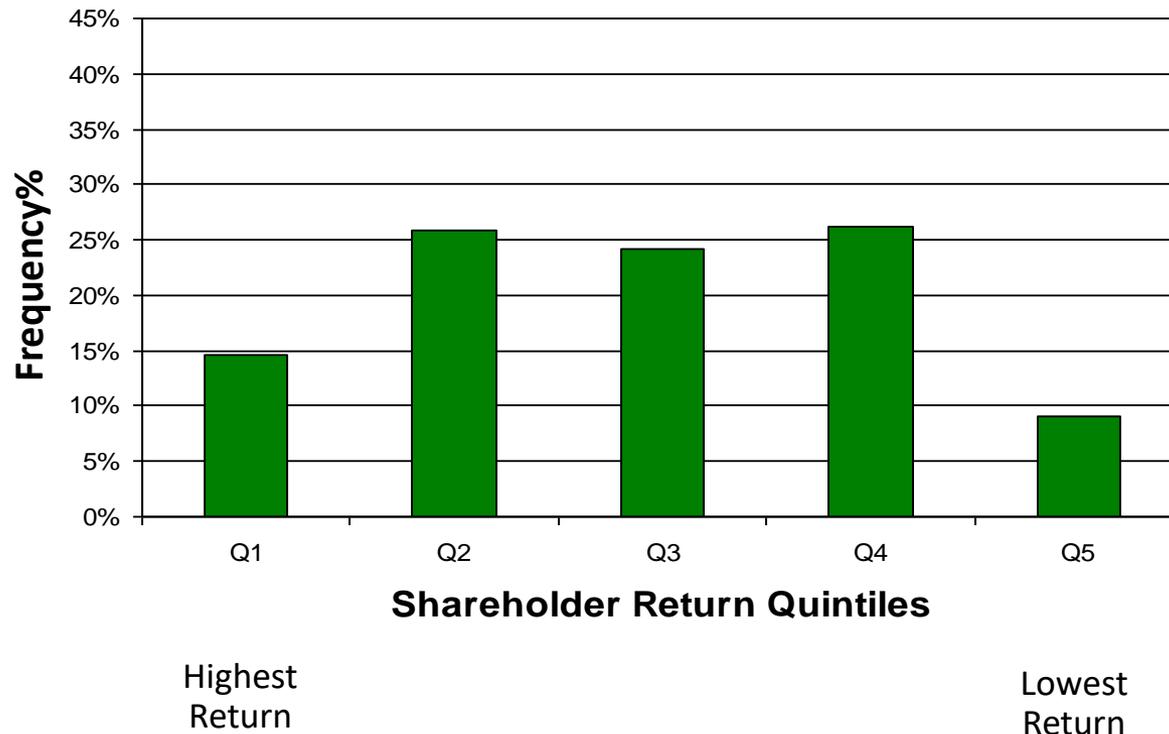


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with high ROA' increase that didn't grow their assets, only 14% were top performers

1991-1994

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?



Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with high ROA' increase that didn't grow their assets, only 16% were top performers

1994-1997

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?

