

# VALENS RESEARCH



## Why Bruce Lee Would Have Been Great in Finance

Professor Joel Litman  
September 2016

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# One of the major problems of financial analysis...

Different styles, different metrics...

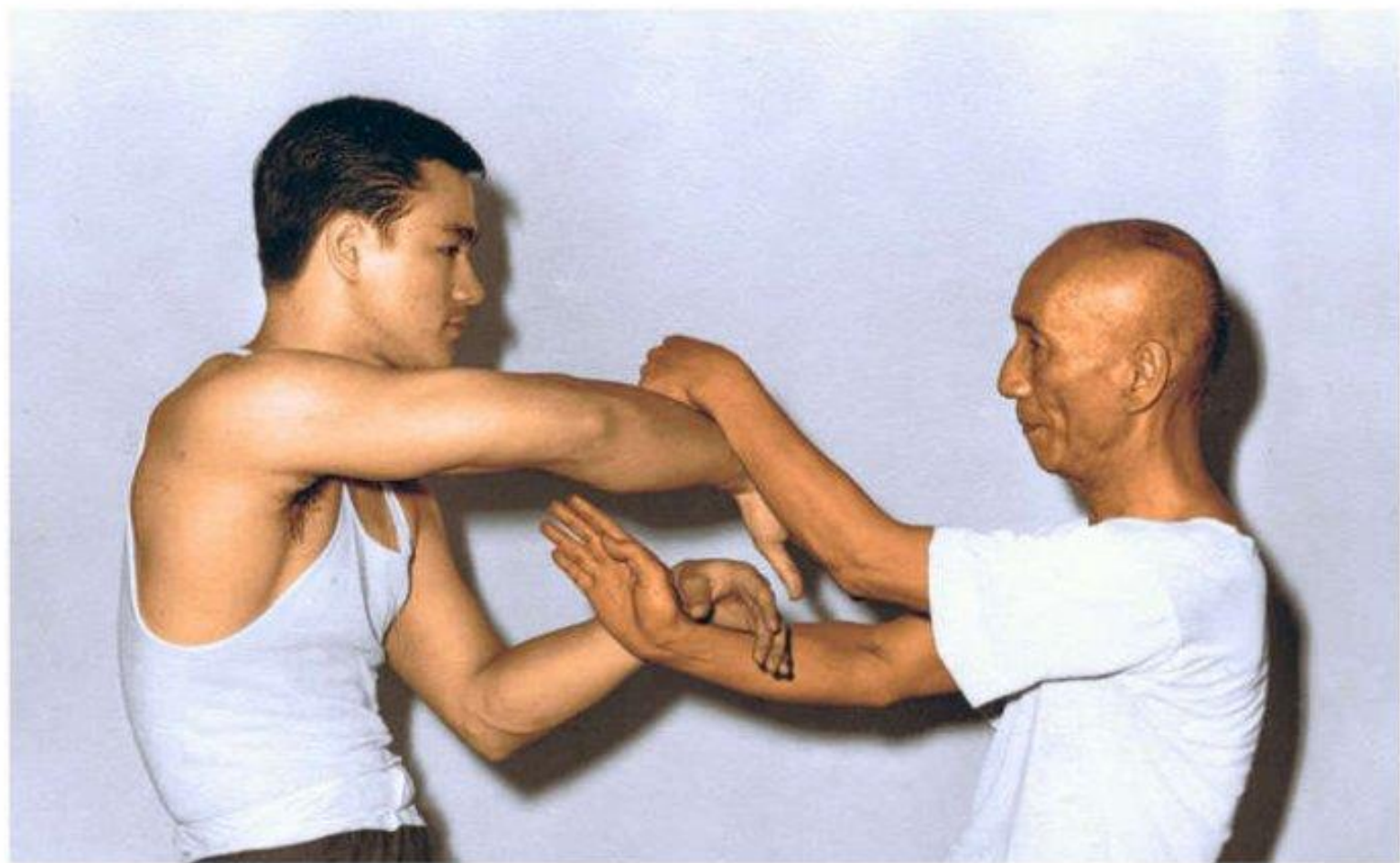
- **Quality: EPS, Net income, margins, CFFO, EBITDA?**
  - **ROA, ROTA, RONA, ROIC, CFROI, CROGA, CFROGI?**
- **Value: P/B, P/E, DCF, cash % of mkt cap?**
- **GARP or Growth: In sales , assets, organic, acquisitive?**
- **Momentum: Price, earnings, surprises, revisions?**
- **Special sit, event-driven, credit driven, turnarounds?**

# “Which Martial Art is Superior?”

A similar issue: Thousands of Martial Arts Styles

By his pinnacle, studied many great martial arts:

















# “Which Martial Art is Superior?”

A similar issue: Thousands of Martial Arts Styles

By his pinnacle, studied many great martial arts

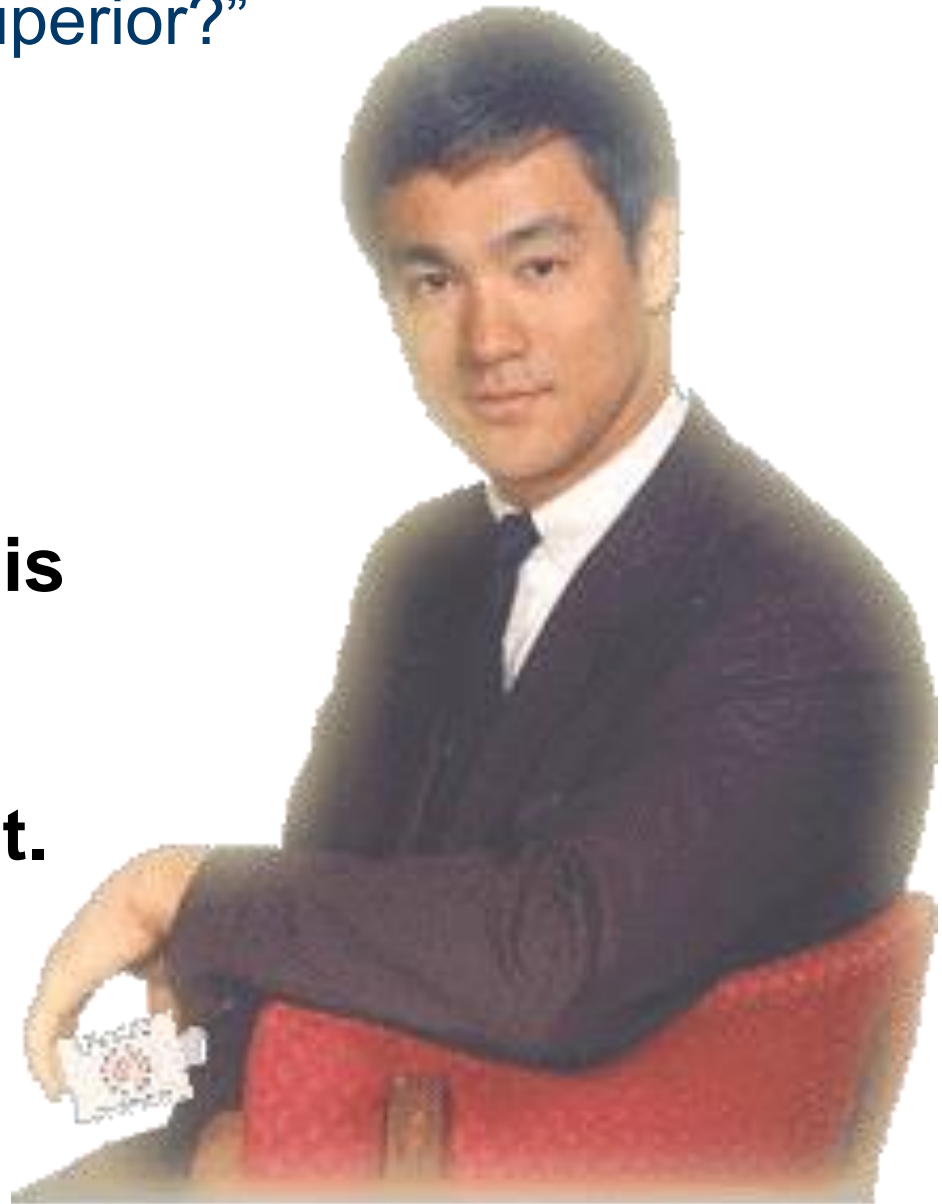
Bruce Lee was asked...

**“Which Martial Art is Superior?”**

**There is no fixed  
teaching.**

**All I can provide is  
an appropriate  
medicine for a  
particular ailment.**

**-- Bruce Lee**



# There is never one best metric...

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**Two companies merge**

	<u><b>Company A</b></u>	<u><b>Company B</b></u>
<b>Op. Cash Flows</b>	<b>15</b>	<b>15</b>
<b>Assets</b>	<b>100</b>	<b>100</b>
<b>ROI</b>	<b>15%</b>	<b>15%</b>

**Company A buys company B for \$400**

**What is the ROA?**

**What ROA expected on \$100 organic growth?**

**What ROA for management compensation?**

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# There is never one best metric...

**Two companies merge**

	<u>Company A</u>	<u>Company B</u>
<b>Op. Cash Flows</b>	<b>15</b>	<b>10</b>
<b>Assets</b>	<b>100</b>	<b>100</b>
<b>ROI</b>	<b>15%</b>	<b>??%</b>

**Company A buys company B for \$400**

**What is the ROA?**

**What ROA expected on \$100 organic growth?**

**What ROA for management compensation?**

# There is never one best metric...

**Two companies merge**

	<u>Company A</u>	<u>Company B</u>
<b>Op. Cash Flows</b>	<b>15</b>	<b>7.5</b>
<b>Assets</b>	<b>100</b>	<b>100</b>
<b>ROI</b>	<b>15%</b>	<b>??%</b>

**Company A buys company B for \$400**

**What is the ROA?**

**What ROA expected on \$100 organic growth?**

**What ROA for management compensation?**

# There is never one best metric...

**Two companies merge**

	<u>Company A</u>	<u>Company B</u>
<b>Op. Cash Flows</b>	<b>15</b>	<b>5</b>
<b>Assets</b>	<b>100</b>	<b>100</b>
<b>ROI</b>	<b>15%</b>	<b>??%</b>

**Company A buys company B for \$400**

**What is the ROA?**

**What ROA expected on \$100 organic growth?**

**What ROA for management compensation?**

# There is never one best metric...

**Two companies merge**

	<u>Company A</u>	<u>Company B</u>
<b>Op. Cash Flows</b>	<b>15</b>	<b>2</b>
<b>Assets</b>	<b>100</b>	<b>100</b>
<b>ROI</b>	<b>15%</b>	<b>??%</b>

**Company A buys company B for \$400**

**What is the ROA?**

**What ROA expected on \$100 organic growth?**

**What ROA for management compensation?**

# The Difference Between a Great Company and a Great Stock

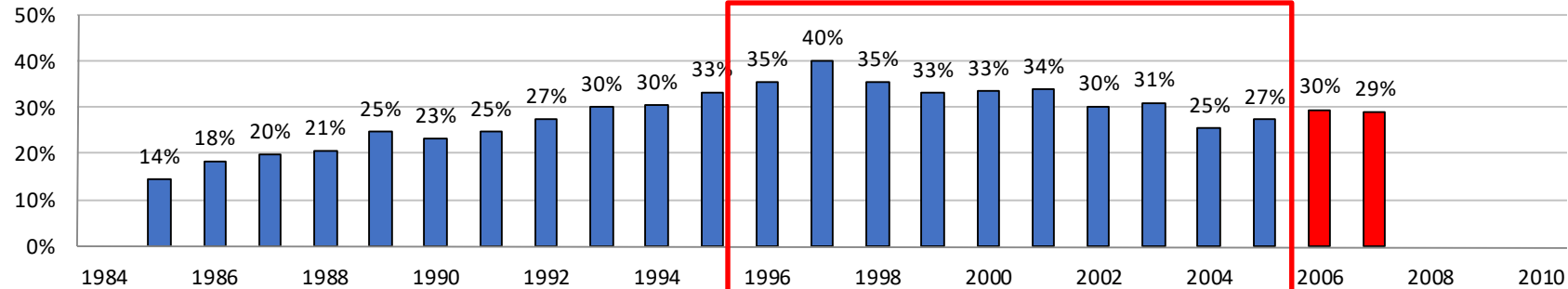
# Great company versus great stock



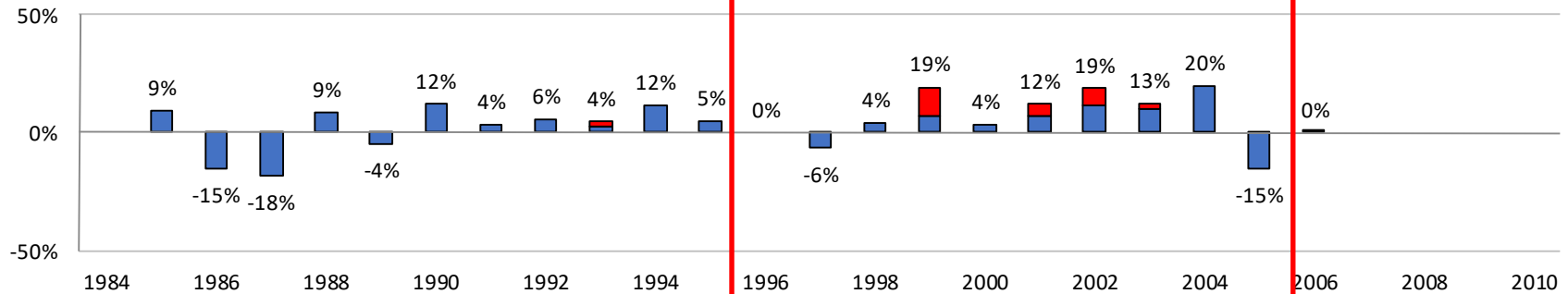


# KO

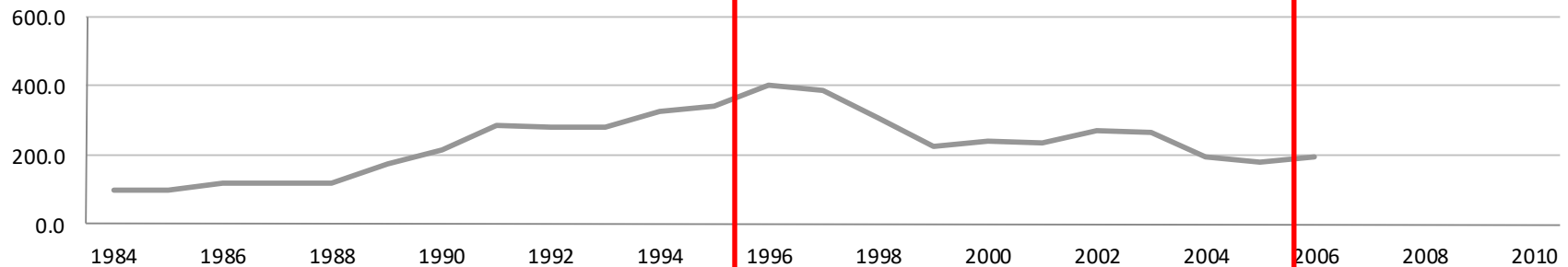
ROA'



Asset'  
Growth



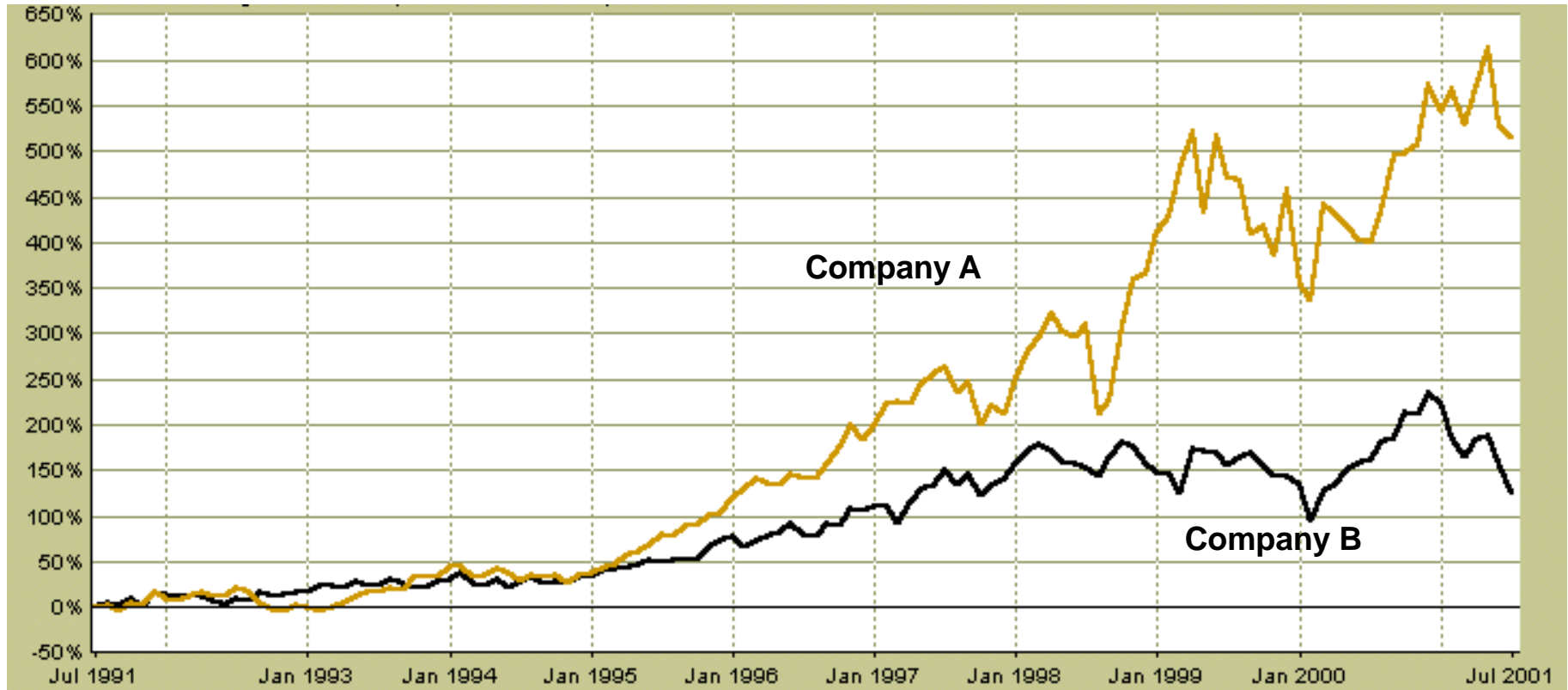
TSRr



# Great company versus great stock

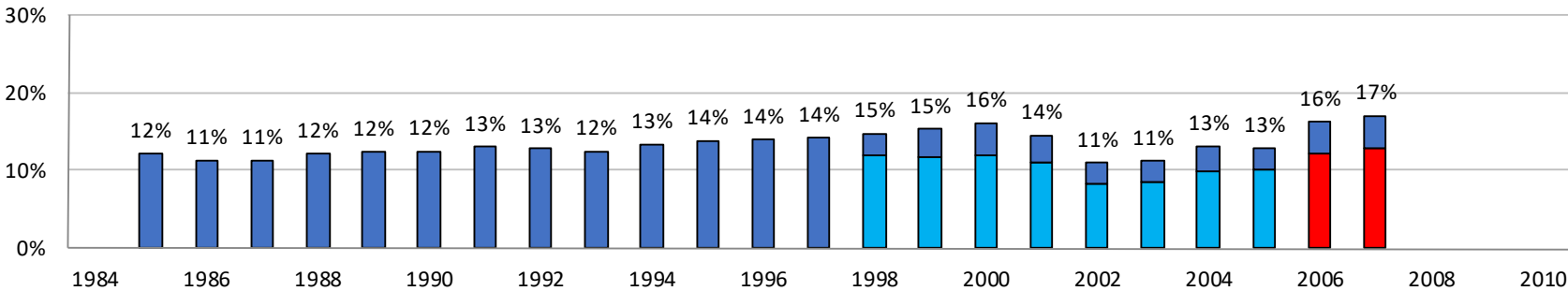


Over the last ten years, which company has been managed in a more consistent, superior manner?

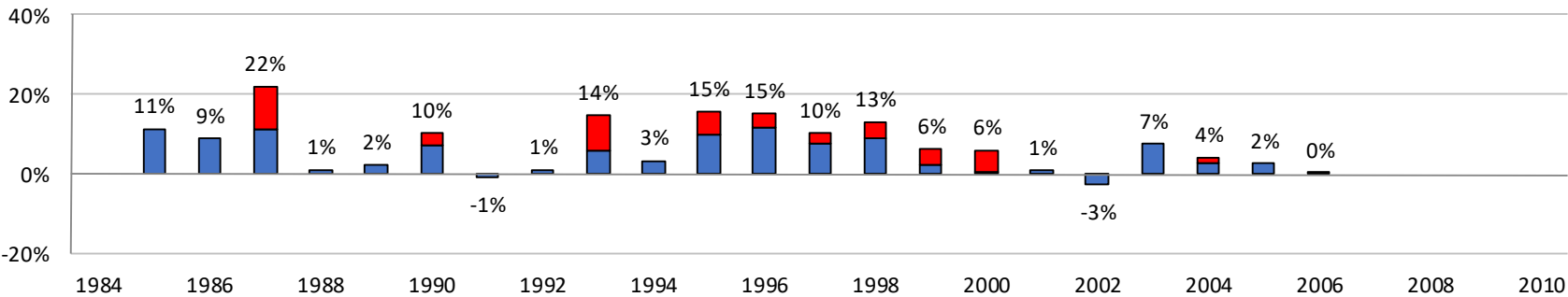


# EMR – Great Stock vs. Great Company

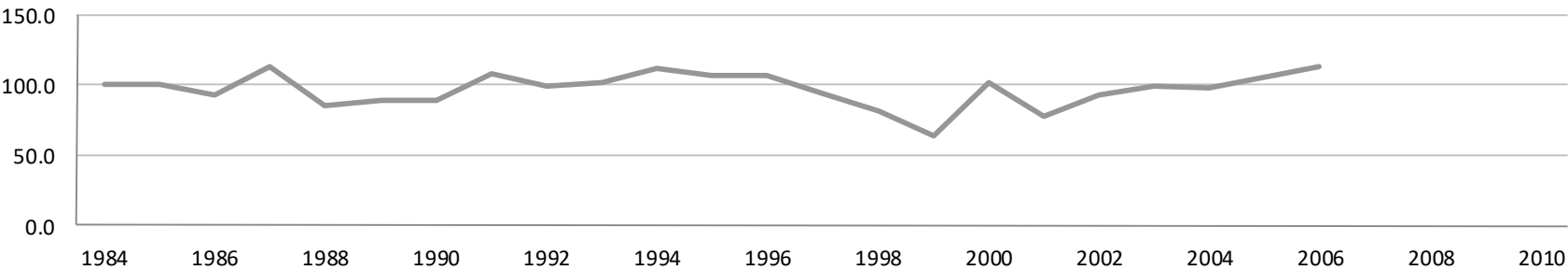
ROA'