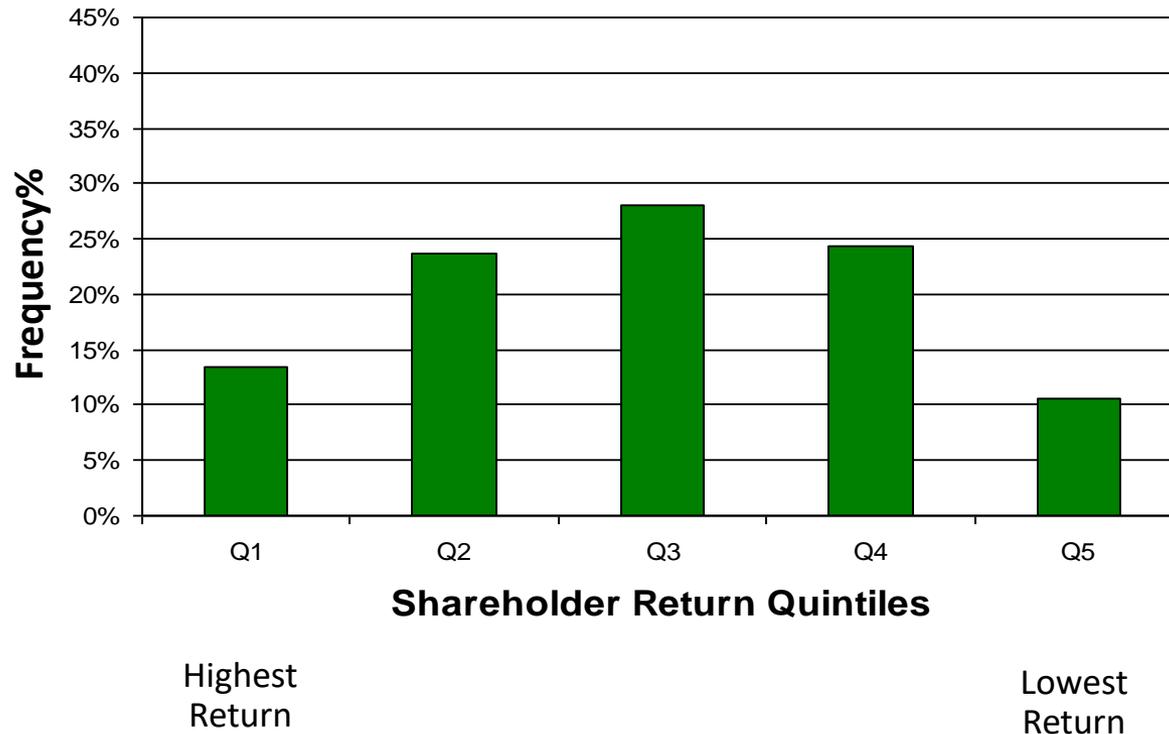


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with high ROA' increase that didn't grow their assets, only 14% were top performers

1997-2000

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?

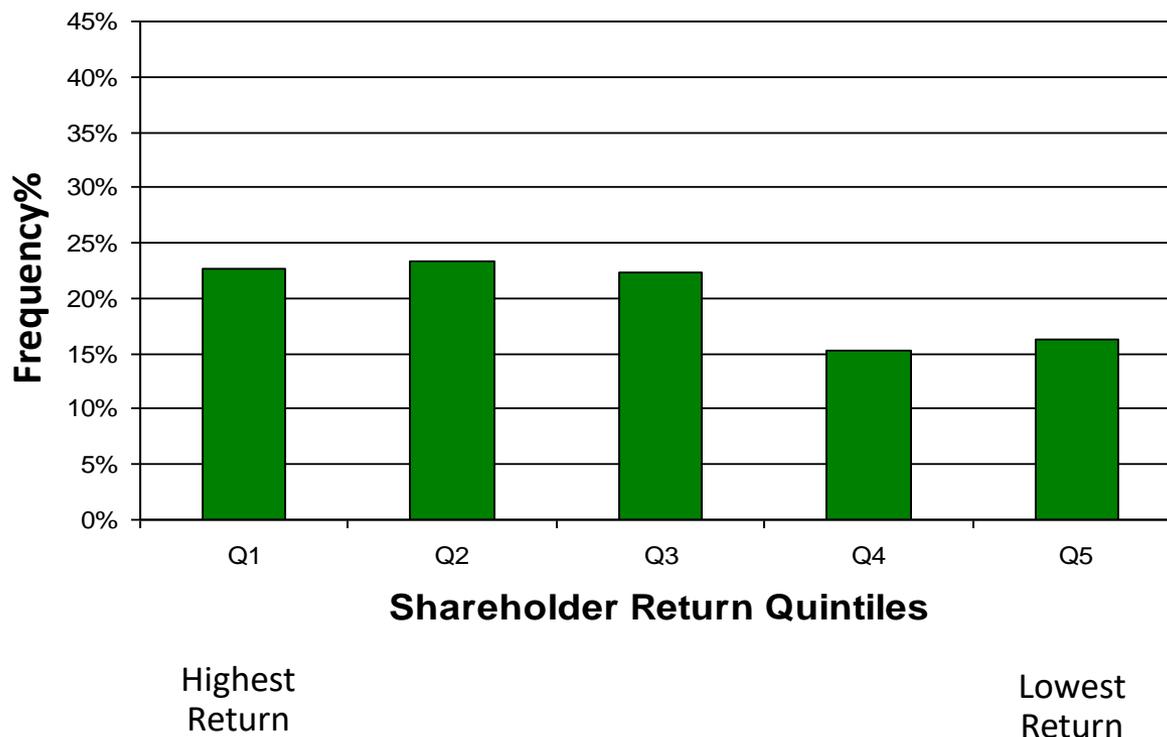


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with high ROA' increase that didn't grow their assets, only 23% were top performers

2000-2003

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?

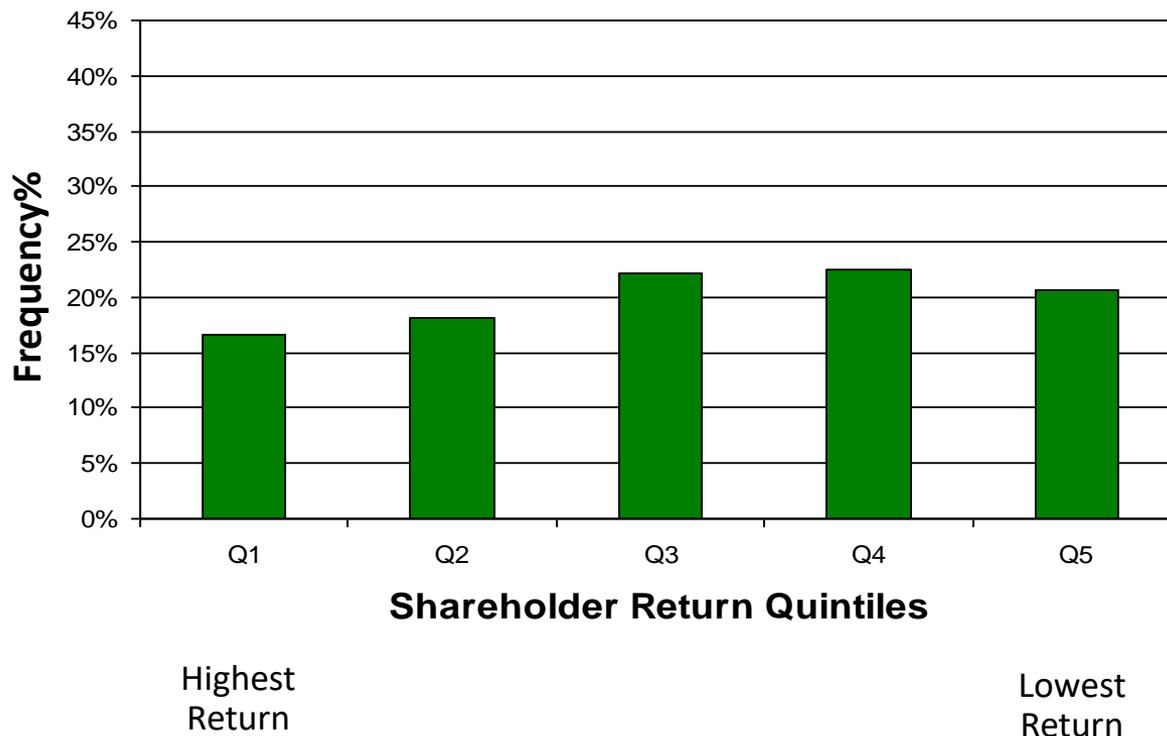


Source: ValueSearch™7. Data Date: December 31, 2006.

Of the companies with high ROA' increase that didn't grow their assets, only 17% were top performers

2002-2005

Of Higher ROA' Change & Low Asset' Growers, what percent achieved each level of shareholder return?