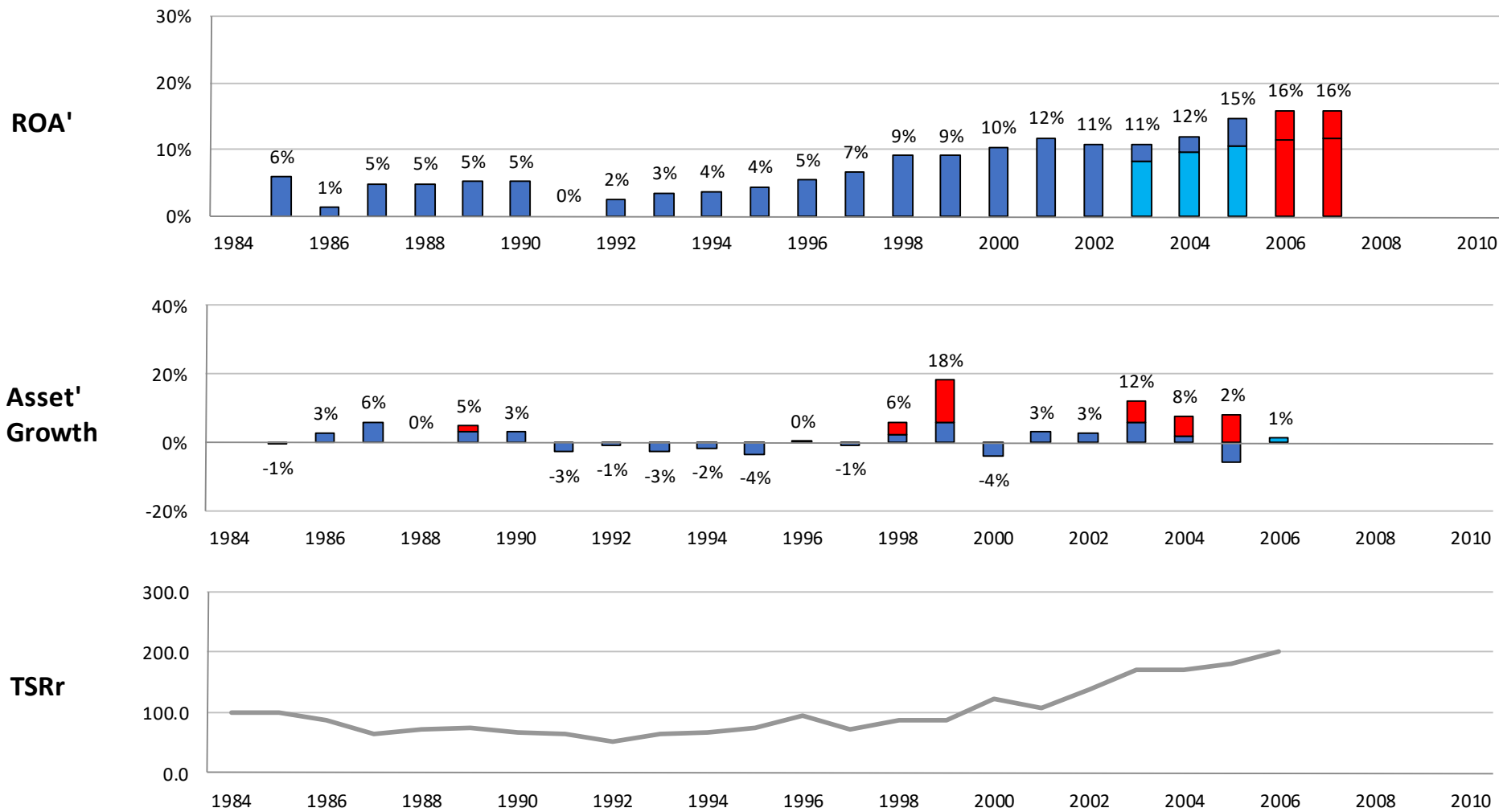
Asset'  
Growth



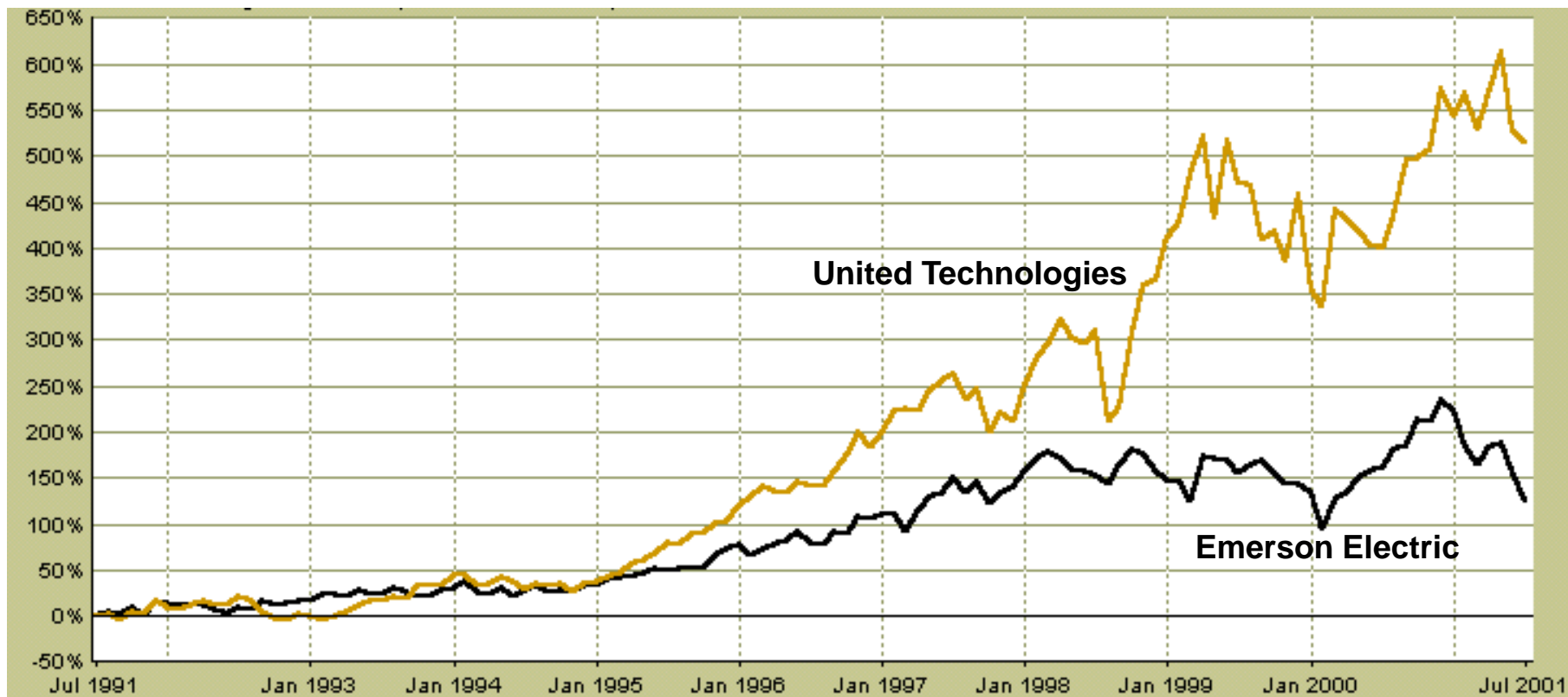
TSRr



# UTX – Great Stock vs. Great Company

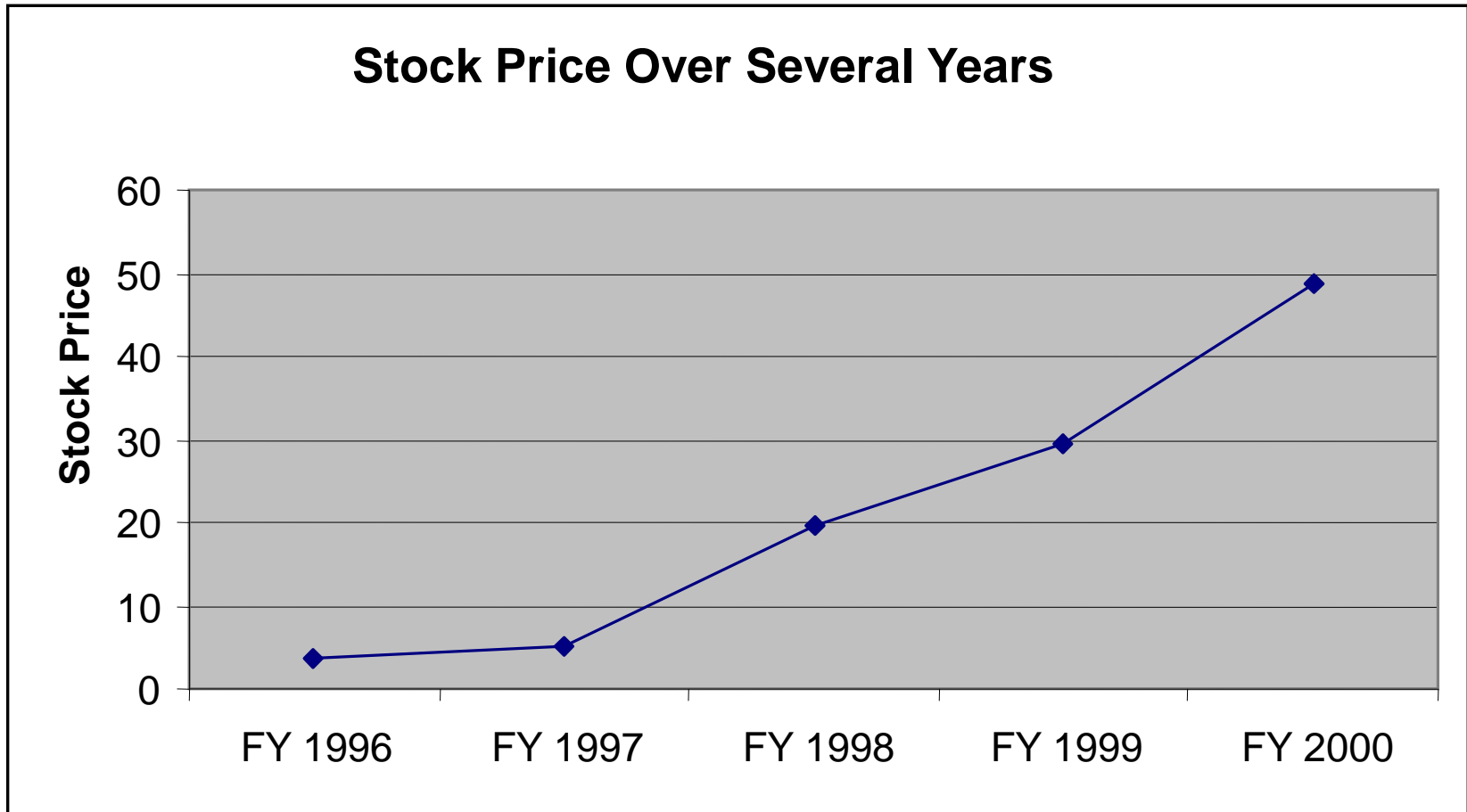


# EMR vs. UTX – Great Stock vs. Great Company

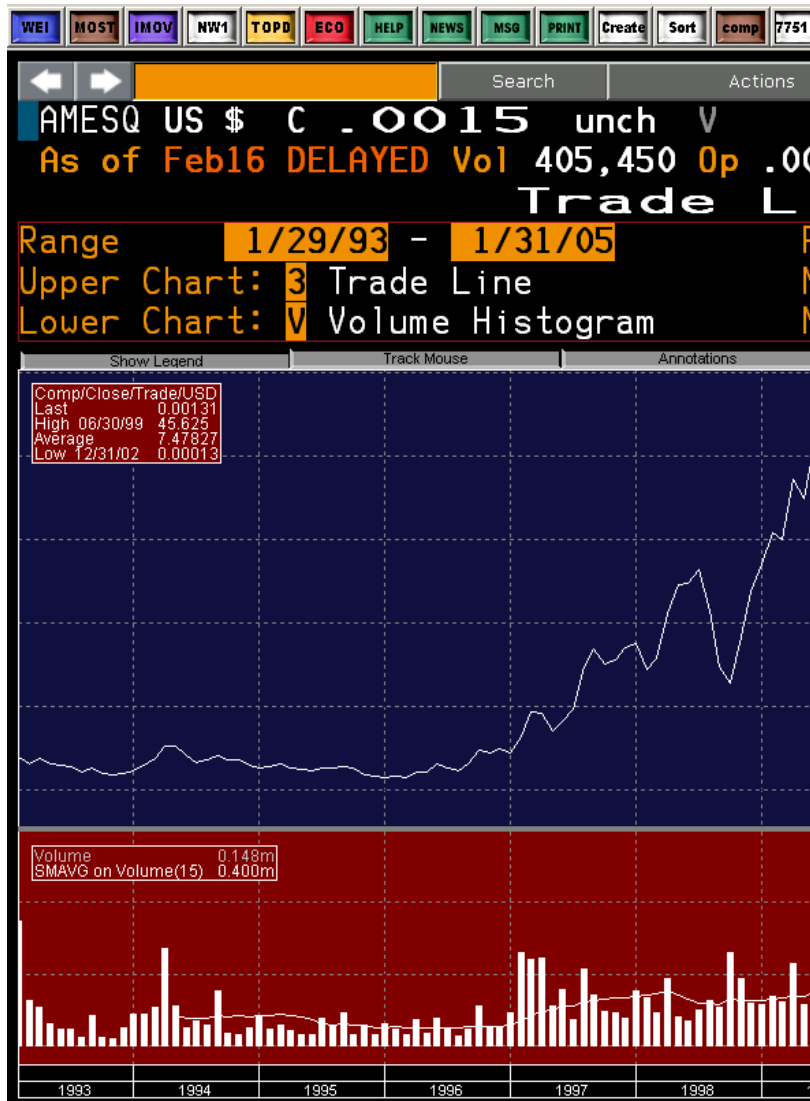




# Shall we follow this company's business strategy?



# Shall we follow this company's business strategy?



# AMES – Grow and grow poor

**November 13, 1998: Ames Reaches a Deal to Buy Hills Stores**

**March 9, 1999: Metro Business; Ames to Buy 8 Caldors**

**March 9, 1999: Ames Announces Grand Opening of 50 Stores**

**August 11, 1999: Metro Business; Ames Leases Caldor Space**

**November 12, 1999: Metro Business; Ames Plans Neptune Store**

**January 15, 2000: AMES Department Stores plans layoffs and new hiring**

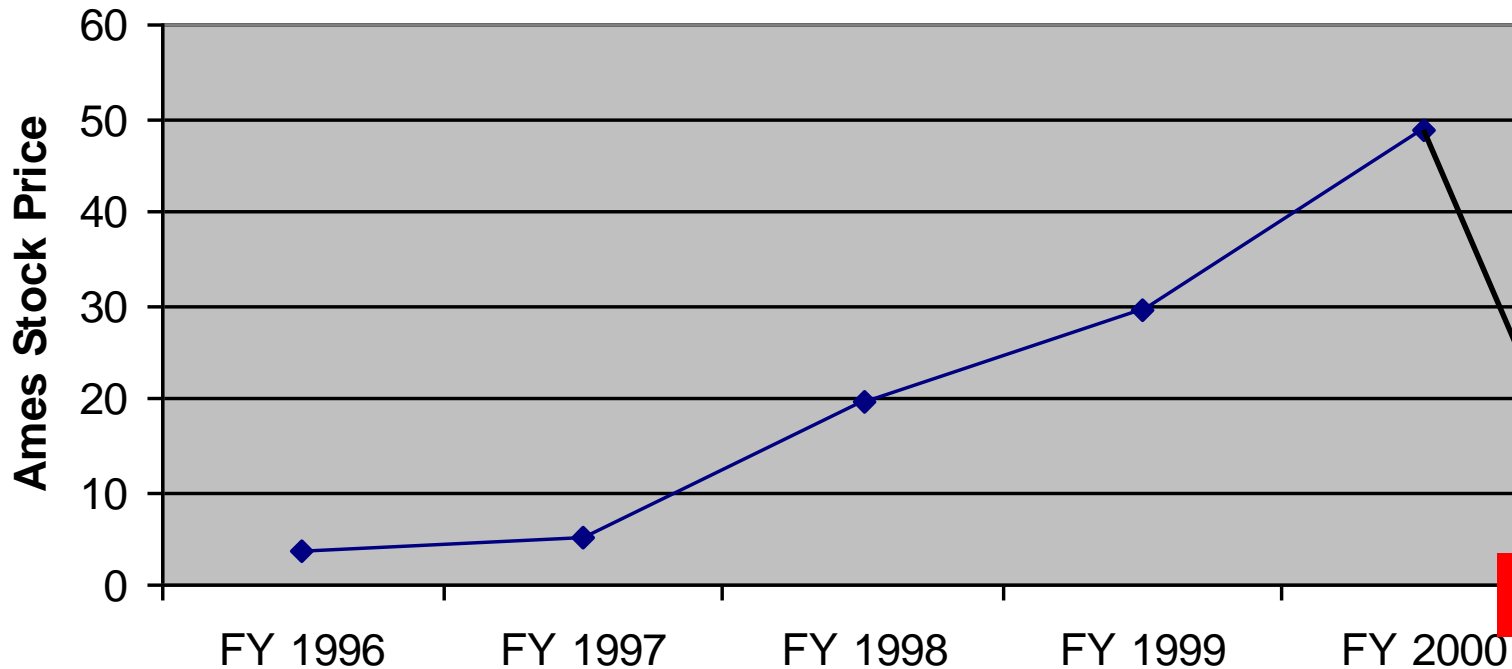
**November 10, 2000: AMES to close 32 discount stores early next year**

**August 17, 2001: AMES to close 47 stores and lay off 2,000 workers**

**August 21, 2001: Battling Competition, Ames Files for Bankruptcy Protection**

# Stock price alone may not be telling us the whole picture

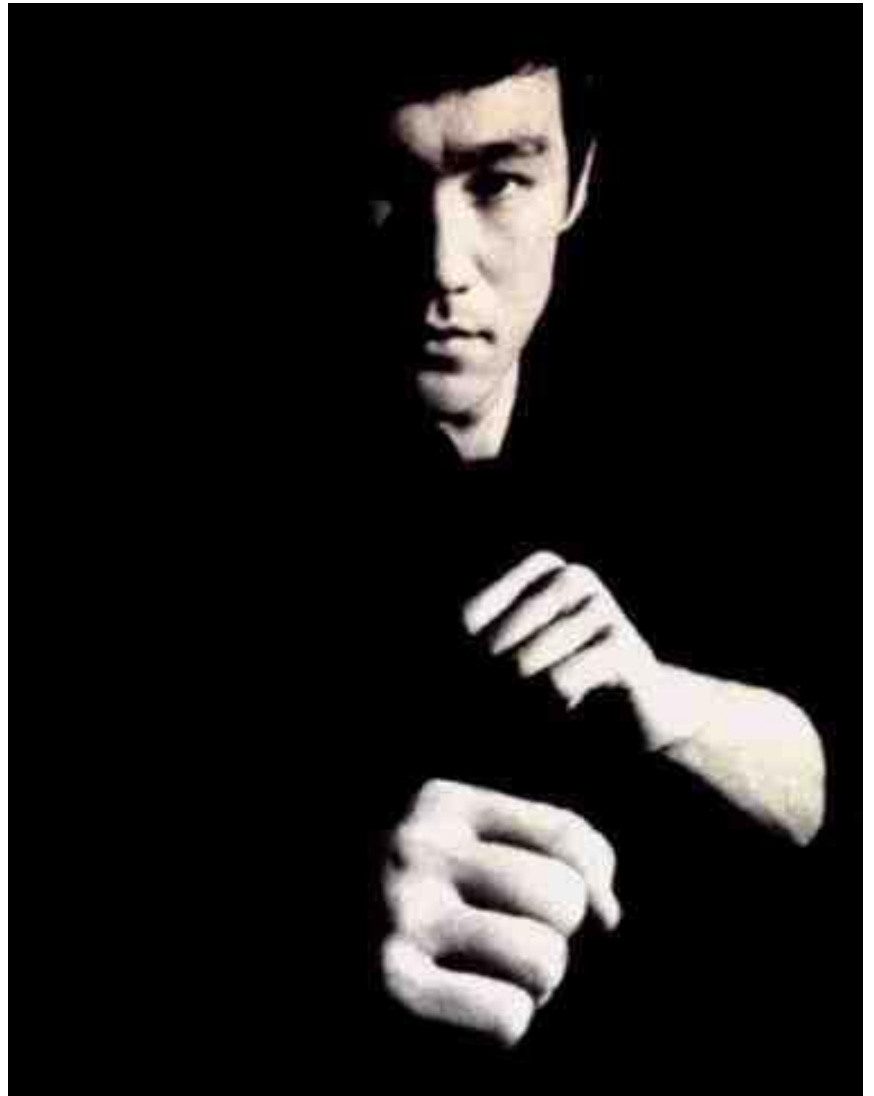
**AMES Stock Price Over The Last Several Years**



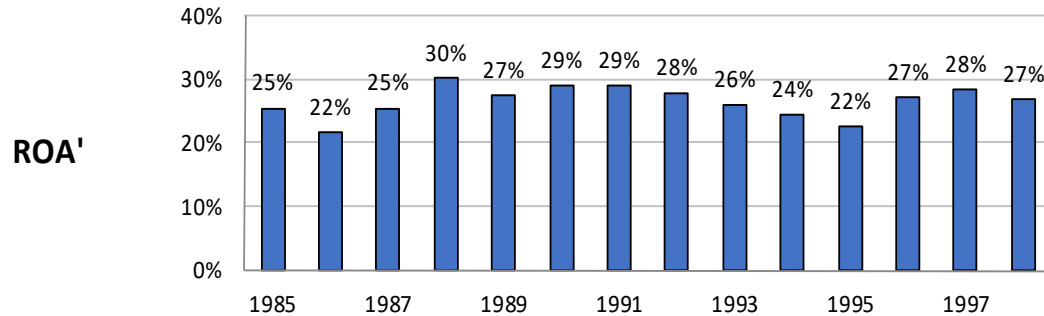
**BANKRUPT**

*True refinement  
seeks simplicity.*

*-- Bruce Lee*

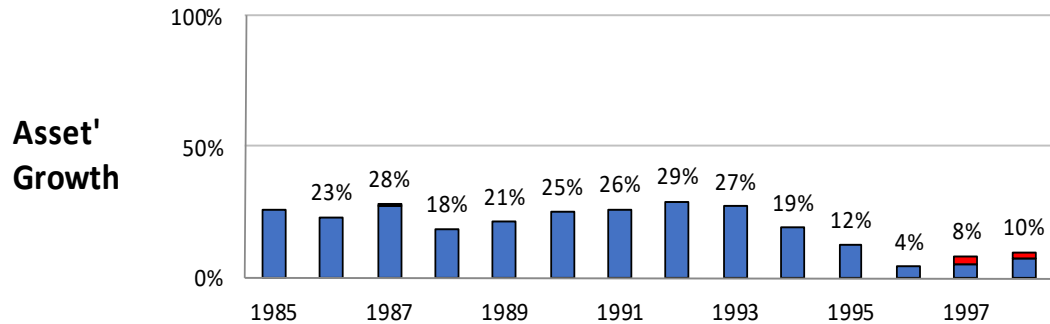


# Seeing every company like a bank account



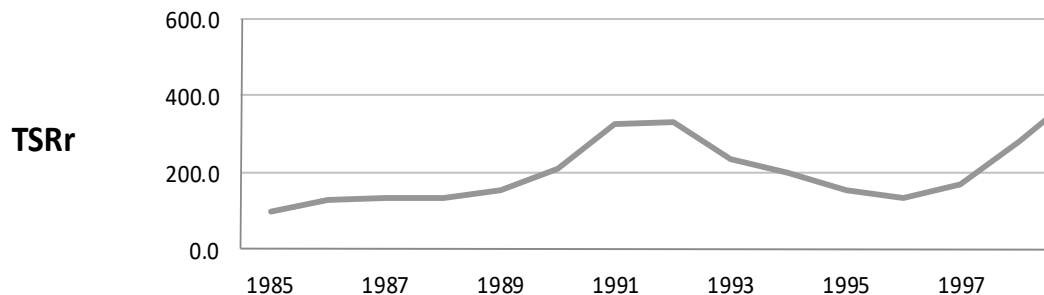
ROA' (Adjusted Earnings/  
Adjusted Assets)

*"Like an Interest Rate"*



Growth in Adjusted Assets

*"Like growth in principal"*



TSRr = Relative Total  
Shareholder Returns

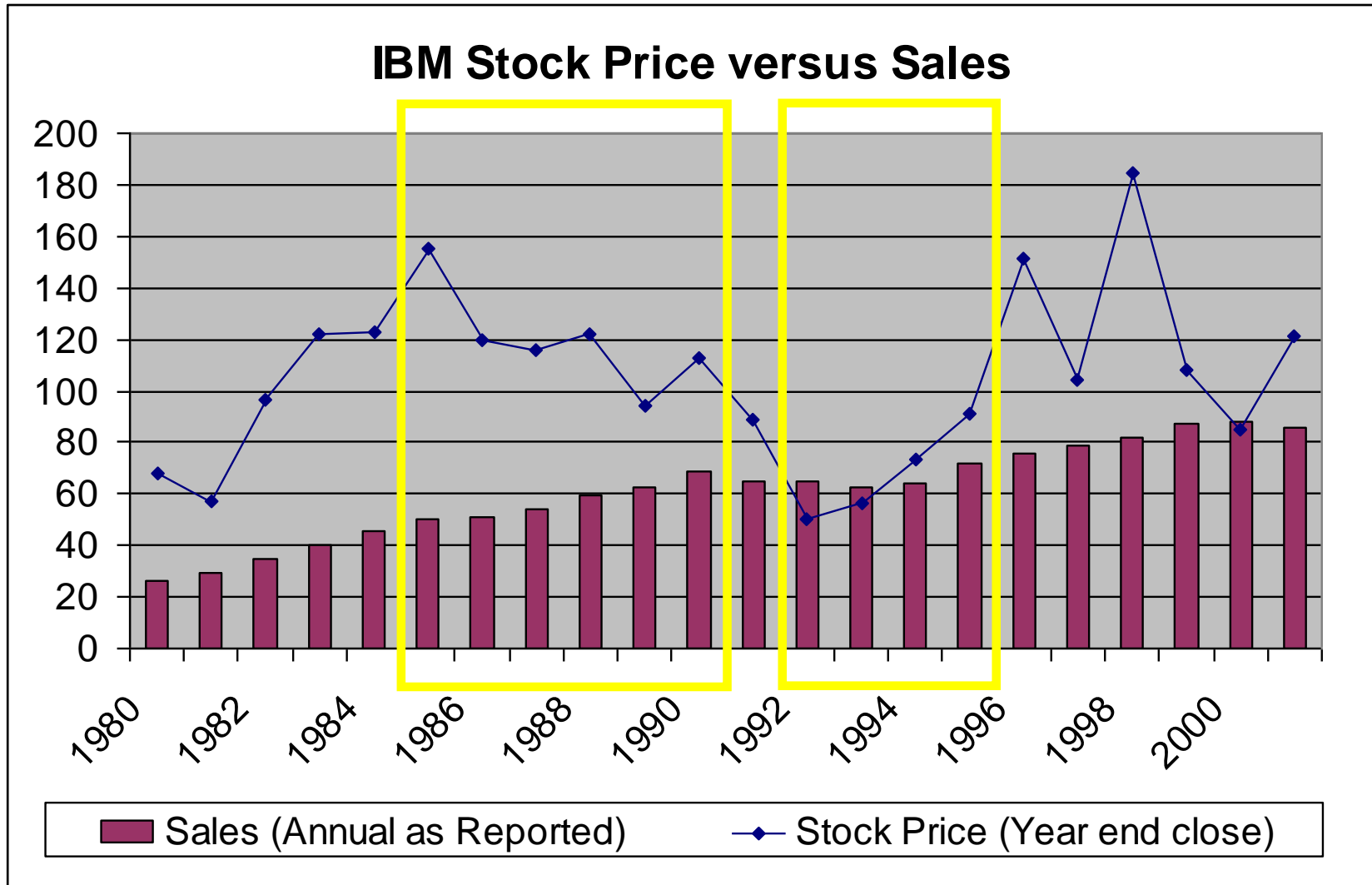
*"Value of the account"*

Source: Valens Securities



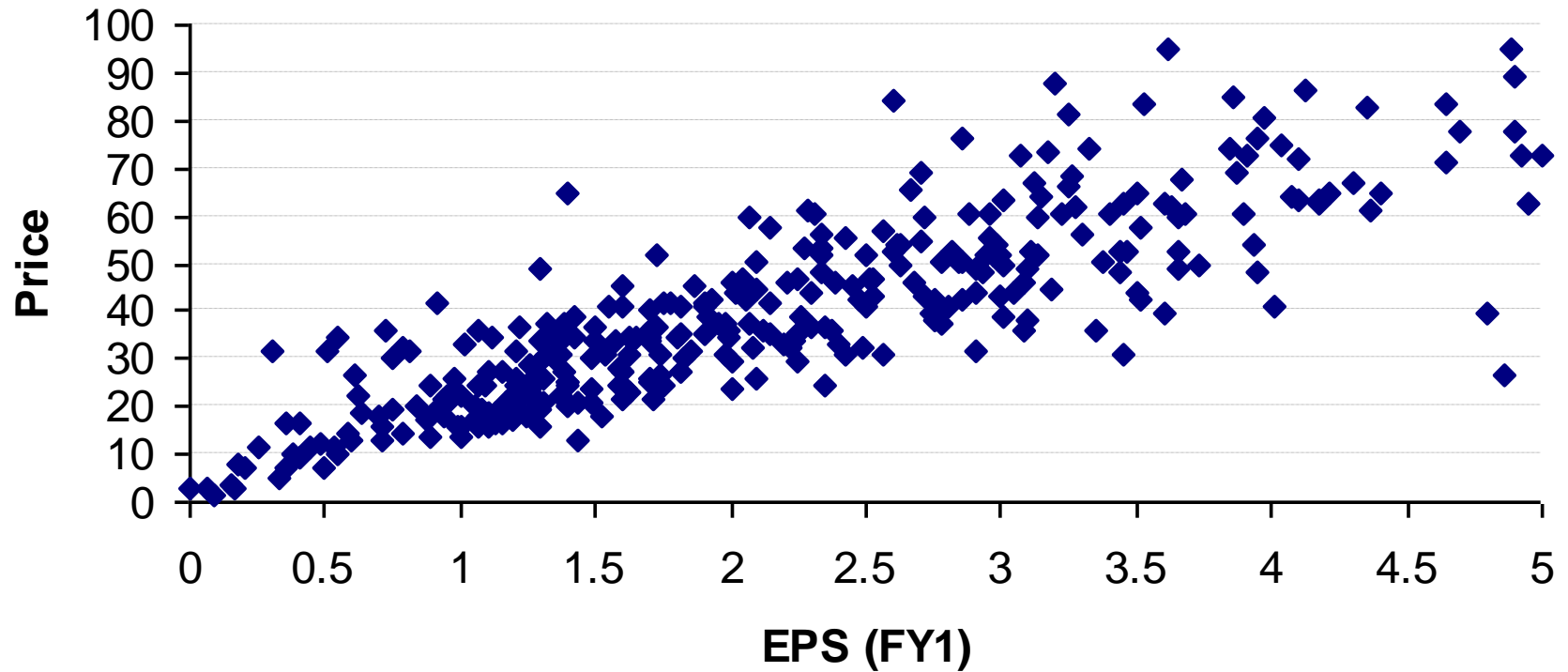
*Top-line?*

# What about the top line?

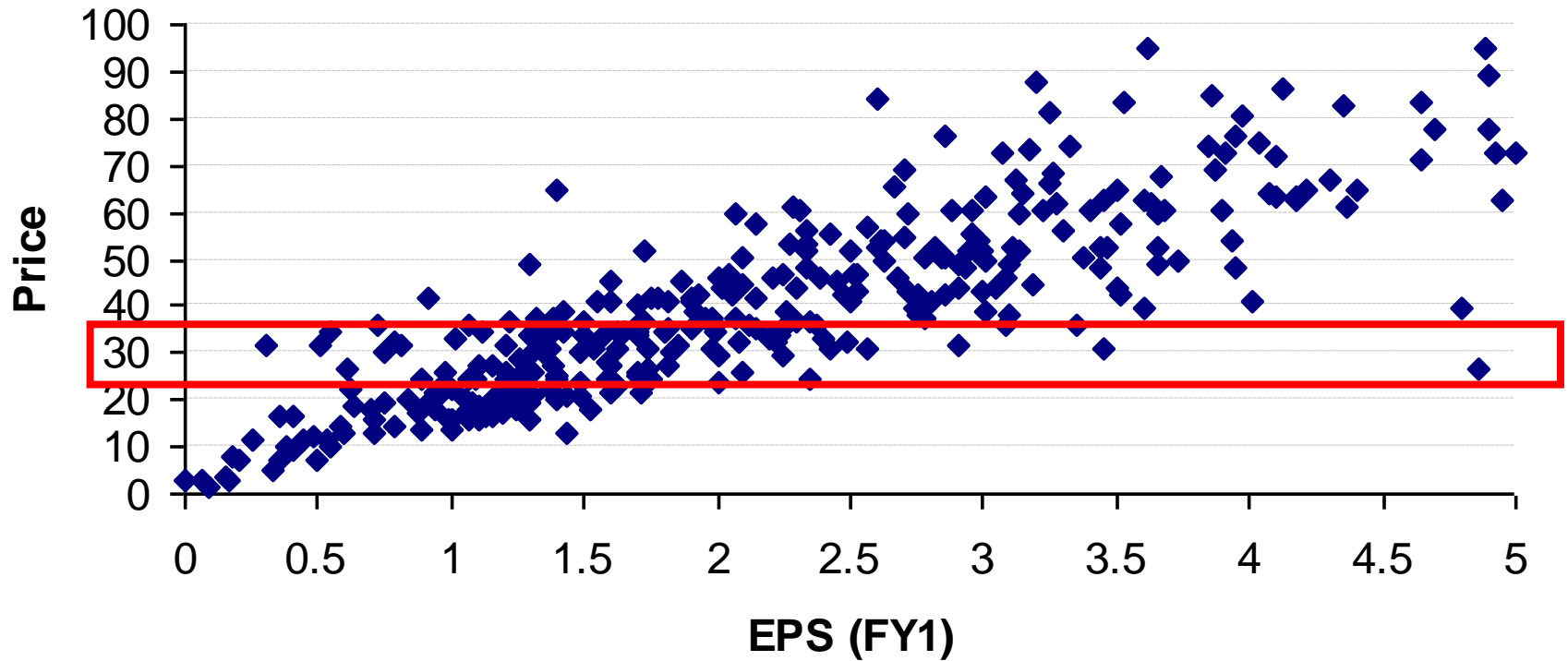


*Earnings?*

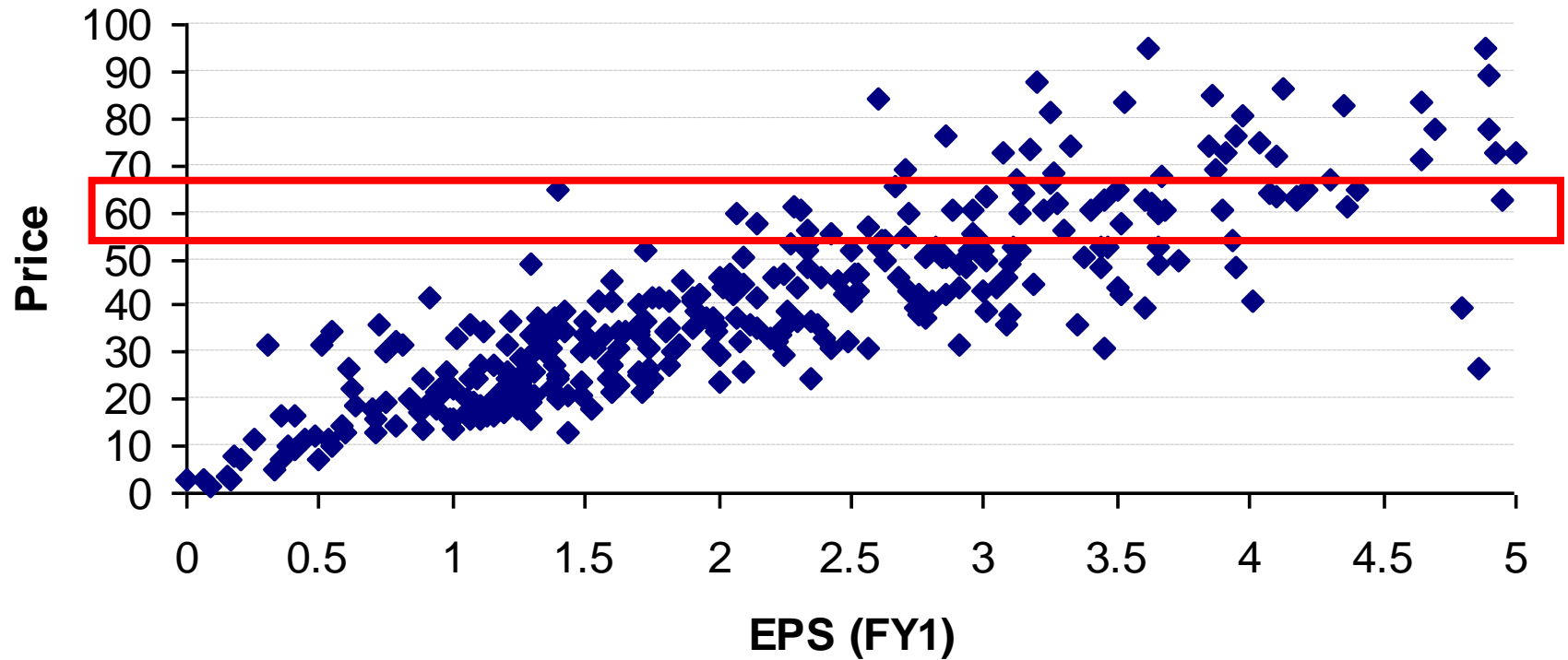
## EPS to Price



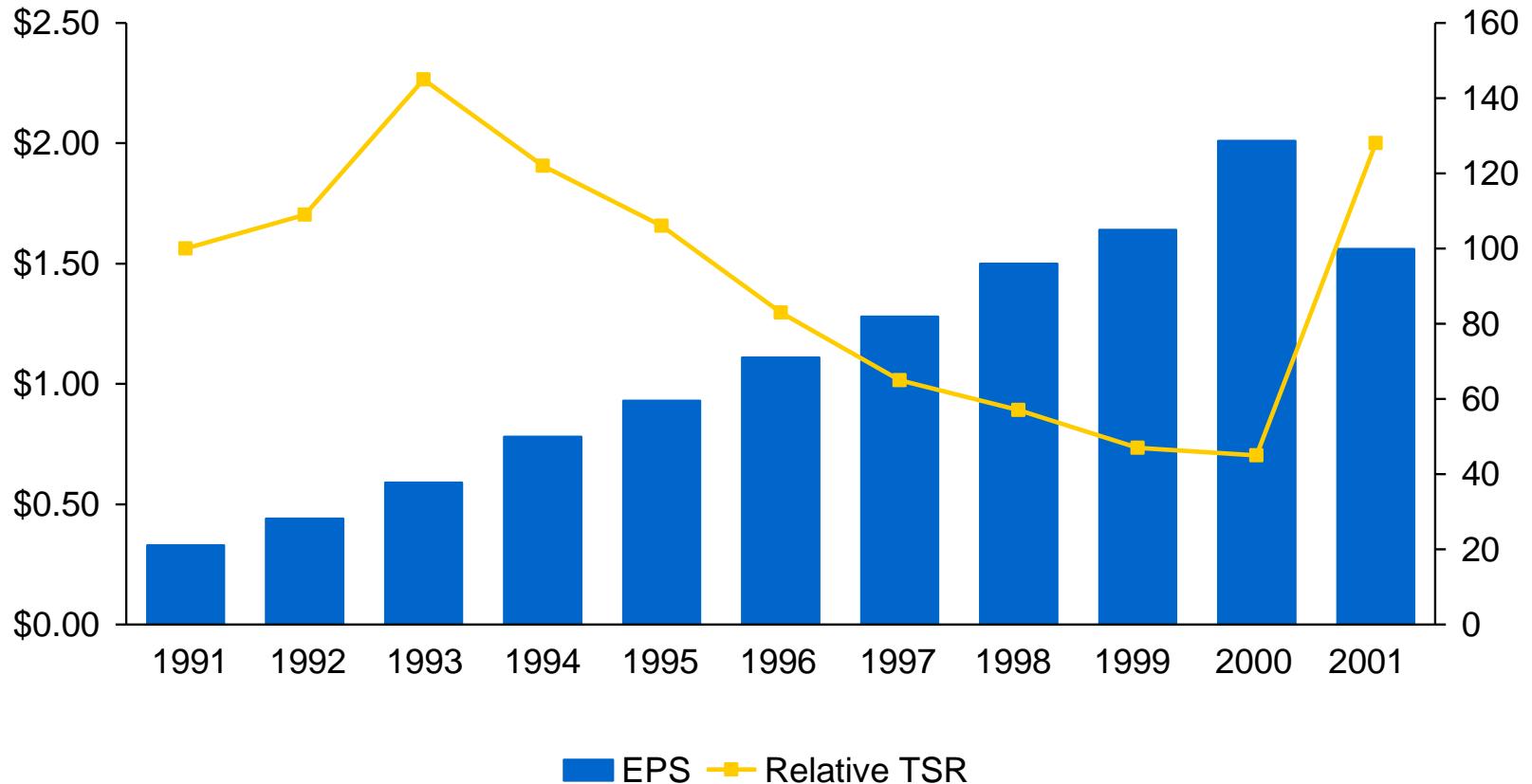
## EPS to Price



## EPS to Price



# Even radical changes in earnings can be unreliable



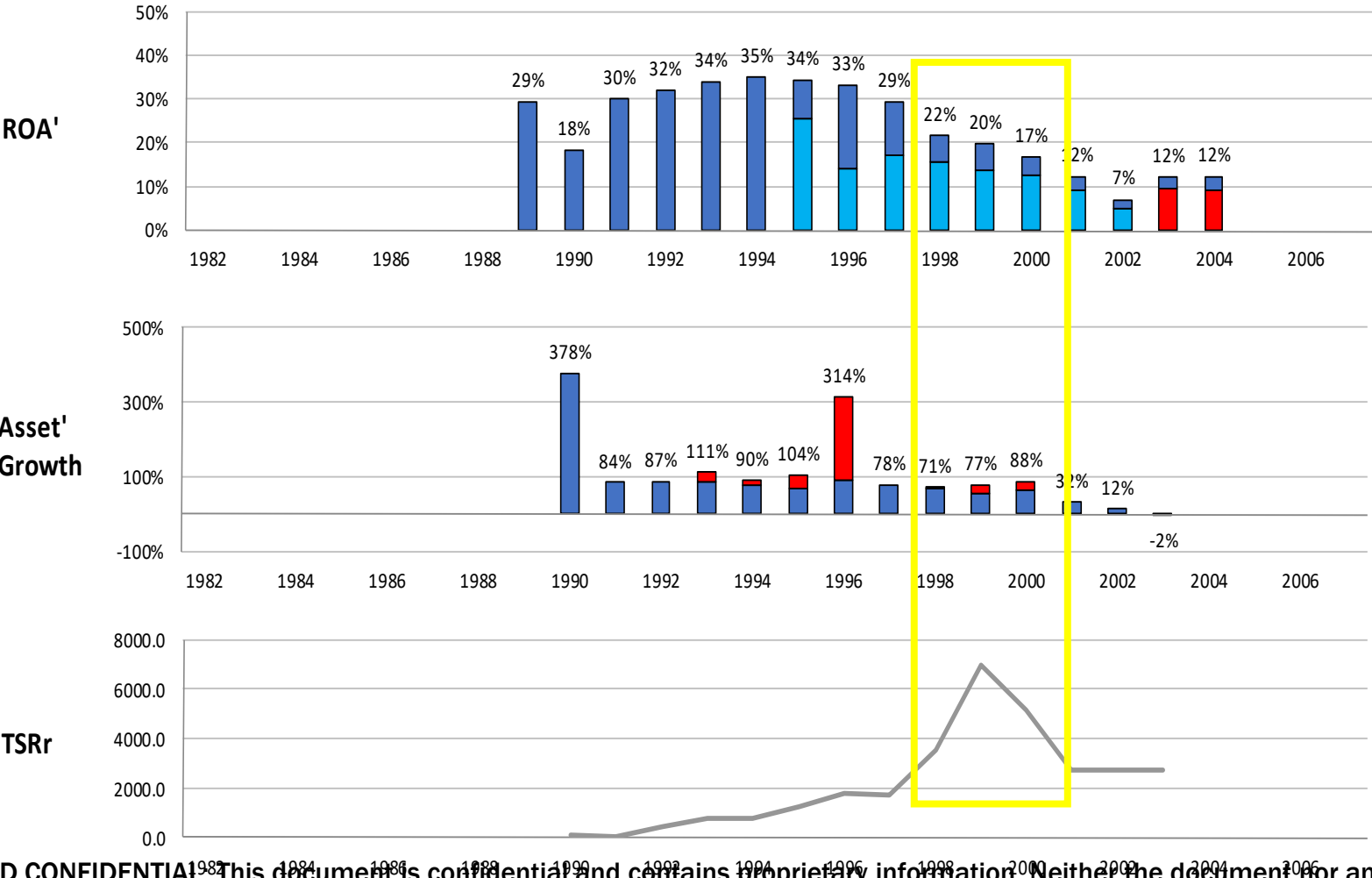
*Through the 90's – Autozone's EPS grew at a 25% CAGR,  
but when did the stock jump versus the market?*

# Can order of magnitude in earnings tell us anything?

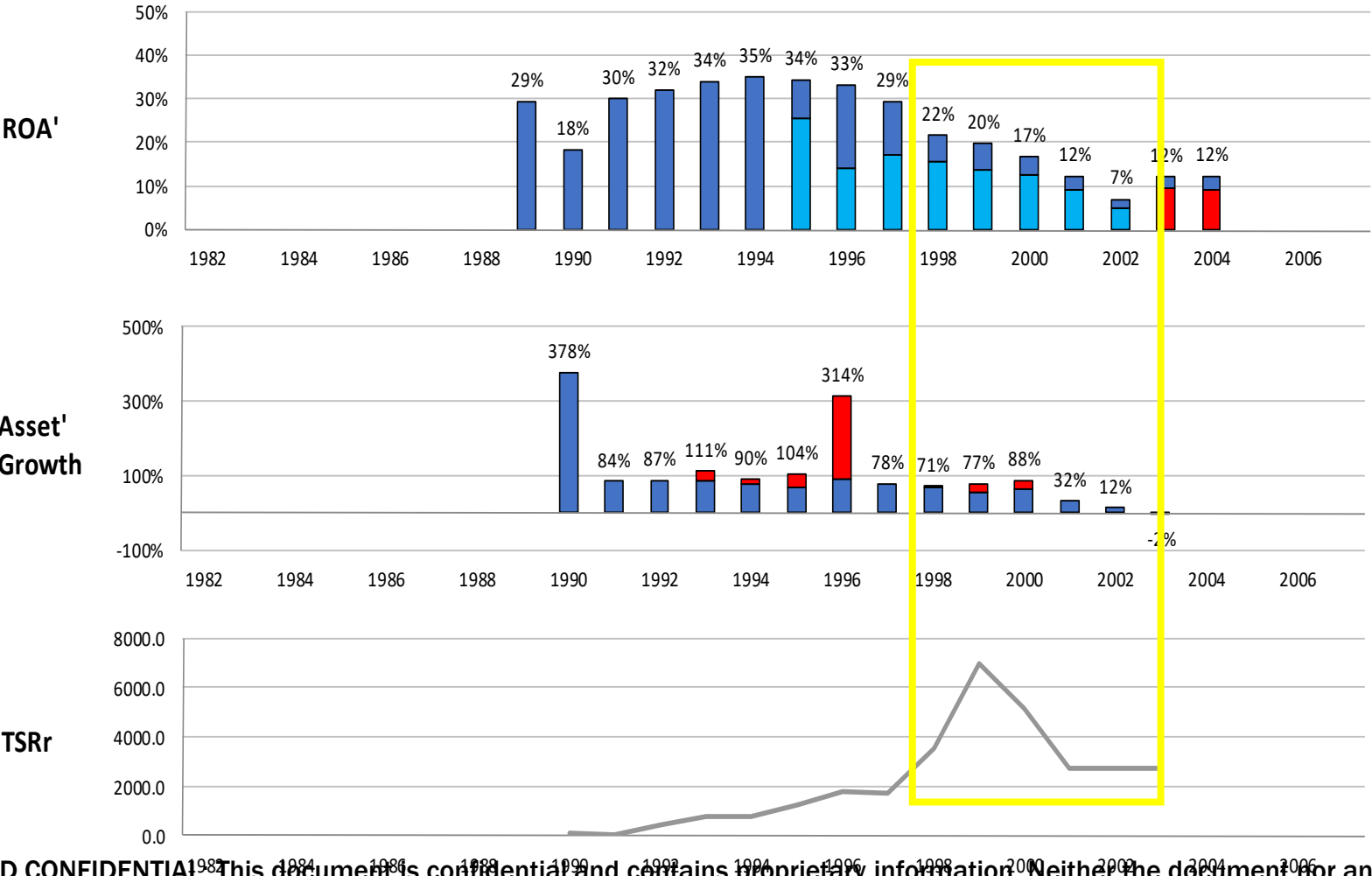
Calendar Year Fiscal Year	1993 7/1993 USD	1994 7/1994 USD	1995 7/1995 USD	1996 7/1996 USD	1997 7/1997 USD	1998 7/1998 USD	1999 7/1999 USD	2000 7/2000 USD
Net Income	172	315	421	913	1,049	1,350	2,096	2,668