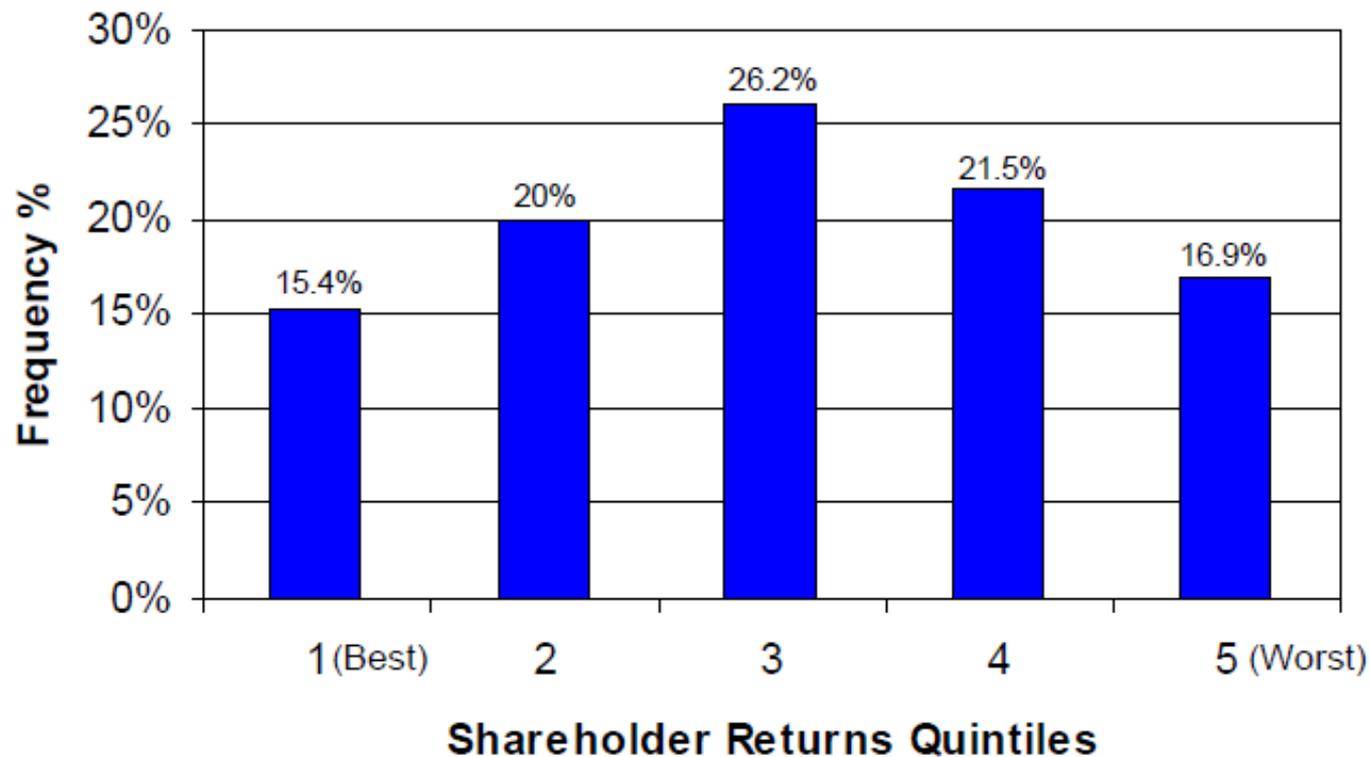


Source: ValueSearch™7. Data Date: December 31, 2006.

Does this hold true globally?

Of the companies with high ROA' increase that didn't grow their assets...