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Net Income	172	315	421	913	1,049	1,350	2,096	2,668	(1,014)	1,893



# Does net income reflect real economic profitability?

Calendar Year Fiscal Year	1993 5/1994 USD	1994 5/1995 USD	1995 5/1996 USD	1996 5/1997 USD	1997 5/1998 USD	1998 5/1999 USD	1999 5/2000 USD
Net Income Available for Common Stock	204	298	308	361	503	631	688

Calendar Year  
Fiscal Year

1993  
5/1994  
USD

1994  
5/1995  
USD

1995  
5/1996  
USD

1996  
5/1997  
USD

1997  
5/1998  
USD

1998  
5/1999  
USD

1999  
5/2000  
USD

Net Income Available for Common Stock

204

298

308

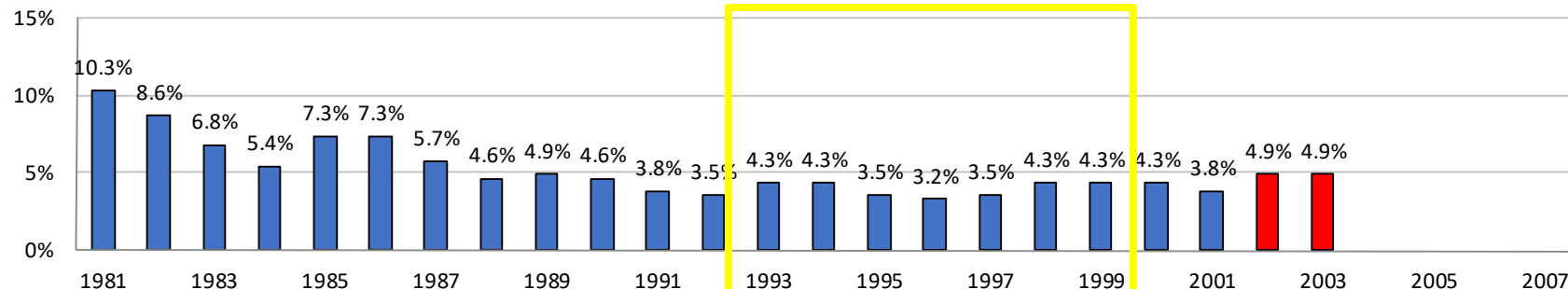
361

503

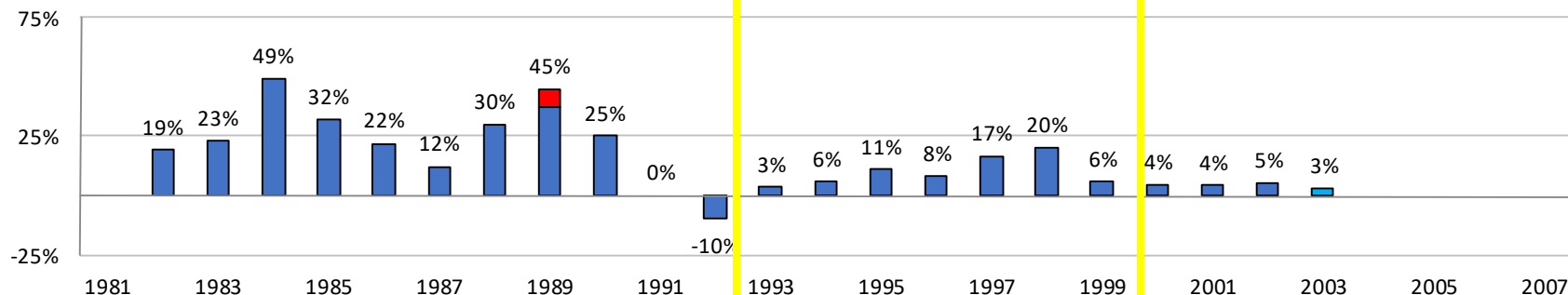
631

688

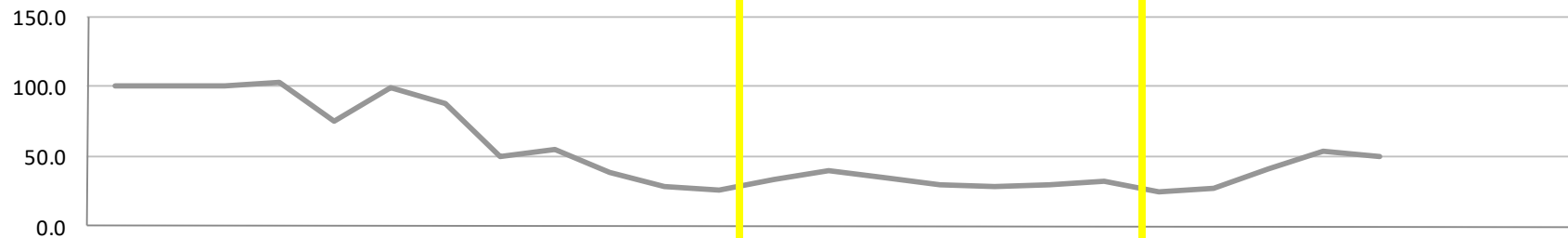
ROA'



Asset'  
Growth



TSRr



Name	Ticker	Last Fiscal Year	NI Increase/ (decrease) (5YR)	Stock Increase/ (decrease) (5YR)
Leap Wireless International Inc.	LEAP	12/31/2011	1191.7%	(84.4%)
MGM Resorts International	MGM	12/31/2011	380.5%	(81.8%)
MetroPCS Communications, Inc.	PCS1	12/31/2011	460.0%	(55.4%)
Navistar International Corporation	NAV	10/31/2011	472.4%	51.7%
GameStop Corp.	GME	1/28/2012	114.8%	(6.9%)
Las Vegas Sands Corp.	LVS	12/31/2011	253.0%	(52.2%)

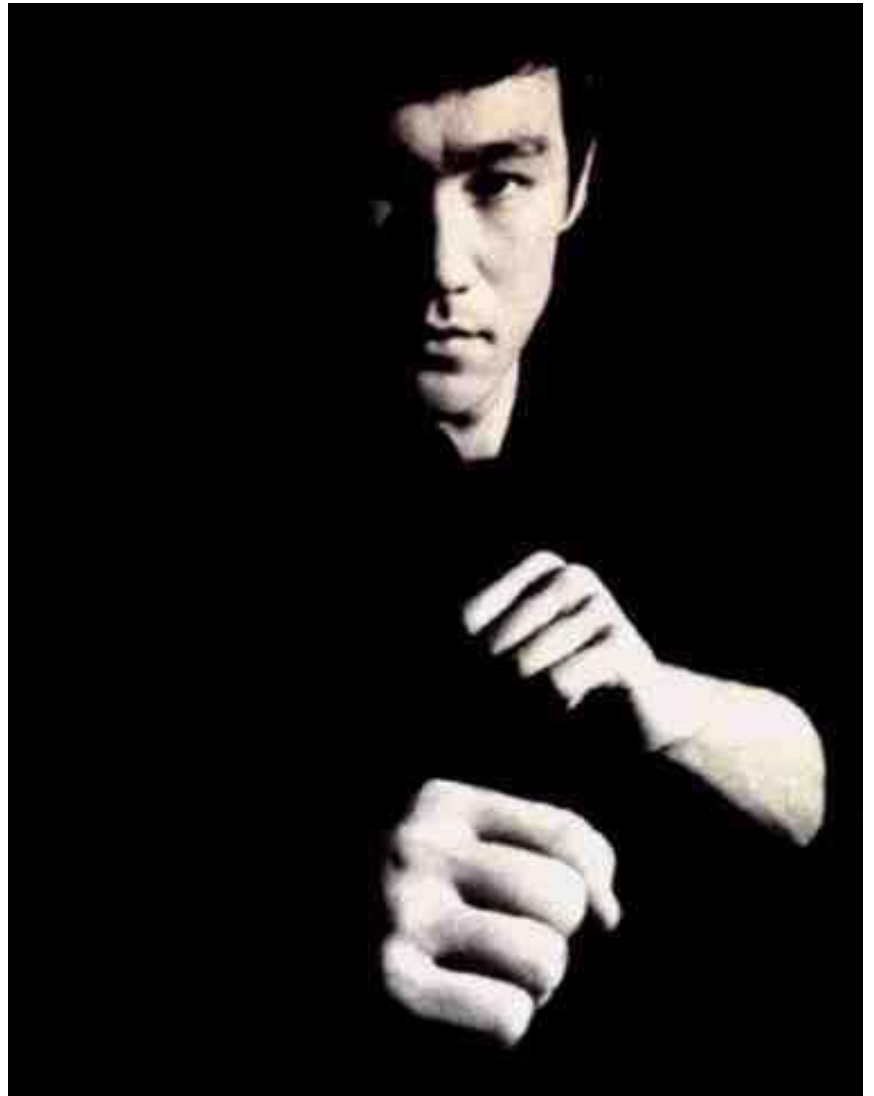
Find a Company:

🔍 Enter a ticker or company name to get started

Ticker ⬆	Company ⬆	Industry ⬆	Market Cap ⬆
SEHK:700	Tencent Holdings Limited	Internet Software and Services	1,145,027.1 (CNY)
PSE:SM	SM Investments Corp.	Industrial Conglomerates	706,602.1 (PHP)
AAPL	Apple Inc.	Technology Hardware, Storage and Peripherals	674,949.6 (USD)
PSE:JGS	JG Summit Holdings, Inc.	Industrial Conglomerates	531,482.9 (PHP)
GOOGL	Google Inc.	Internet Software and Services	514,152.7 (USD)
PSE:TEL	Philippine Long Distance Telephone Company	Wireless Telecommunication Services	482,668.6 (PHP)
MSFT	Microsoft Corporation	Systems Software	438,696.2 (USD)
SGX:Y92	Thai Beverage Public Company Limited	Distillers and Vintners	427,666.6 (THB)
SEHK:1	CK Hutchison Holdings Limited	Industrial Conglomerates	402,178.5 (HKD)
PSE:MER	Manila Electric Co.	Electric Utilities	370,815.5 (PHP)
XOM	Exxon Mobil Corporation	Integrated Oil and Gas	351,643.5 (USD)
PSE:AEV	Aboitiz Equity Ventures Inc.	Industrial Conglomerates	318,537.2 (PHP)
AMZN	Amazon.com Inc.	Internet Retail	309,087.6 (USD)
FB	Facebook, Inc.	Internet Software and Services	302,864.0 (USD)
GE	General Electric Company	Industrial Conglomerates	302,468.4 (USD)
PSE:GLO	Globe Telecom Inc.	Wireless Telecommunication Services	301,320.3 (PHP)
JNJ	Johnson & Johnson	Pharmaceuticals	282,006.9 (USD)
PSE:JFC	Jollibee Foods Corp.	Restaurants	221,416.1 (PHP)
BABA	Alibaba Group Holding Limited	Internet Software and Services	210,064.1 (CNY)
PFE	Pfizer Inc.	Pharmaceuticals	209,450.0 (USD)

**“Notice that the stiffest tree is most easily cracked, while the bamboo or willow survives by bending with the wind.”**

**-- Bruce Lee,  
paraphrasing  
the Buddha**



## The DuPont Formula: (Financial, not Chemical)



An overreliance on “margins”

# Return On Assets

$$\frac{\text{Net Operating Profit After Taxes}}{\text{Net Assets}} = \text{ROA}$$

# Return On Assets

**Margins**

**Turns**

$$\frac{\text{NOPAT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Net Assets}}$$

# Return On Assets

**Margins**

$$\frac{\text{NOPAT}}{\cancel{\text{Sales}}}$$

**X**

**Turns**

$$\frac{\cancel{\text{Sales}}}{\text{Net Assets}}$$

# Return On Assets

$$\frac{\text{Net Operating Profit After Tax}}{\text{Net Assets}} = \text{ROA}$$

# WMT and DG

- From 1996-2000, nearly identical ROAs of about 14-15%
- DG margins are 14% during this period
- WMT margins were about 6.5%
- WMT's asset turns are nearly double

# Return on Investment

**Margins**

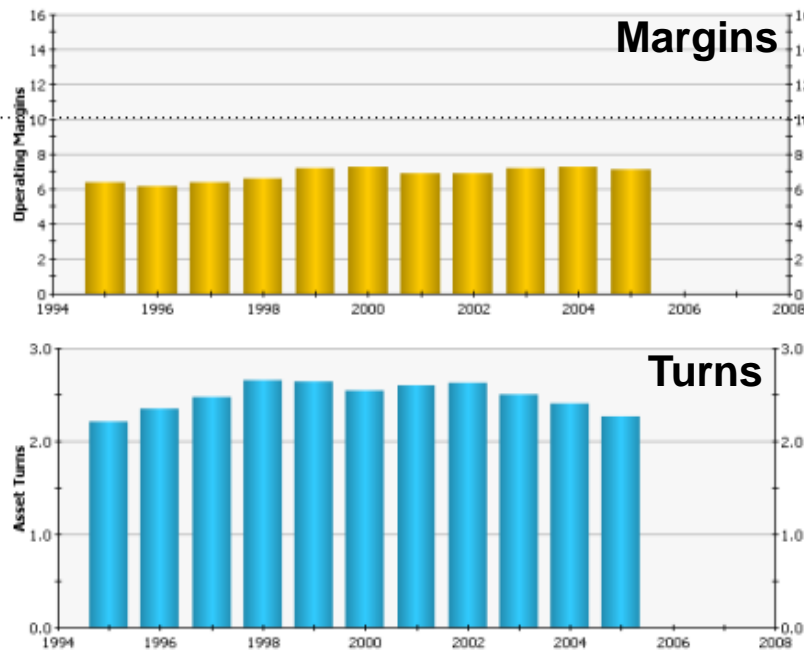
**Turns**

$$\frac{\text{NOPAT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Net Assets}}$$

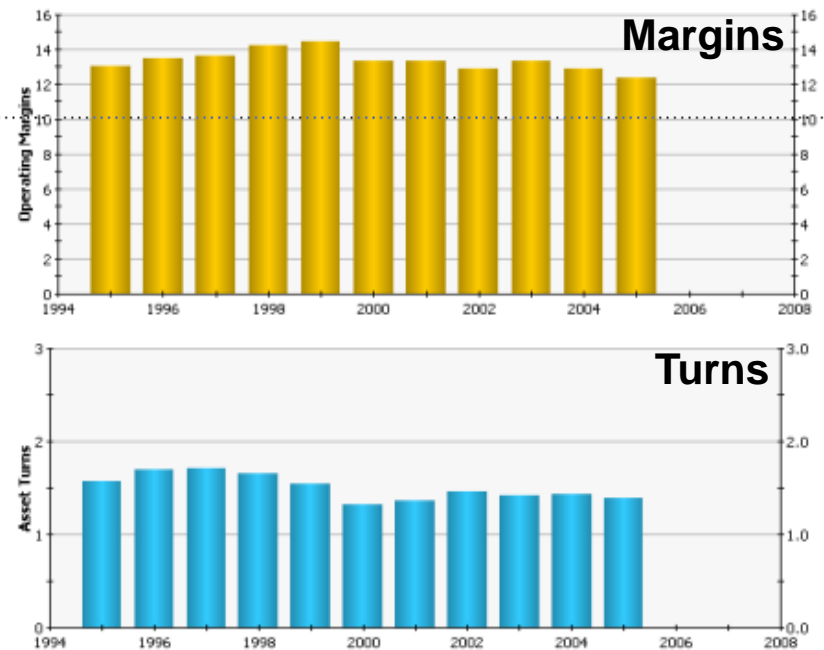
# WMT and DG: 6.5% versus 14.5%

## A major difference in margins despite identical ROAs

### WMT



### DG



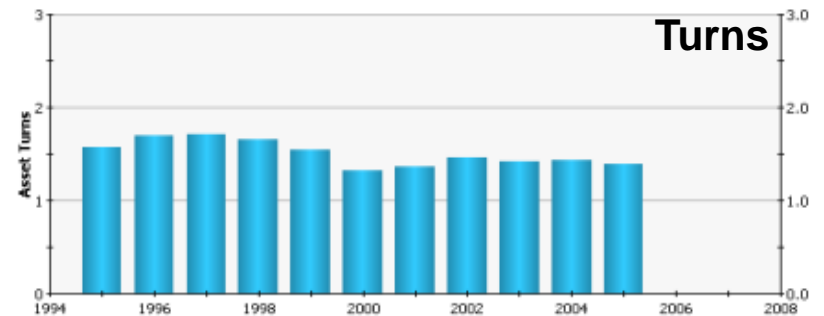
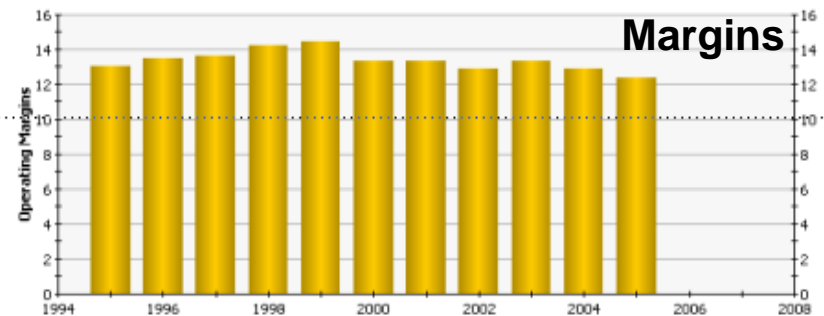
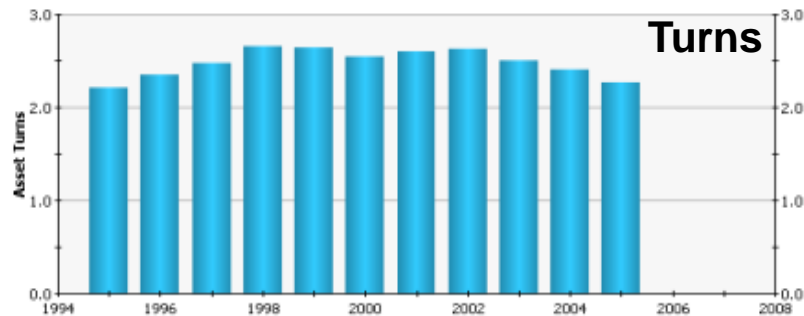
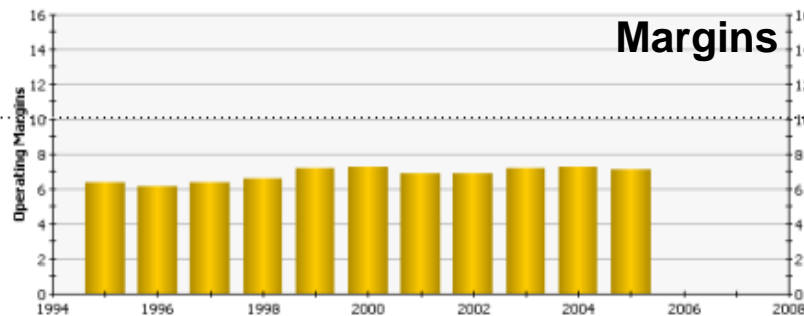