Europe

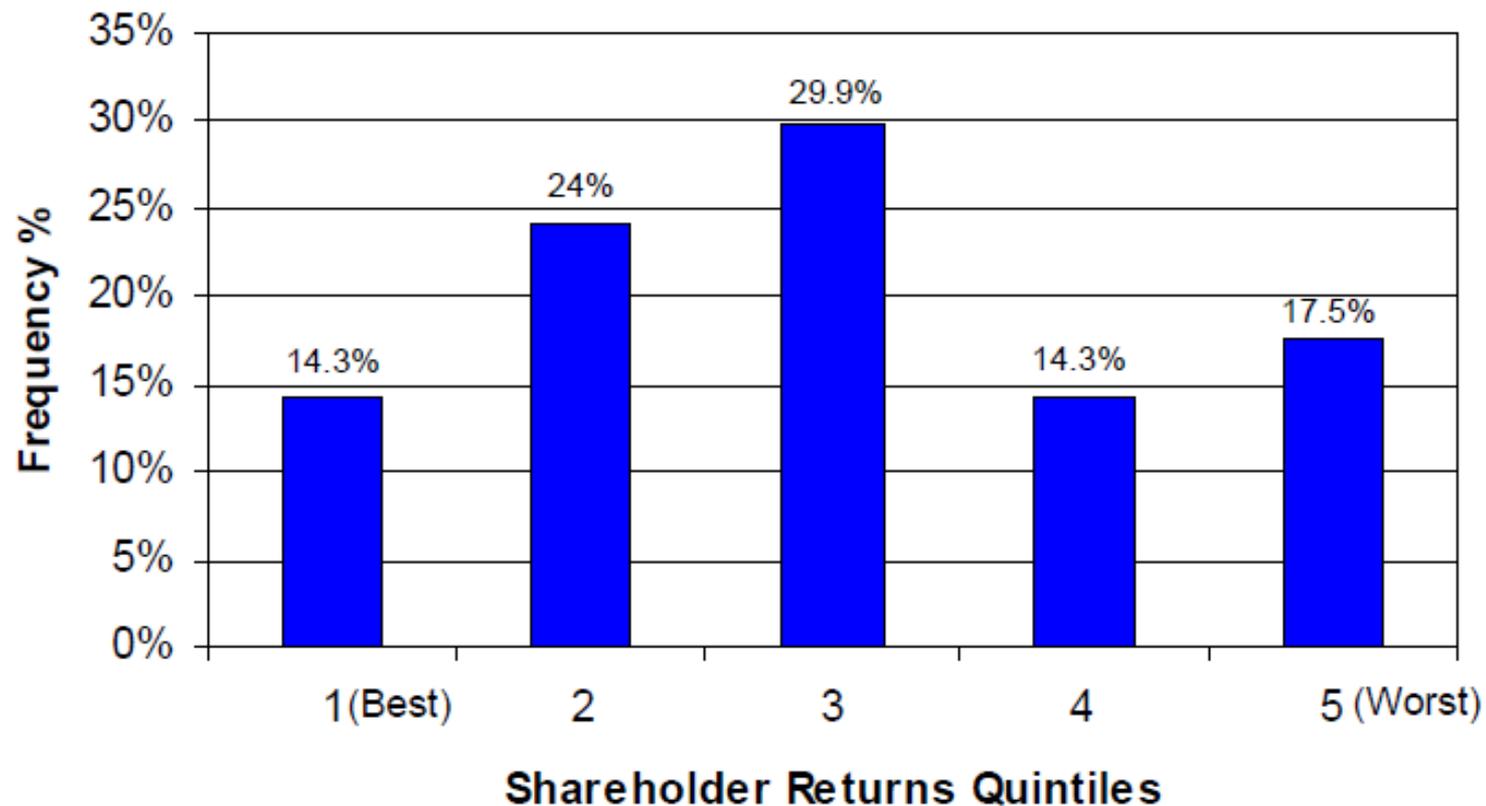


Source: CSFB HOLT Equity Research

PRIVATE AND CONFIDENTIAL: This document is confidential and contains proprietary information. Neither the document nor any of the information contained herein may be reproduced or disclosed to any person under any circumstances without express written permission.

Of the companies with high ROA' increase that didn't grow their assets...

Asia



Source: CSFB HOLT Equity Research

Thinking about business growth

- ROA' improvement always matters
- Reinvestment rates as important as ROA's to TSRr (Relative Total Shareholder Returns)
- CAPEX is a poor measure for reinvestment rates
- Earnings growth from organic asset growth is very different from earnings from productivity
- The importance of *quantitative, non-financial* measures

Disclosures

Disclosures

© 2014 Valens Securities and/or its licensors and affiliates (collectively, "Valens").

All rights reserved. CREDIT ANALYSES ISSUED BY VALENS CREDIT AND ITS AFFILIATES ARE VALENS' CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT ANALYSES AND RESEARCH PUBLICATIONS PUBLISHED BY VALENS ("VALENS PUBLICATIONS") MAY INCLUDE VALENS' CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. VALENS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE, AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. VALENS' CREDIT ANALYSES DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. VALENS' CREDIT ANALYSES AND OPINIONS INCLUDED IN VALENS PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. VALENS' CREDIT ANALYSES AND VALENS PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE. VALENS' CREDIT ANALYSES AND VALENS PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER VALENS' CREDIT ANALYSES NOR VALENS PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. VALENS ISSUES ITS CREDIT ANALYSES AND PUBLISHES VALENS PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT VALENS' PRIOR WRITTEN CONSENT.

All information contained herein is obtained by VALENS from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. VALENS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources VALENS considers to be reliable including, when appropriate, independent third-party sources. However, VALENS is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Under no circumstances shall VALENS have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of VALENS or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if VALENS is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ANALYSIS, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY VALENS IN ANY FORM OR MANNER WHATSOEVER.

VALENS' credit analyses are opinions as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for retail clients to make any investment decision based solely on VALENS' credit ratings. If in doubt, you should contact your financial or other professional adviser.

Do Not Distribute Without Express Written Consent From Author