# WMT and DG: 6.5% versus 14.5%

## A major difference in margins despite identical ROAs

**WMT**

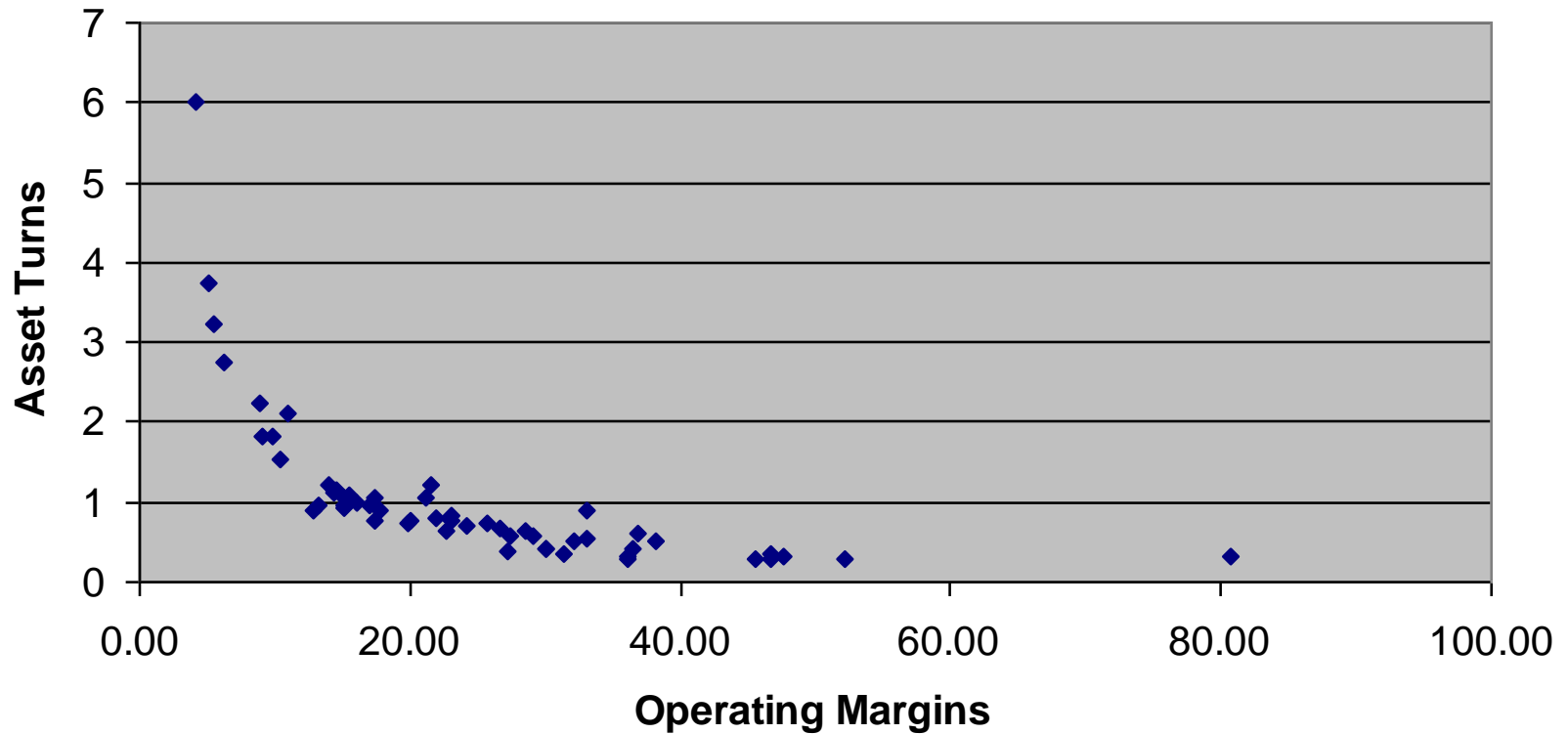
**DG**



**14% ROA**

**14% ROA**

## All 10% ROA Companies

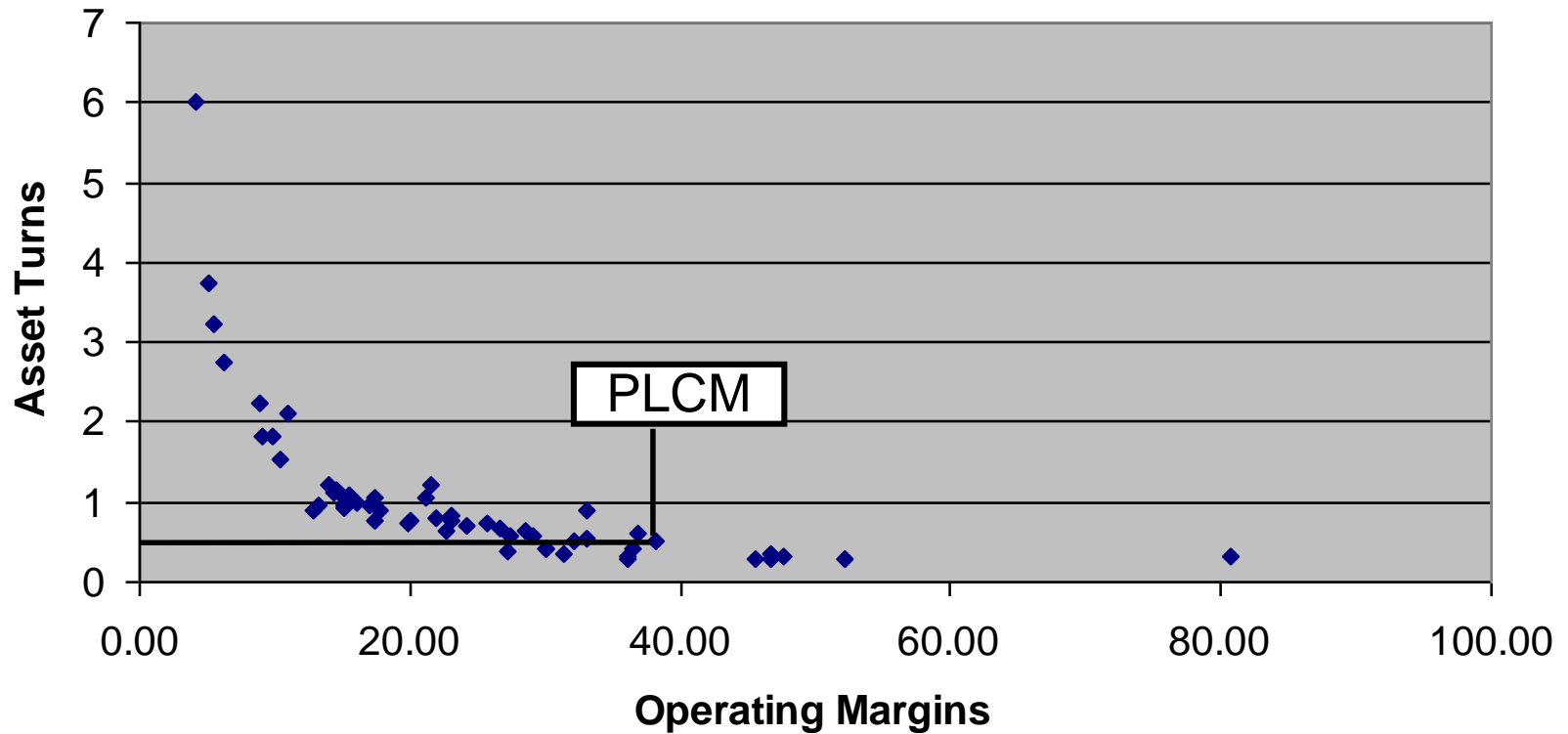


\*EBITDARR margins are used

\*\*Sales/Gross Investment is used

As of 2007

## All 10% ROA Companies

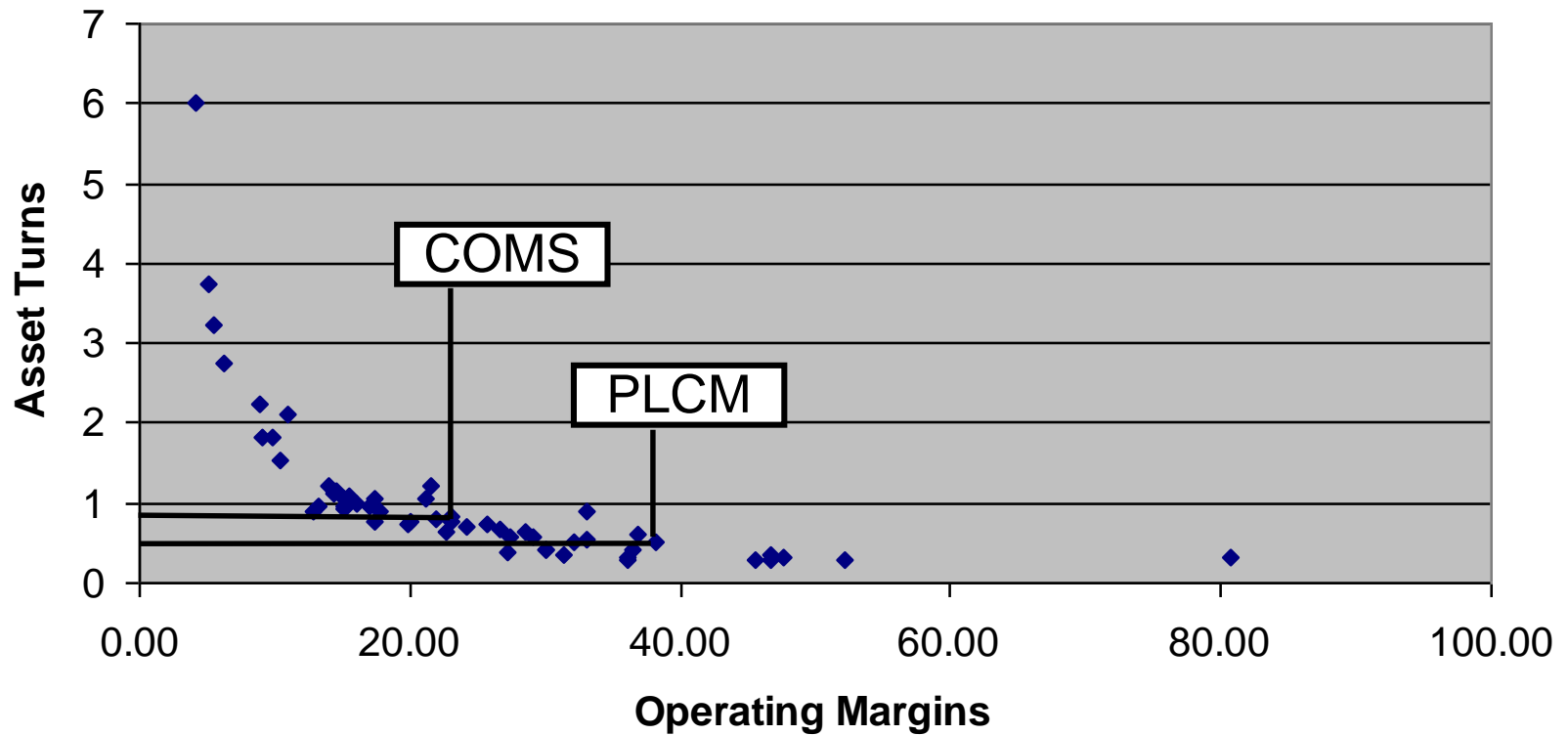


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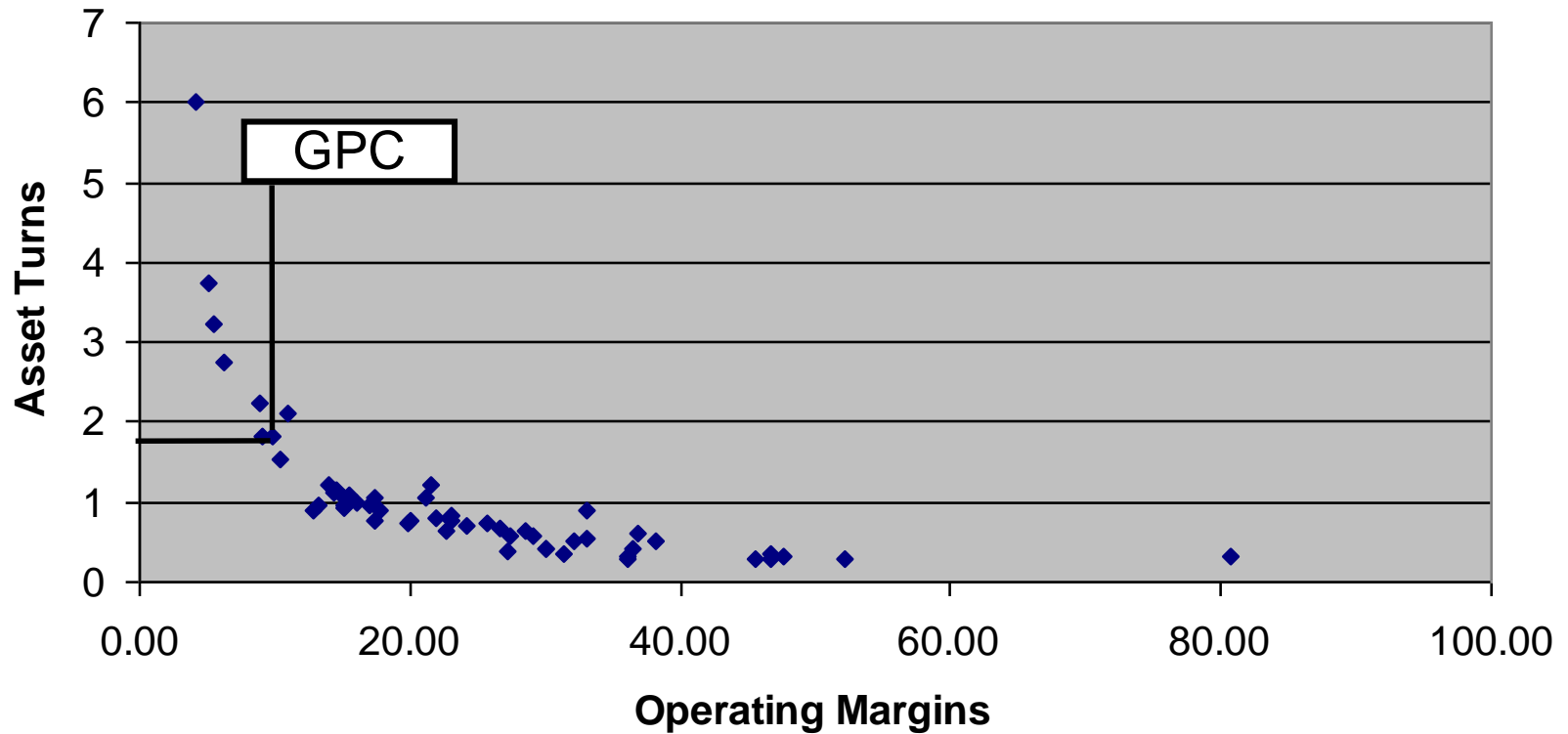


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## All 10% ROA Companies



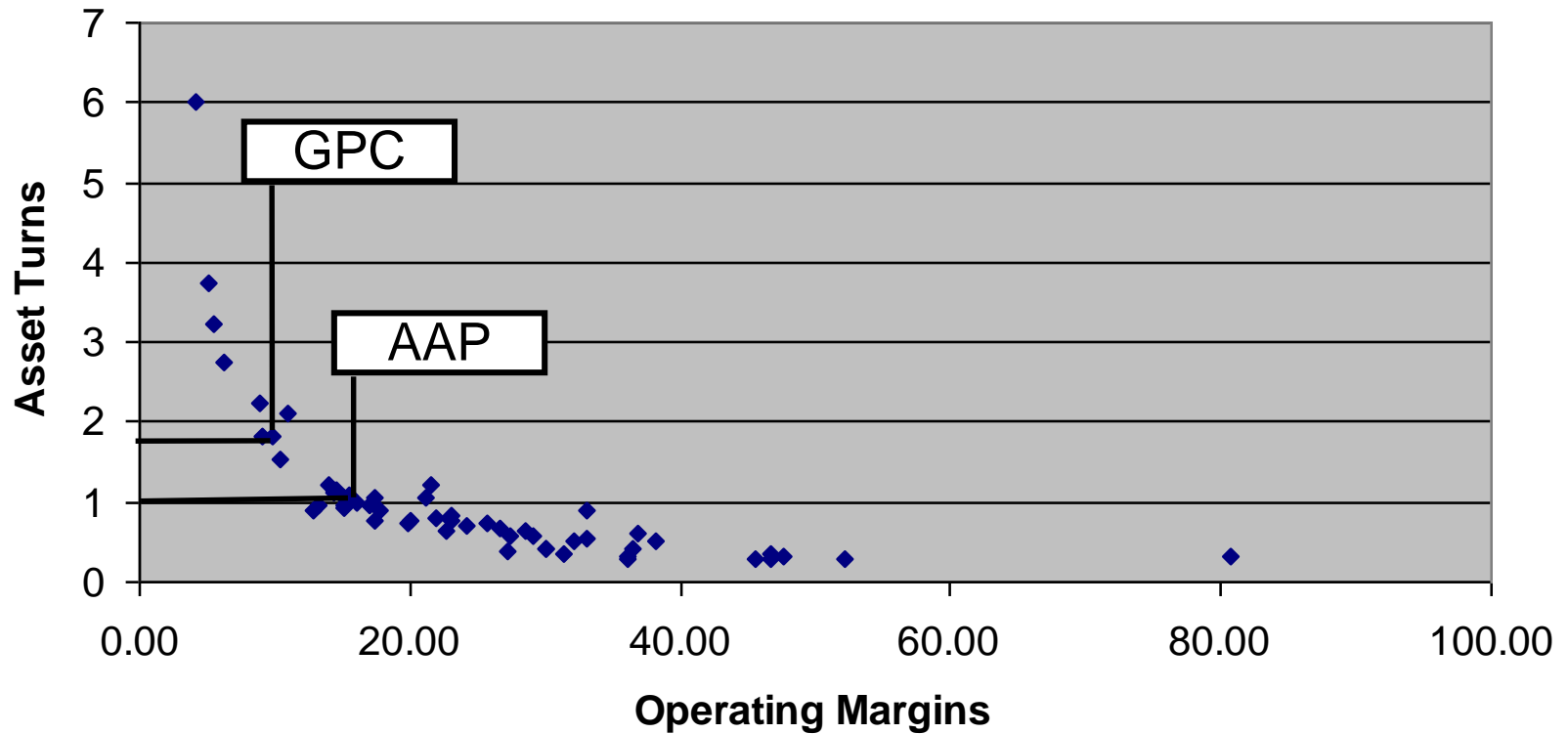
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## All 10% ROA Companies



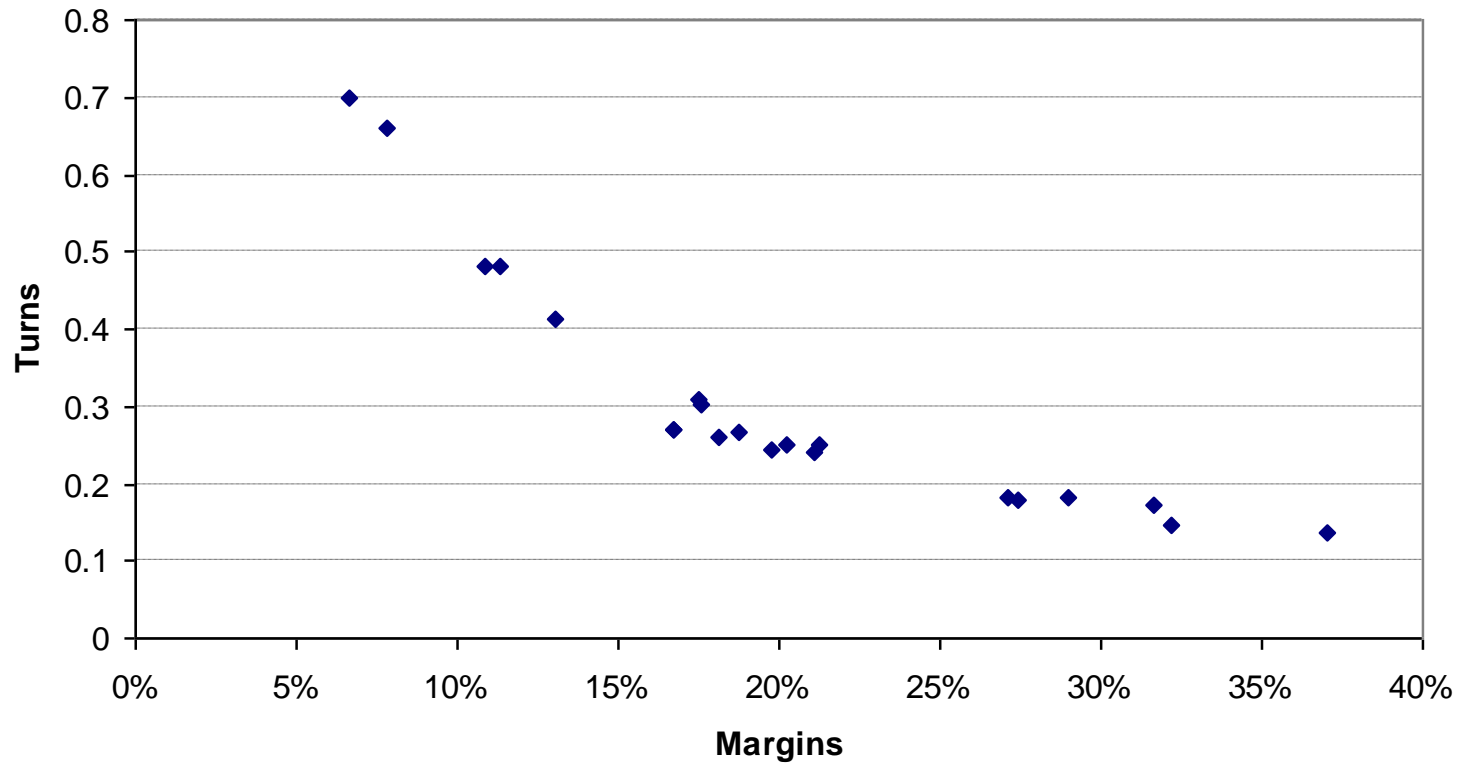
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## All 5% ROA Companies

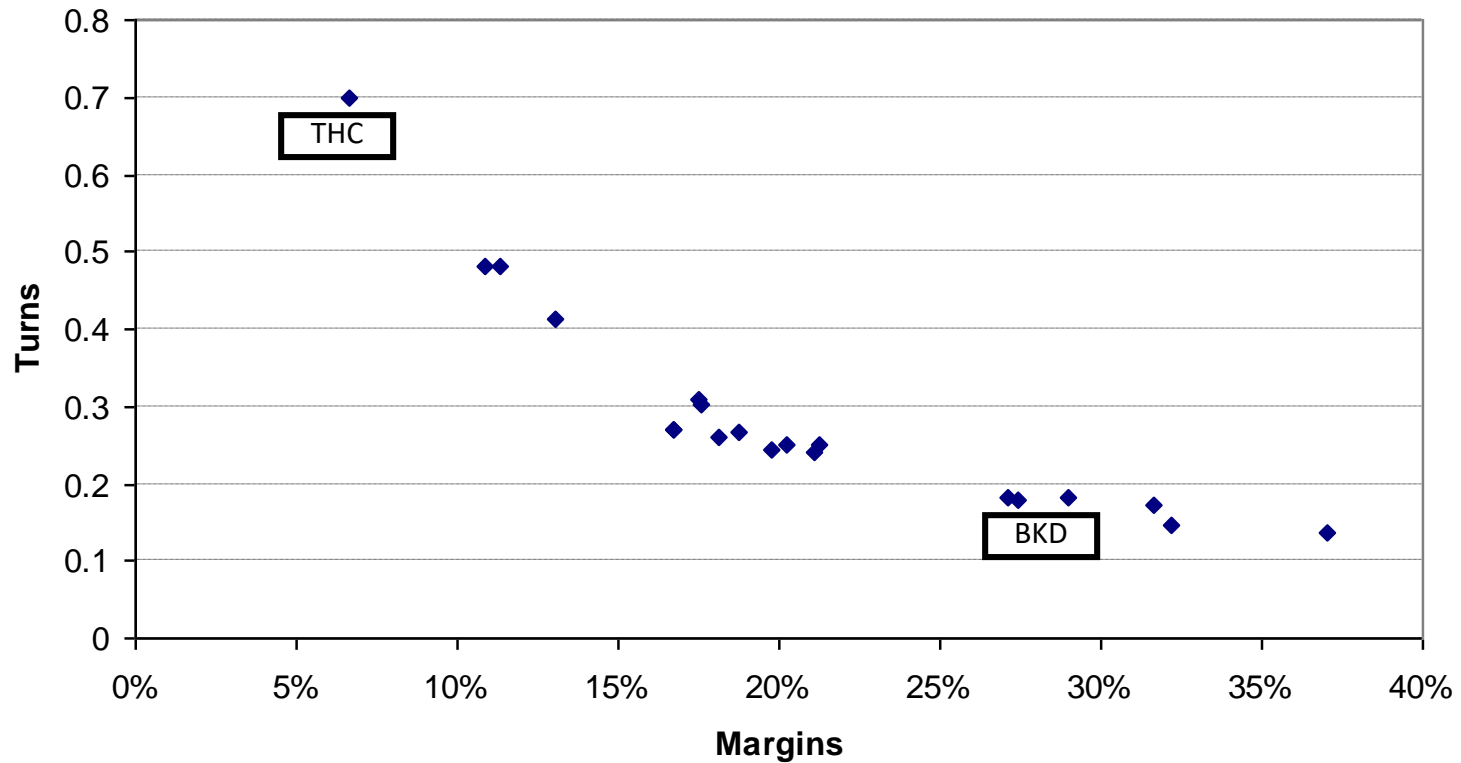


Data from ValueSearch 7™

\*EBITDARR margins are used as a proxy for Net Operating Cash Flow/Sales.

\*\*Sales/Gross Investment is used as a proxy for Sales/Net Assets

## All 5% ROA Companies



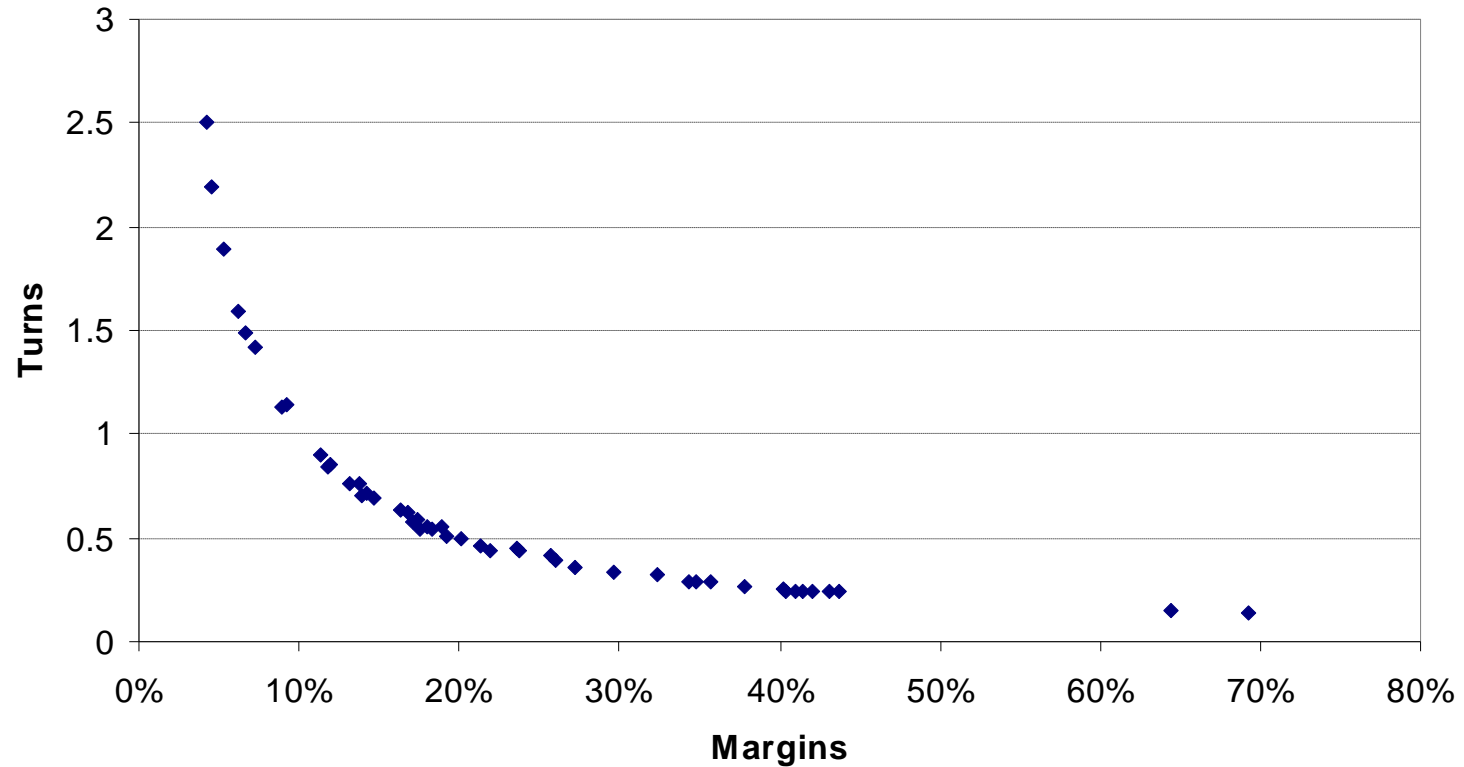
Data from ValueSearch 7™

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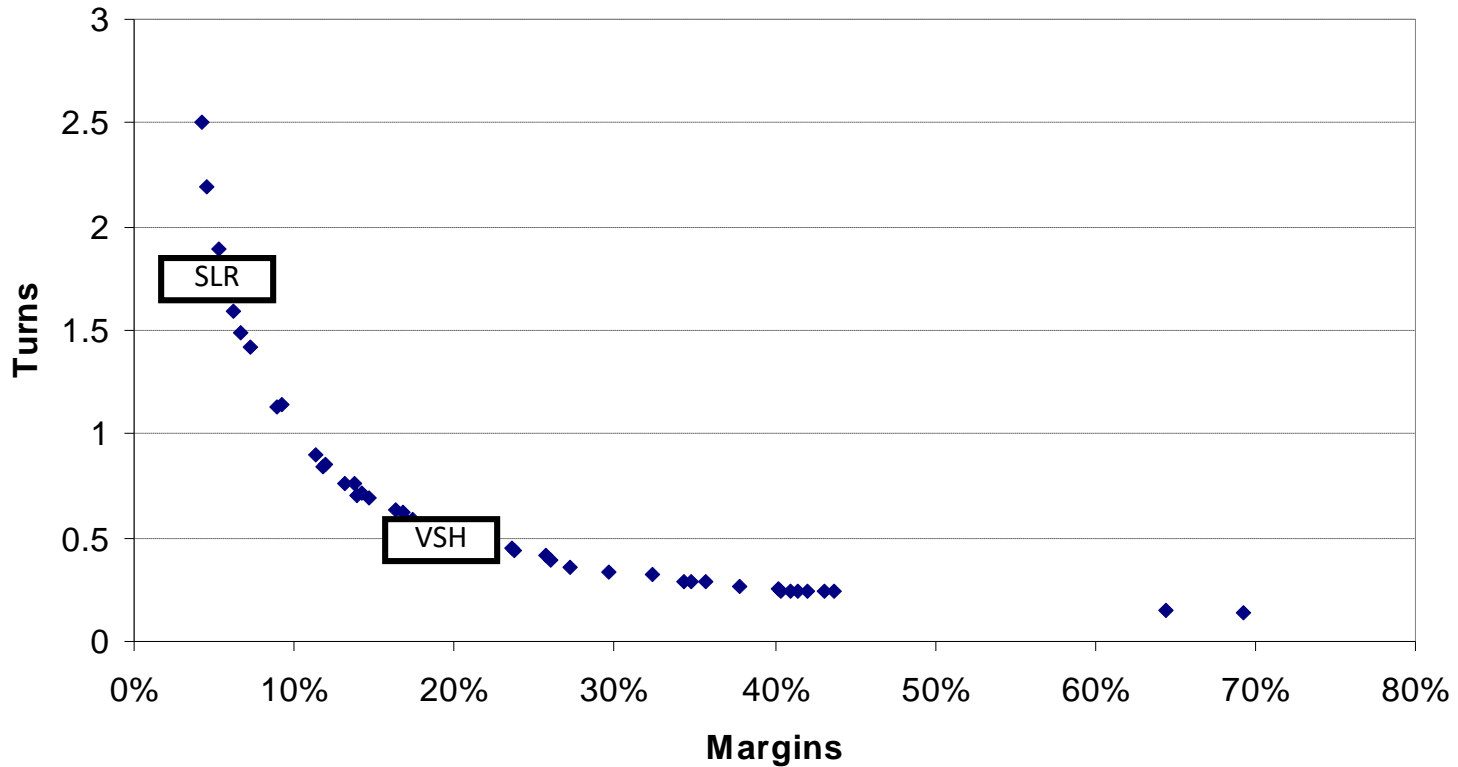
## All 10% ROA Companies



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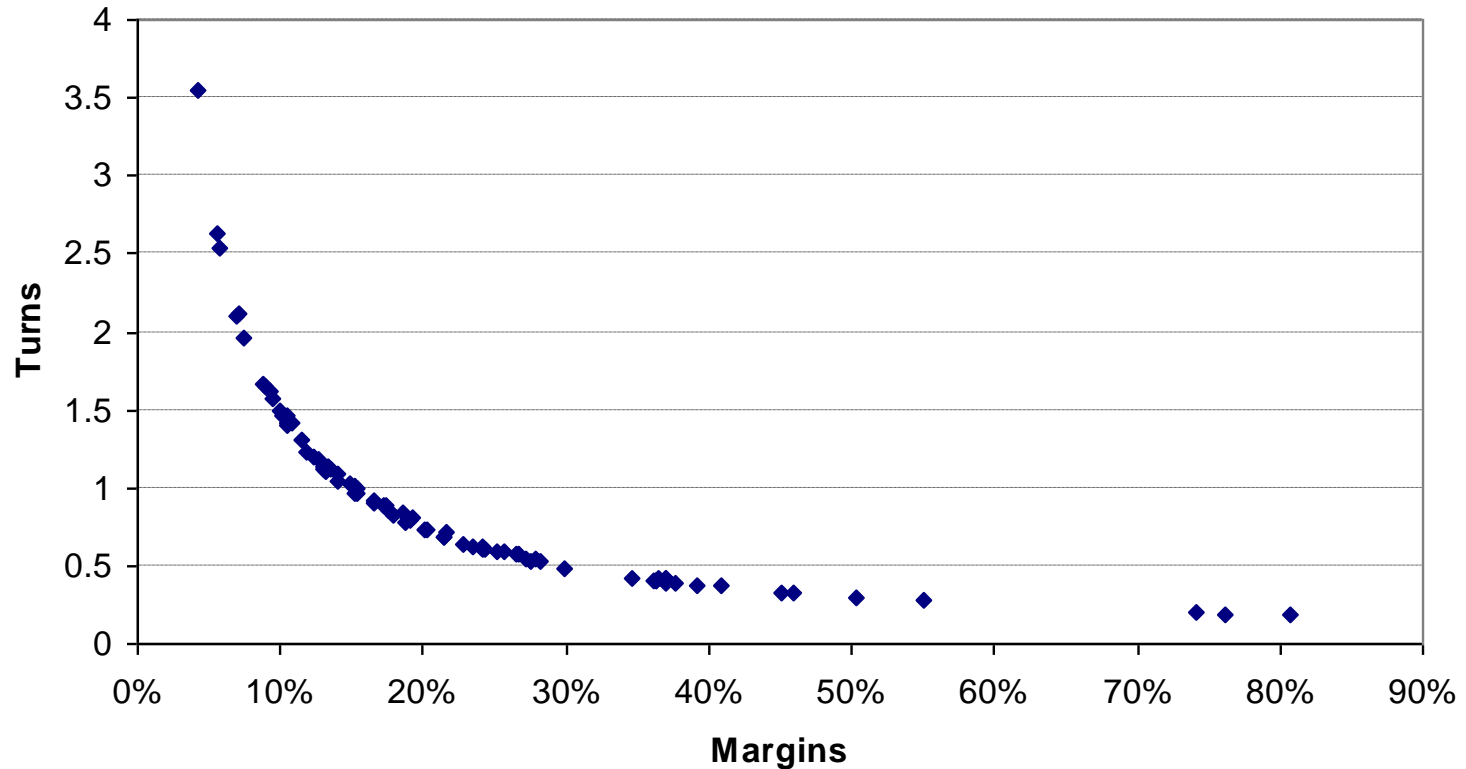
## All 10% ROA Companies



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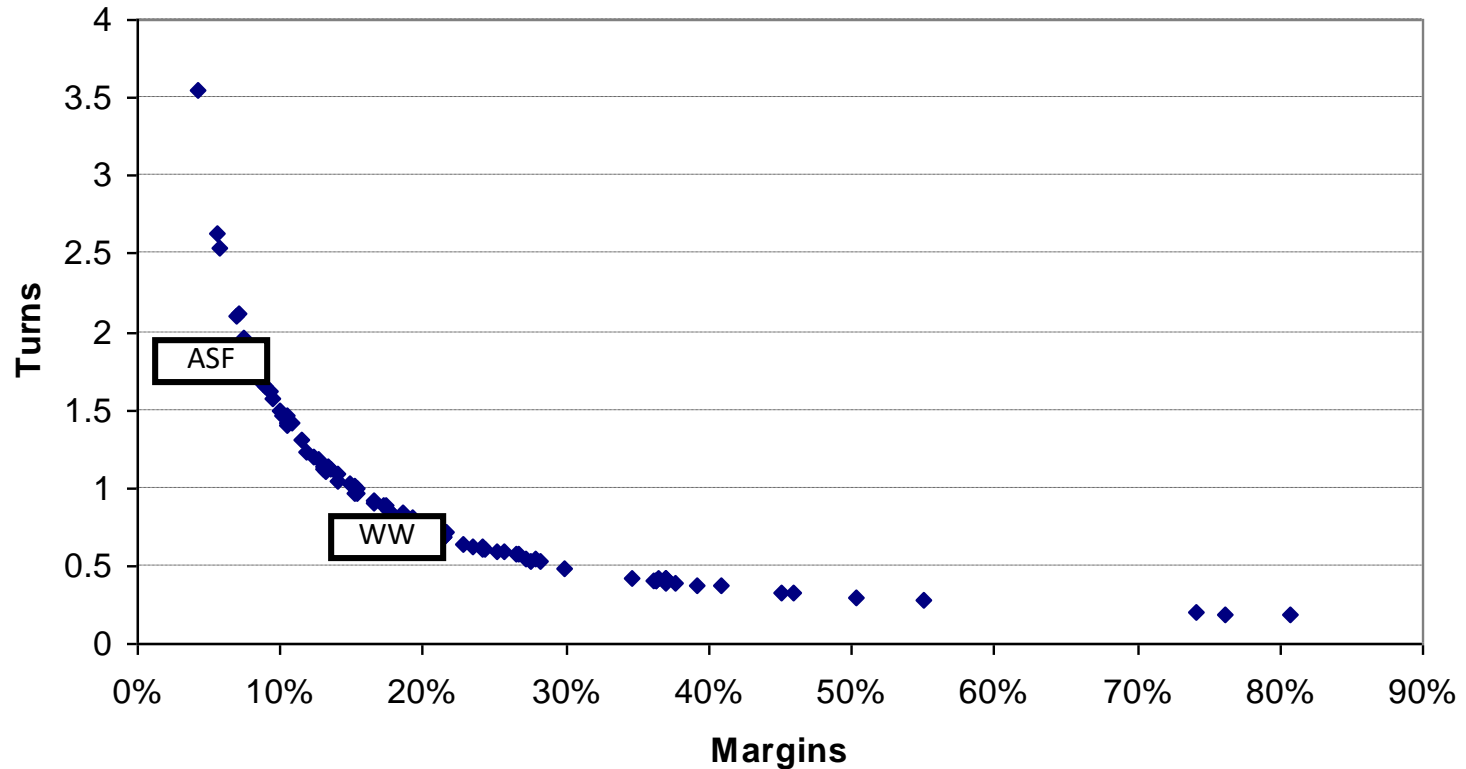
## All 15% ROA Companies



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\*\*Sales/Gross Investment is used as a proxy for Sales/Net Assets

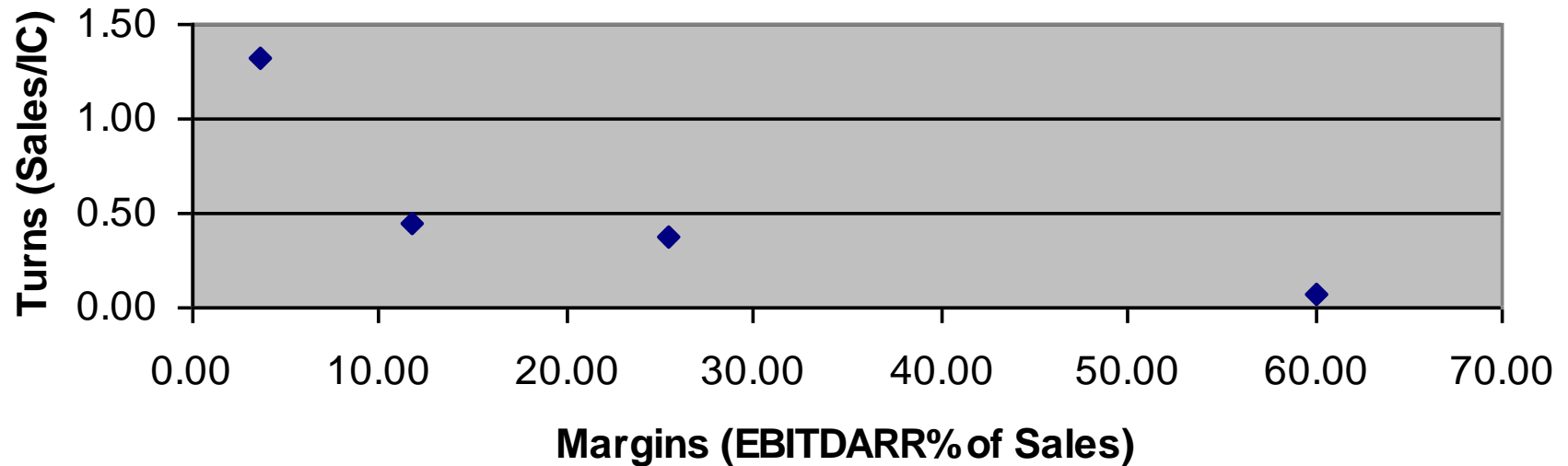
## All 15% ROA Companies



\*EBITDARR margins are used as a proxy for Net Operating Cash Flow/Sales.

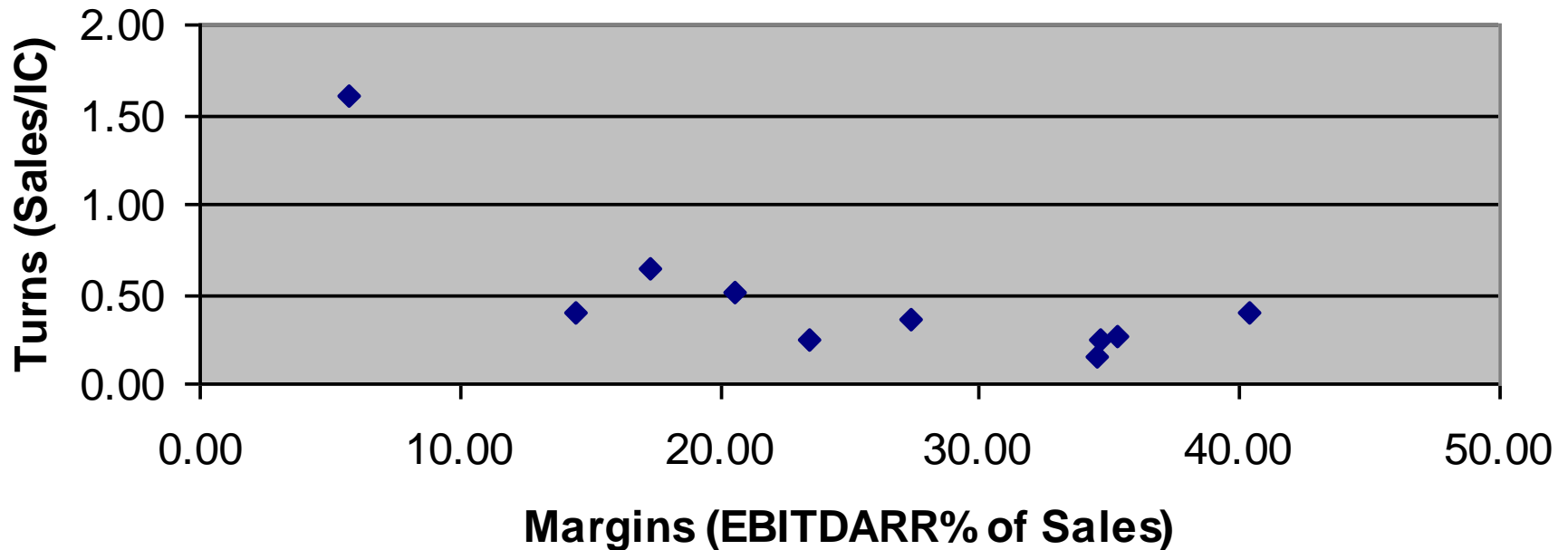
\*\*Sales/Gross Investment is used as a proxy for Sales/Net Assets

## Philippines Non-financials 2% - 4% ROAs



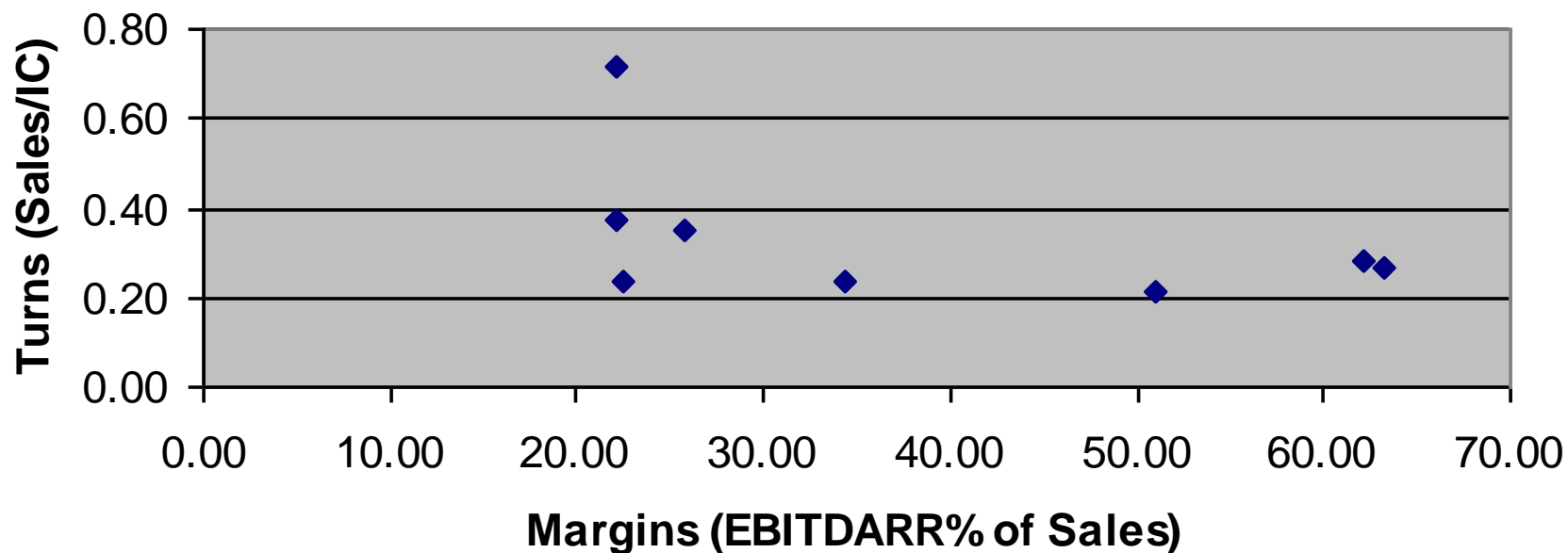
# Philippines Non-financials

4% - 6% ROAs



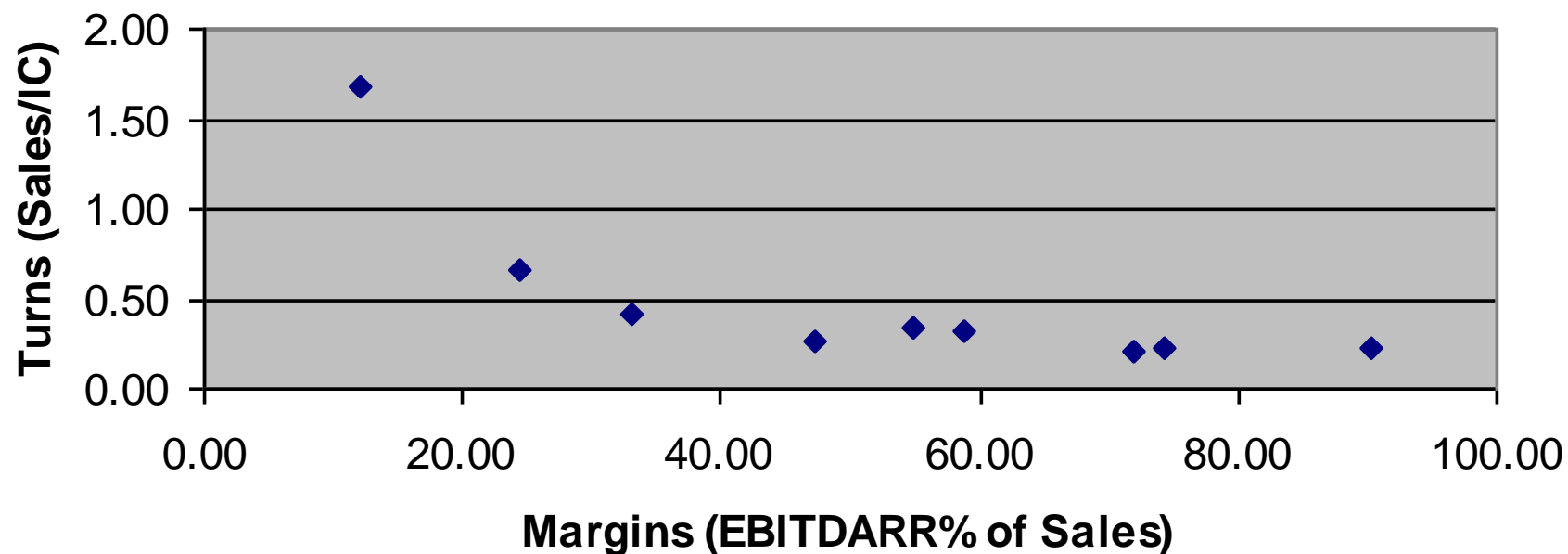
## Philippines Non-financials

### 7.5% - 9.5% ROAs



## Philippines Non-financials

### 10.5% - 14.5% ROAs





“Intelligence is sometimes defined  
as the capacity of the individual  
to adjust himself successfully  
to the environment”

Bruce Lee



“My peculiarity is that  
I don't have a particular style of investing  
or, more exactly, I try to change my style  
to fit the conditions”

Soros

# CFA Pop Quiz: What are A's and B's EBITDA Multiples?

<u>Company A</u>		<u>Company B</u>	
Annual Cash Sales:	\$1,000	Annual Cash Sales:	\$1,000
Cash COGS + SGA:	\$ 800	Cash COGS + SGA:	\$ 500
Cash CAPX:	<u>\$ 100</u>	Cash CAPX:	<u>\$ 400</u>
Annual Free Cash Flow:	\$ 100	Annual Free Cash Flow:	\$ 100
perpetuity	in	perpetuity	in
Cost of Capital:	10%	Cost of Capital:	10%
Valuation?		Valuation?	

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Cash CAPX:	<u>\$ 100</u>		Cash CAPX:	<u>\$ 400</u>	
Annual Free Cash Flow:	\$ 100	in	Annual Free Cash Flow:	\$ 100	in
	perpetuity			perpetuity	
Cost of Capital:	10%		Cost of Capital:	10%	
Valuation?	\$1,000		Valuation?	\$1,000	

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	perpetuity			perpetuity	
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Valuation?	\$1,000		Valuation?	\$1,000	
What is annual EBITDA? \$			What is annual EBITDA? \$		

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perpetuity	in	perpetuity	in
Cost of Capital:	10%	Cost of Capital:	10%
Valuation?	\$1,000	Valuation?	\$1,000
What is annual EBITDA? \$200		What is annual EBITDA? \$	

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<u>Company A</u>		<u>Company B</u>	
Annual Cash Sales:	\$1,000	Annual Cash Sales:	\$1,000
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Cash CAPX:	<u>\$ 100</u>	Cash CAPX:	<u>\$ 400</u>
Annual Free Cash Flow:	\$ 100	Annual Free Cash Flow:	\$ 100
perpetuity	in	perpetuity	in
Cost of Capital:	10%	Cost of Capital:	10%
Valuation?	\$1,000	Valuation?	\$1,000
What is annual EBITDA? \$200		What is annual EBITDA? \$500	

# CFA Pop Quiz: What are A's and B's EBITDA Multiples?

<u>Company A</u>		<u>Company B</u>	
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Cash CAPX:	<u>\$ 100</u>	Cash CAPX:	<u>\$ 400</u>
Annual Free Cash Flow:	\$ 100	Annual Free Cash Flow:	\$ 100
perpetuity	in	perpetuity	in
Cost of Capital:	10%	Cost of Capital:	10%
Valuation?	\$1,000	Valuation?	\$1,000
What is annual EBITDA? \$200		What is annual EBITDA? \$500	
EBITDA Multiple?		EBITDA Multiple?	



# CFA Pop Quiz: What are A's and B's EBITDA Multiples?

<u>Company A</u>		<u>Company B</u>	
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perpetuity	in	perpetuity	in
Cost of Capital:	10%	Cost of Capital:	10%
Valuation?	\$1,000	Valuation?	\$1,000
What is annual EBITDA?	\$200	What is annual EBITDA?	\$500
EBITDA Multiple?	5 X	EBITDA Multiple?	

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EBITDA Multiple?	5 X	EBITDA Multiple?	2 X

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Cost of Capital:	10%	Cost of Capital:	10%
Valuation?	\$1,000	Valuation?	\$1,000
What is annual EBITDA?	\$200	What is annual EBITDA?	\$500
EBITDA Multiple?	5 X	EBITDA Multiple?	2 X

LOOKS EXPENSIVE!

LOOKS CHEAP!

# EBITDA analysis suggests a serious margin issue

Calendar Year Fiscal Year	1997 5/1998 USD	1998 5/1999 USD	1999 5/2000 USD	2000 5/2001 USD	2001 5/2002 USD	2002 5/2003 USD	2003 5/2004 USD
<b>Sales Growth, %</b>	37.79	5.67	8.84	7.52	4.98	9.12	9.89
<b>Operating Margins, %</b>							
Cost of Goods Sold, %	87.11	86.89	86.99	87.41	87.68	87.47	86.85
SG&A - Adjusted, %	(7.54)	(7.79)	(7.66)	(7.59)	(7.69)	(7.24)	(6.89)
Operating Margin - Adjusted, %	20.43	20.89	20.67	20.18	20.01	19.78	20.04
Less: Rental Expense, %	7.54	7.79	7.66	7.59	7.69	7.24	6.89
Less: Research & Development, %	NA	NA	NA	NA	NA	NA	NA
<b>EBITDA, %</b>	12.89	13.11	13.01	12.59	12.32	12.53	13.15

FDX

Calendar Year Fiscal Year	1997 12/1997 USD	1998 12/1998 USD	1999 12/1999 USD	2000 12/2000 USD	2001 12/2001 USD	2002 12/2002 USD	2003 12/2003 USD
<b>Sales Growth, %</b>	0.40	10.37	9.13	10.05	2.94	2.04	7.08
<b>Operating Margins, %</b>							
Cost of Goods Sold, %	87.89	83.05	81.05	80.87	82.76	82.51	82.22
SG&A - Adjusted, %	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Operating Margin - Adjusted, %	12.11	16.95	18.95	19.13	17.24	17.49	17.78
Less: Rental Expense, %	NA	NA	NA	NA	NA	NA	NA
Less: Research & Development, %	NA	NA	NA	NA	NA	NA	NA
<b>EBITDA, %</b>	12.11	16.95	18.95	19.13	17.24	17.49	17.78

UPS

# Or maybe not...

Calendar Year Fiscal Year	1997 5/1998 USD	1998 5/1999 USD	1999 5/2000 USD	2000 5/2001 USD	2001 5/2002 USD	2002 5/2003 USD	2003 5/2004 USD
<b>Sales Growth, %</b>	37.79	5.67	8.84	7.52	4.98	9.12	9.89
<b>Operating Margins, %</b>							
Cost of Goods Sold, %	87.11	86.89	86.99	87.41	87.68	87.47	86.85
SG&A - Adjusted, %	(7.54)	(7.79)	(7.66)	(7.59)	(7.69)	(7.24)	(6.89)
Operating Margin - Adjusted, %	20.43	20.89	20.67	20.18	20.01	19.78	20.04
Less: Rental Expense, %	7.54	7.79	7.66	7.59	7.69	7.24	6.89
Less: Research & Development, %	NA	NA	NA	NA	NA	NA	NA
EBITDA, %	12.89	13.11	13.01	12.59	12.32	12.53	13.15

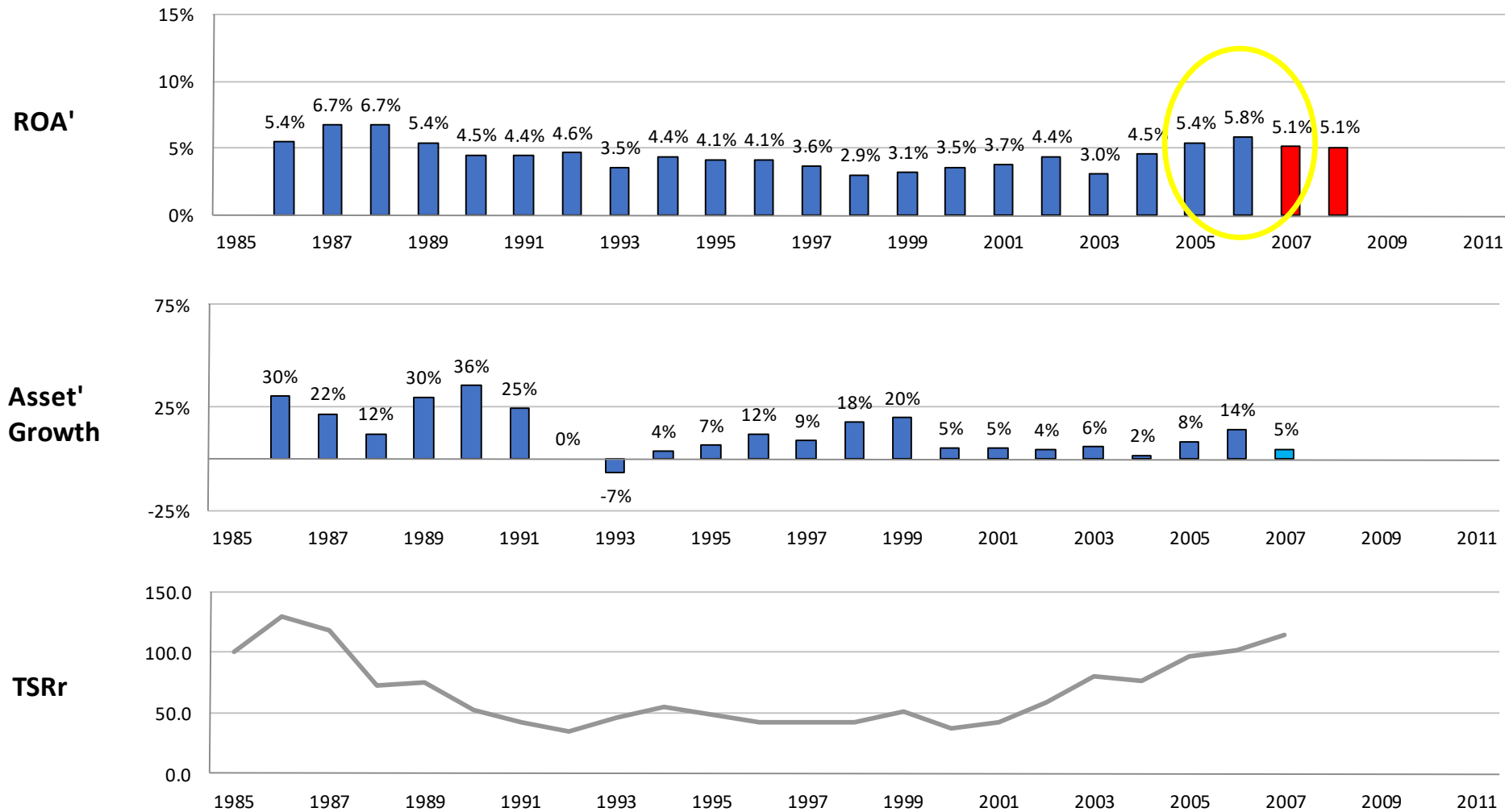
FDX

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Cost of Goods Sold, %	87.89	83.05	81.05	80.87	82.76	82.51	82.22
SG&A - Adjusted, %	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Operating Margin - Adjusted, %	12.11	16.95	18.95	19.13	17.24	17.49	17.78
Less: Rental Expense, %	NA	NA	NA	NA	NA	NA	NA
Less: Research & Development, %	NA	NA	NA	NA	NA	NA	NA
EBITDA, %	12.11	16.95	18.95	19.13	17.24	17.49	17.78

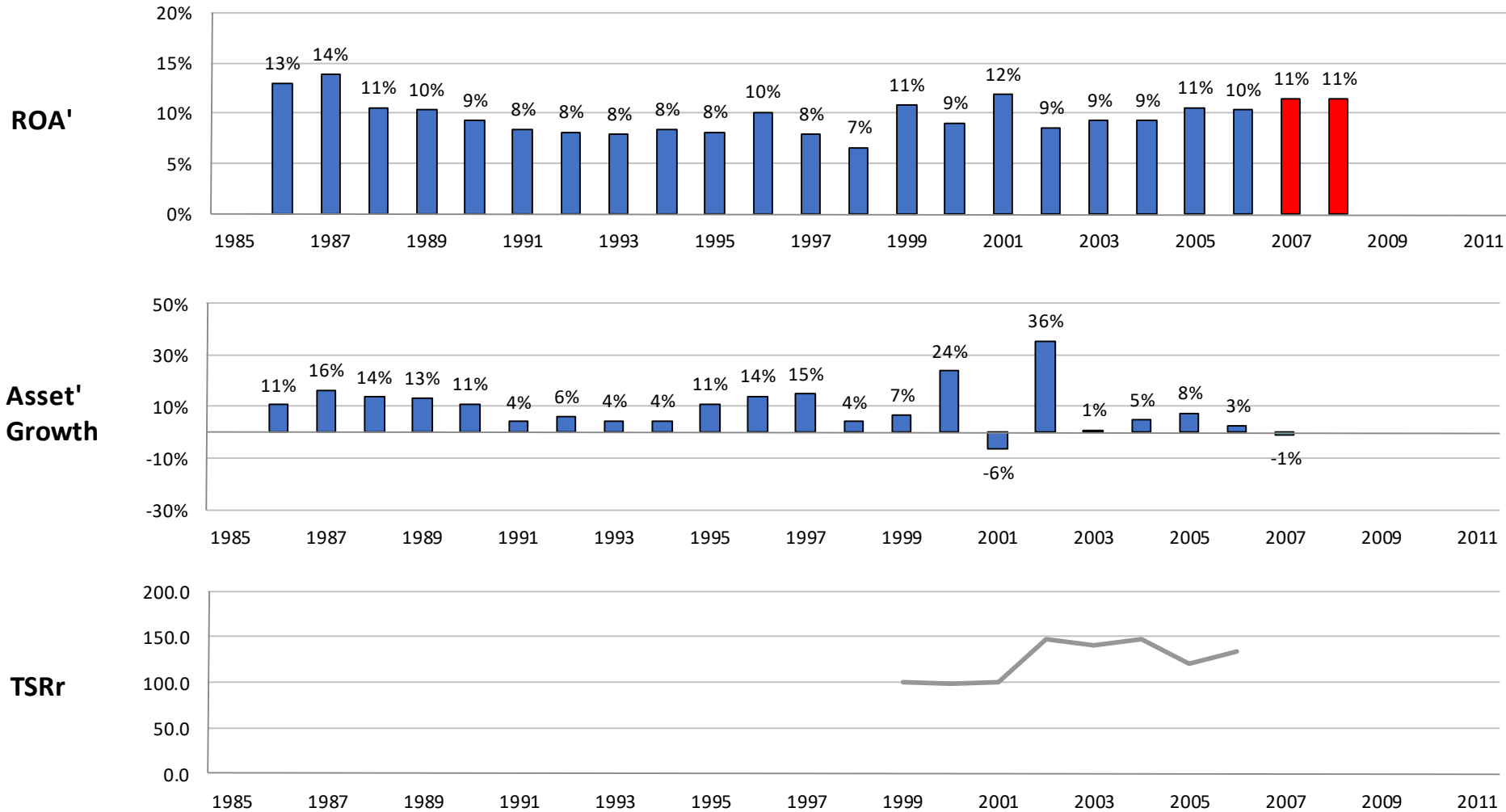
UPS

# FDX – Great Stock vs. Great Company

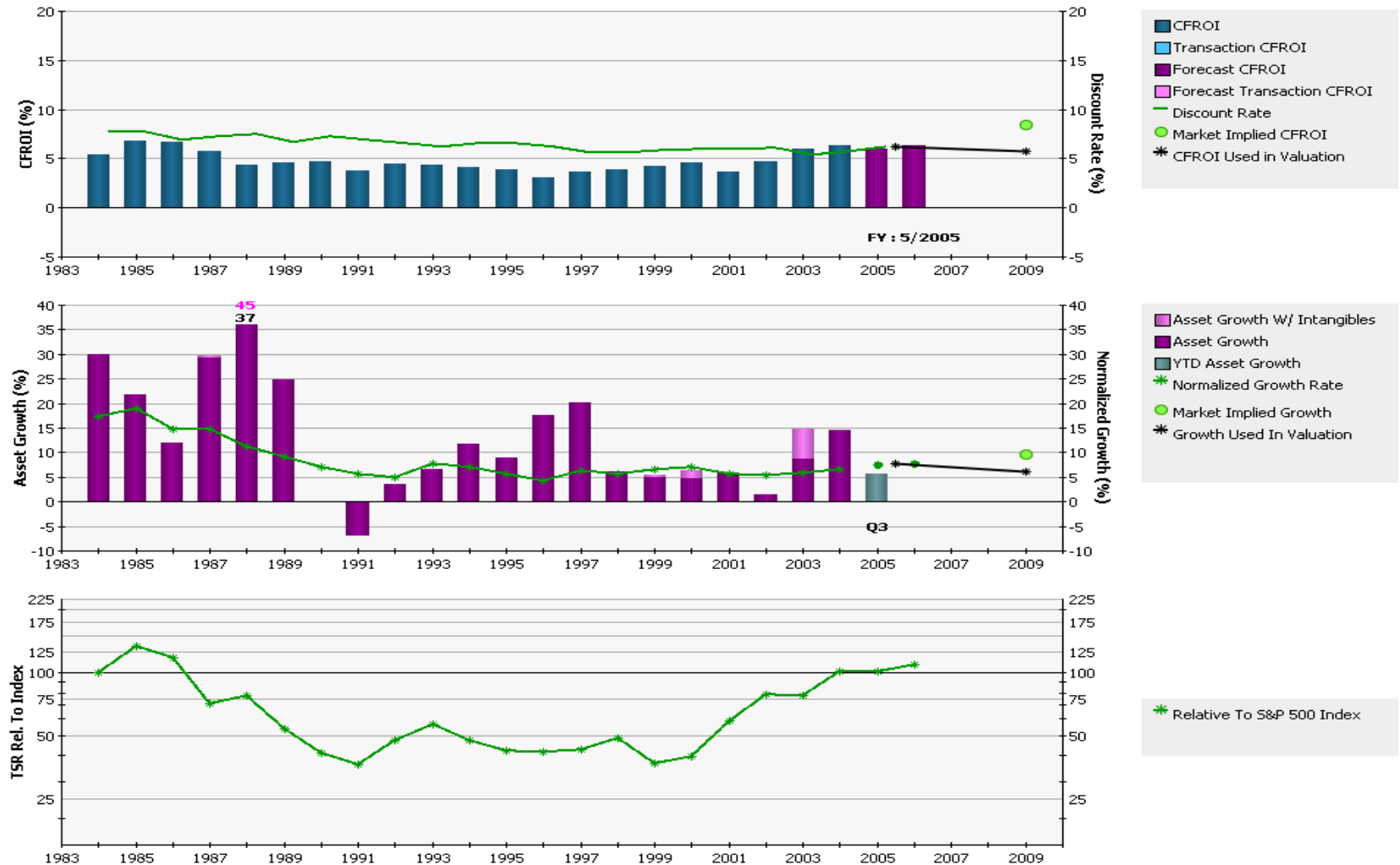
**FORTUNE**



# UPS – Great Stock vs. Great Company

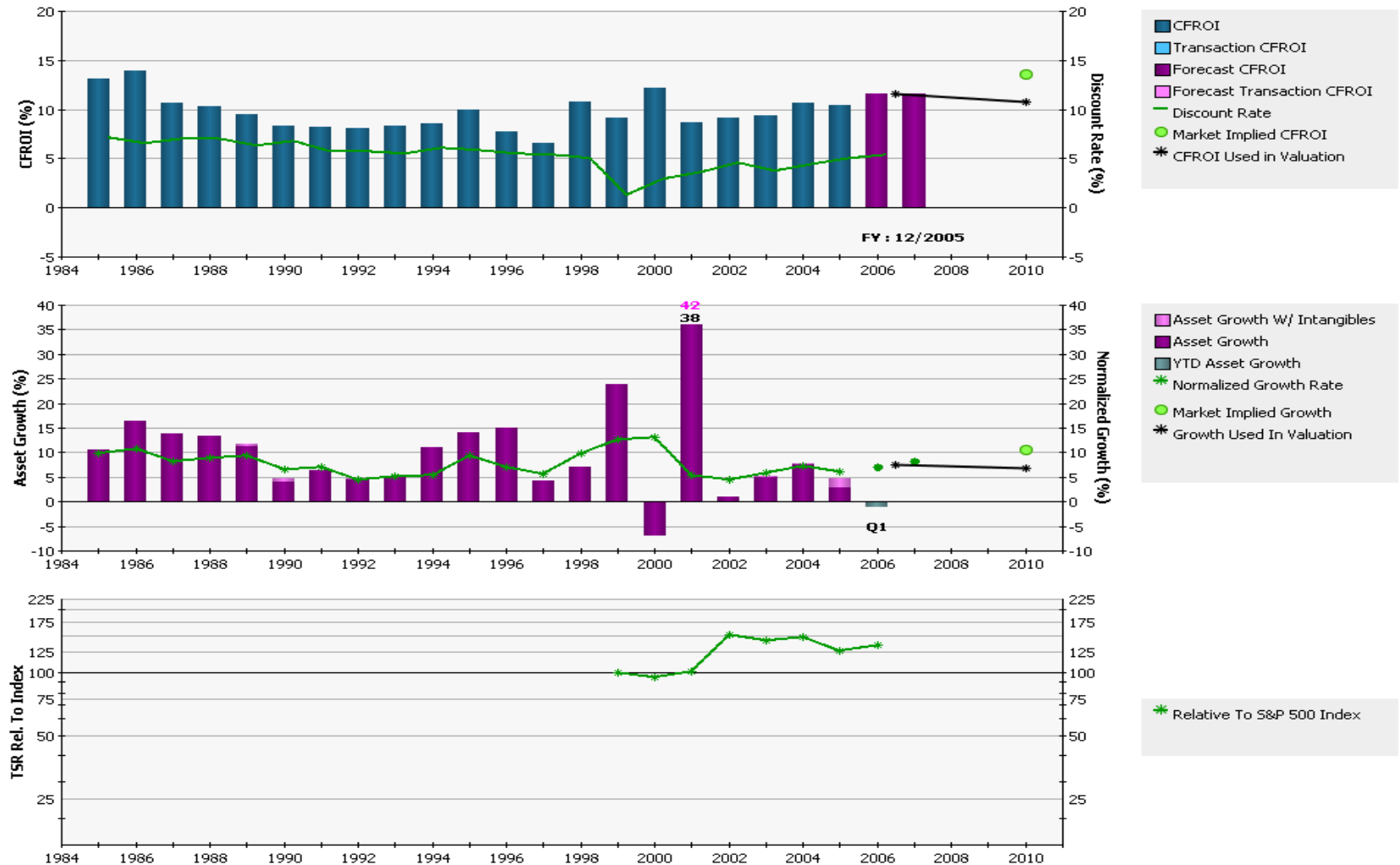


# FDX: Until recently, 20 years of poor performance

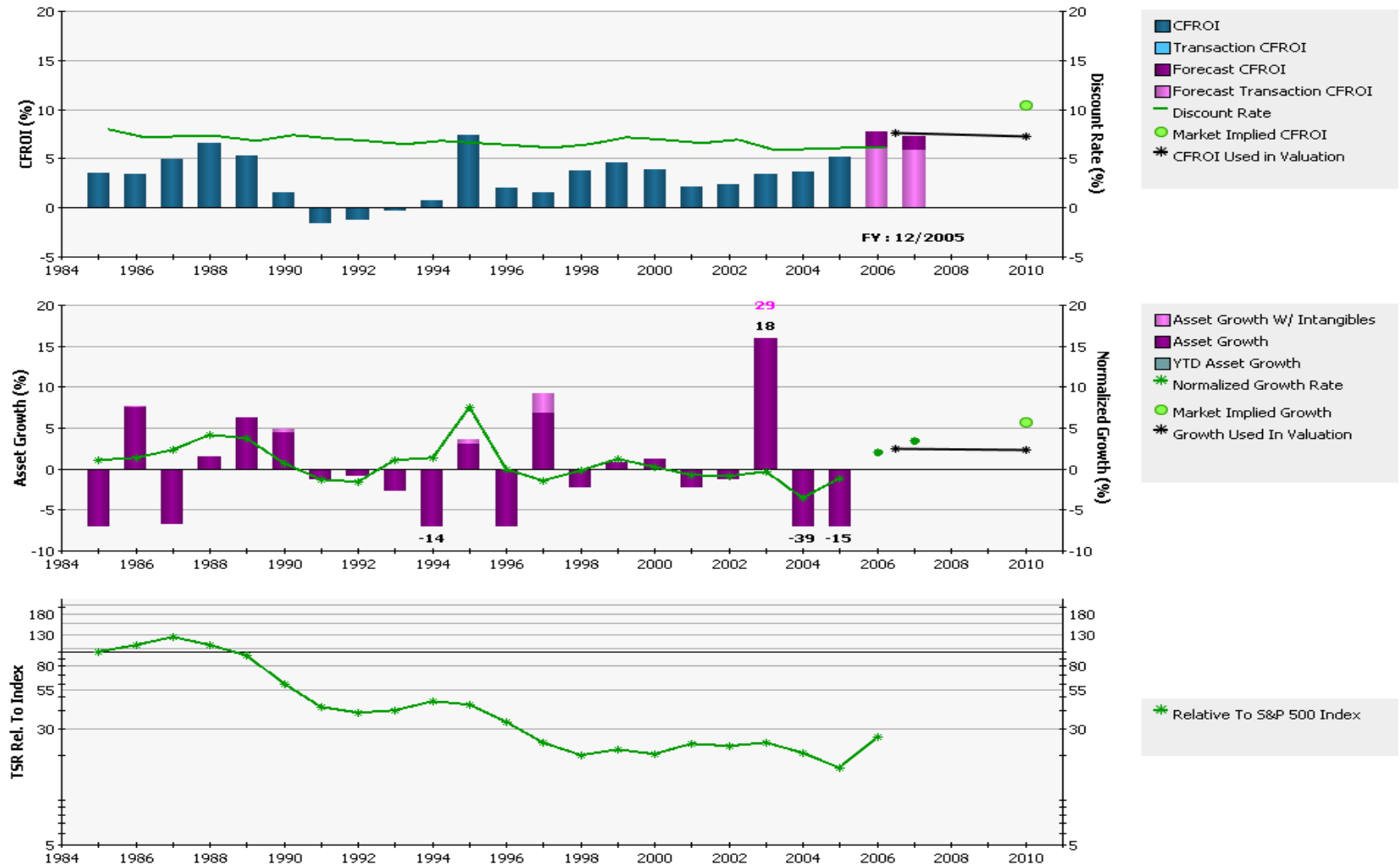




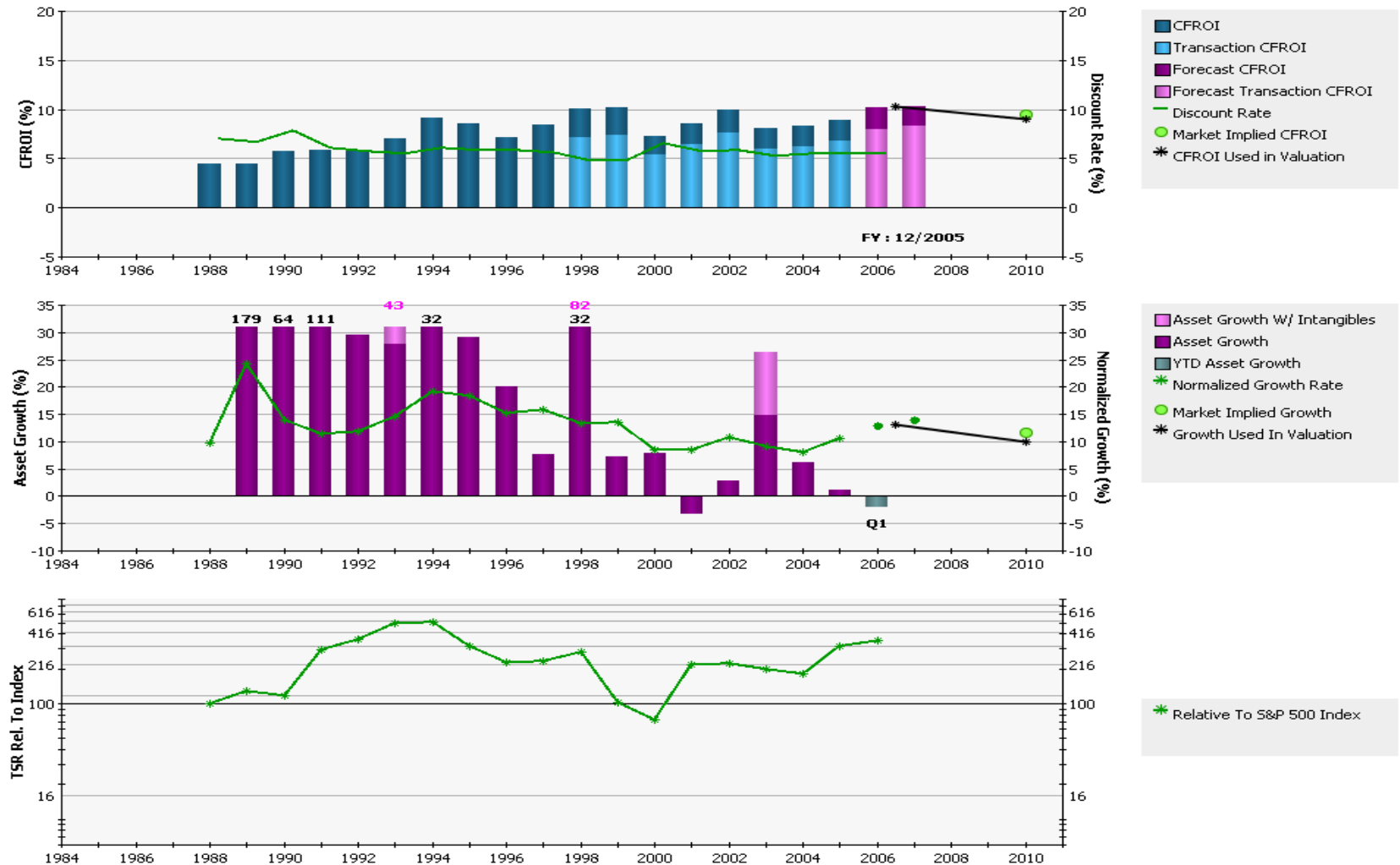
# UPS: A stark difference in long-term performance



# OMX: 20 year history of sub-par performance



# ODP: Solid 5-10% returns in long-term performance



Again, utilizing our database, we can examine EBITDA margins – in this case, we see similar margin results

Calendar Year Fiscal Year	1998 12/1998 USD	1999 12/1999 USD	2000 12/2000 USD	2001 12/2001 USD	2002 12/2002 USD	2003 12/2003 USD
Sales Growth, %	12.16	12.83	12.28	(4.93)	(0.13)	11.24
Operating Margins, %						
Cost of Goods Sold, %	78.69	77.36	79.34	80.71	81.13	80.69
SG&A - Adjusted, %	12.07	11.60	11.39	11.45	11.78	12.44
Operating Margin - Adjusted, %	9.24	11.04	9.27	7.84	7.09	6.87
Less: Rental Expense, %	1.00	0.88	0.80	0.84	0.86	0.97
Less: Research & Development, %	0.19	0.05	0.07	0.06	0.04	0.04
EBITDA, %	8.05	10.11	8.40	6.93	6.19	5.86

OMX

Calendar Year Fiscal Year	1998 12/1998 USD	1999 12/1999 USD	2000 12/2000 USD	2001 12/2001 USD	2002 12/2002 USD	2003 12/2003 USD
Sales Growth, %	33.94	14.07	12.73	(3.59)	1.82	8.82
Operating Margins, %						
Cost of Goods Sold, %	70.57	70.25	71.29	69.79	68.88	66.64
SG&A - Adjusted, %	19.26	19.89	20.49	21.30	21.24	23.80
Operating Margin - Adjusted, %	10.17	9.86	8.22	8.91	9.89	9.56
Less: Rental Expense, %	2.85	3.16	3.43	3.60	3.59	3.46
Less: Research & Development, %	0.00	0.00	0.00	0.00	0.00	0.00
EBITDA, %	7.32	6.70	4.79	5.32	6.29	6.10

ODP

# Real operating margin *tells a different story*

Calendar Year Fiscal Year	1998 12/1998 USD	1999 12/1999 USD	2000 12/2000 USD	2001 12/2001 USD	2002 12/2002 USD	2003 12/2003 USD
<b>Sales Growth, %</b>	12.16	12.83	12.28	(4.93)	(0.13)	11.24
<b>Operating Margins, %</b>						
Cost of Goods Sold, %	78.69	77.36	79.34	80.71	81.13	80.69
SG&A - Adjusted, %	12.07	11.60	11.39	11.45	11.78	12.44
Operating Margin - Adjusted, %	9.24	11.04	9.27	7.84	7.09	6.87
Less: Rental Expense, %	1.00	0.88	0.80	0.84	0.86	0.97
Less: Research & Development, %	0.19	0.05	0.07	0.06	0.04	0.04
EBITDA, %	8.05	10.11	8.40	6.93	6.19	5.86

OMX

Calendar Year Fiscal Year	1998 12/1998 USD	1999 12/1999 USD	2000 12/2000 USD	2001 12/2001 USD	2002 12/2002 USD	2003 12/2003 USD
<b>Sales Growth, %</b>	33.94	14.07	12.73	(3.59)	1.82	8.82
<b>Operating Margins, %</b>						
Cost of Goods Sold, %	70.57	70.25	71.29	69.79	68.88	66.64
SG&A - Adjusted, %	19.26	19.89	20.49	21.30	21.24	23.80
Operating Margin - Adjusted, %	10.17	9.86	8.22	8.91	9.89	9.56
Less: Rental Expense, %	2.85	3.16	3.43	3.60	3.59	3.46
Less: Research & Development, %	0.00	0.00	0.00	0.00	0.00	0.00
EBITDA, %	7.32	6.70	4.79	5.32	6.29	6.10

ODP

*When does EBITDA matter?*

*E B I T D A*

## Free Cash Flows (FCF)

Good Negative FCF or Bad Negative FCF?

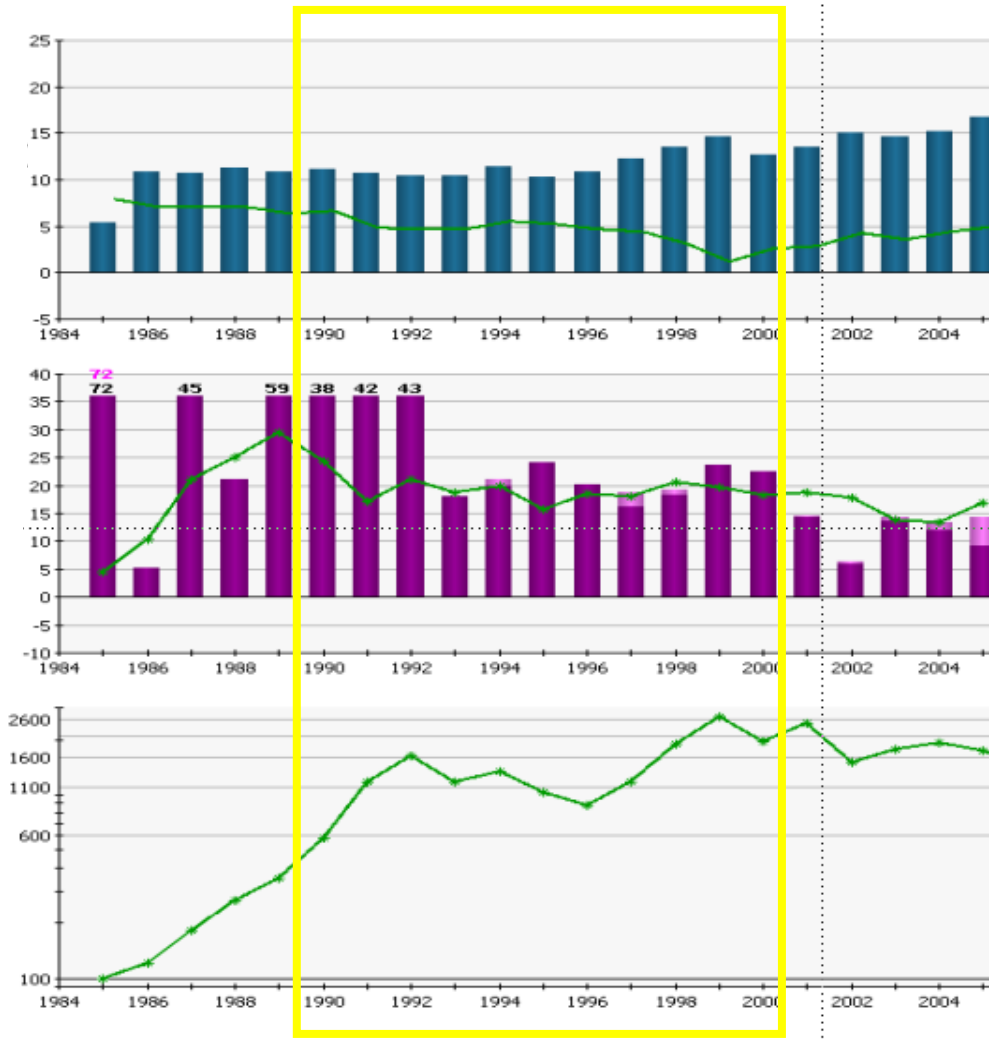
## HD 1990-2006 – Rising Price with Negative FCF

### HD FCF 1996-2005

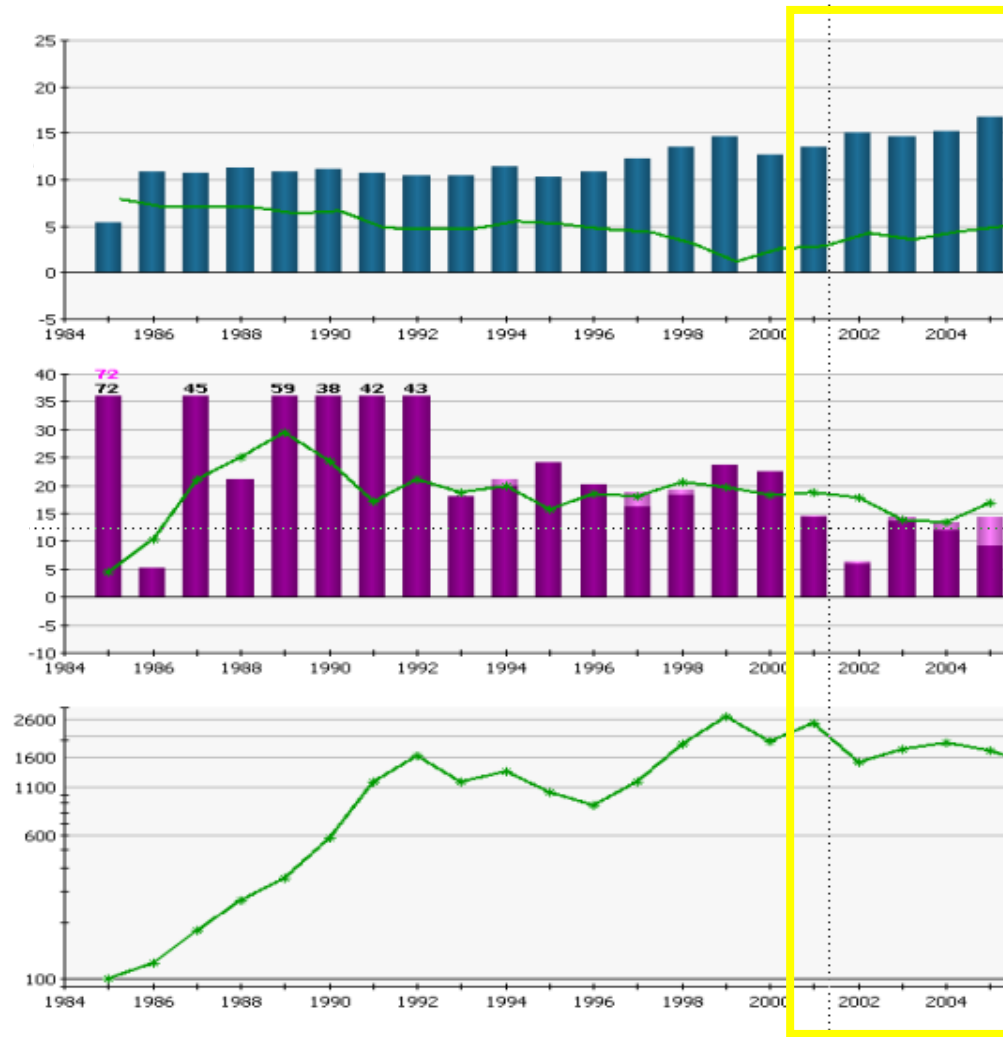
1996	1997	1998	1999	2000
-\$94	-\$452	-\$142	-\$135	-\$762



# HD 1990-2000 – Rising Price with Negative FCF



# HD 2000-2005 – Falling Price with Positive FCF



## HD 1990-2006 – When to own it?

### HD FCF 1996-2005

1996	1997	1998	1999	2000
-\$94	-\$452	-\$142	-\$135	-\$762
2001	2002	2003	2004	2005
\$2,570	\$2,053	\$3,037	\$3,956	\$2,603

*Sources: Bloomberg*

# SBUX – Good negative FCF or bad negative FCF?



# SBUX – Negative FCF, Signs of a Growing Business

## SBUX FCF 1991-2000

1991	1992	1993	1994	1995
-\$8	-\$7	-\$34	-\$87	-\$118
1996	1997	1998	1999	2000
-\$25	-\$74	-\$59	-\$51	\$2

*Source: Bloomberg*

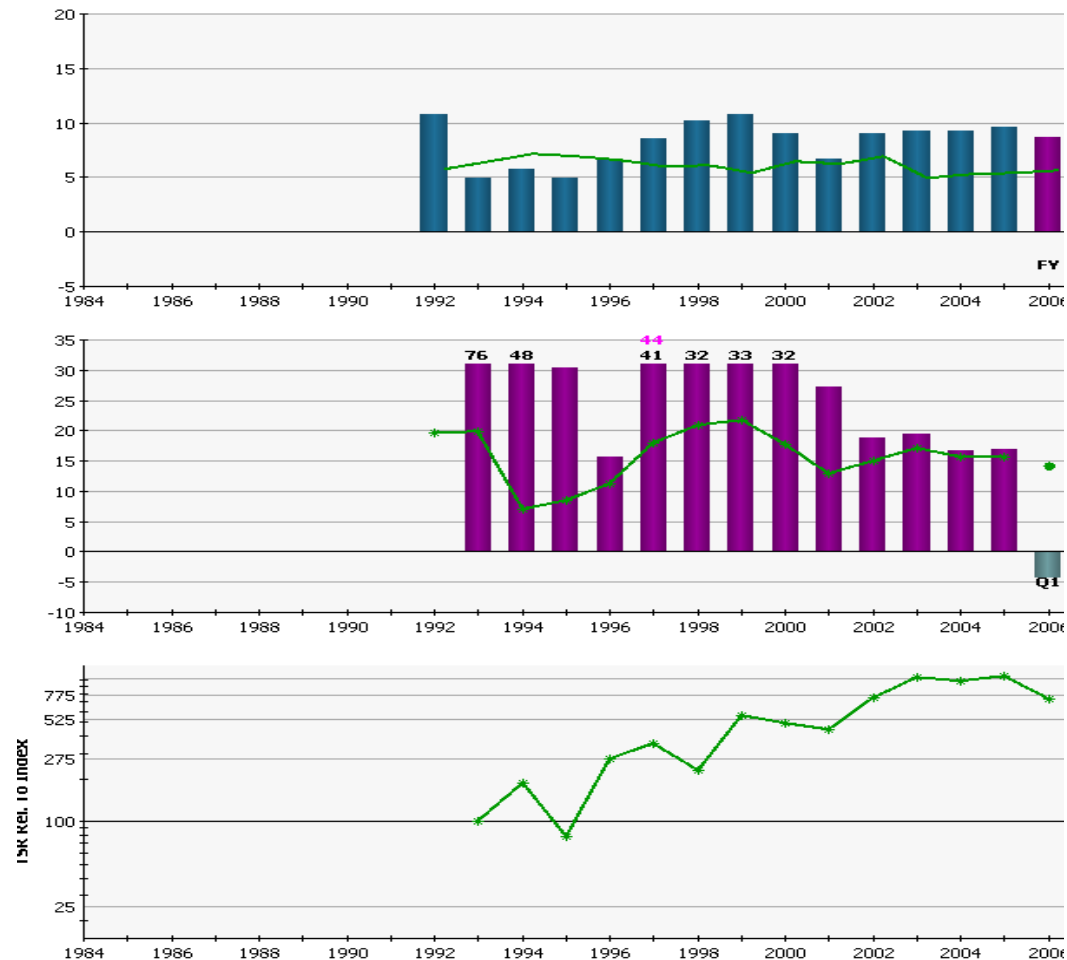
## PSUN – Negative FCF – good or bad?

### PSUN FCF 1995-2004

1995	1996	1997	1998	1999
-\$5	\$5	-\$3	-\$1	\$9
2000	2001	2002	2003	2004
-\$10	-\$35	\$36	\$111	\$61

*Source: Bloomberg*

# PSUN – Negative FCF – good or bad?



*To know oneself is  
to study oneself  
in action with  
another person.*

*-- Bruce Lee*





*EVA©: Economic Value Added*  
*(Operating Profit) – (Charge on Capital Employed)*

*OR*

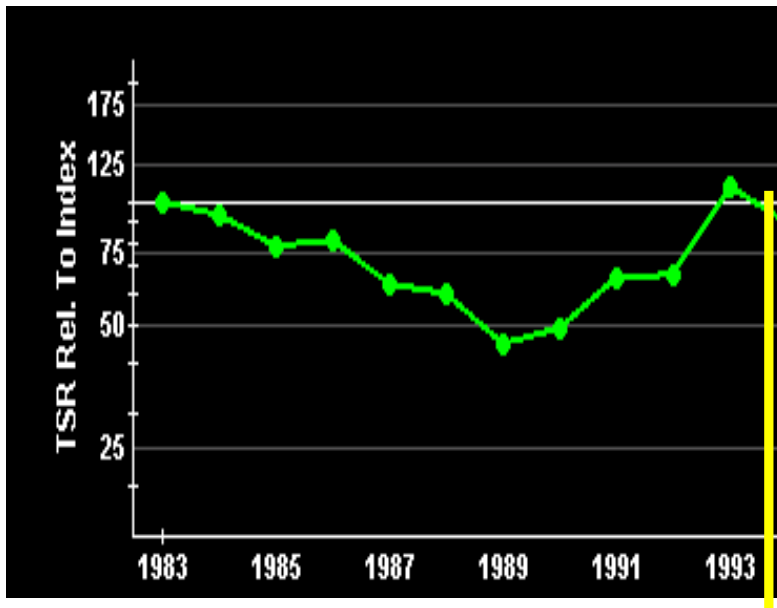
*(ROA-CoCap) \* Adjusted Assets*

*Aka economic profit*

*Aka residual income*

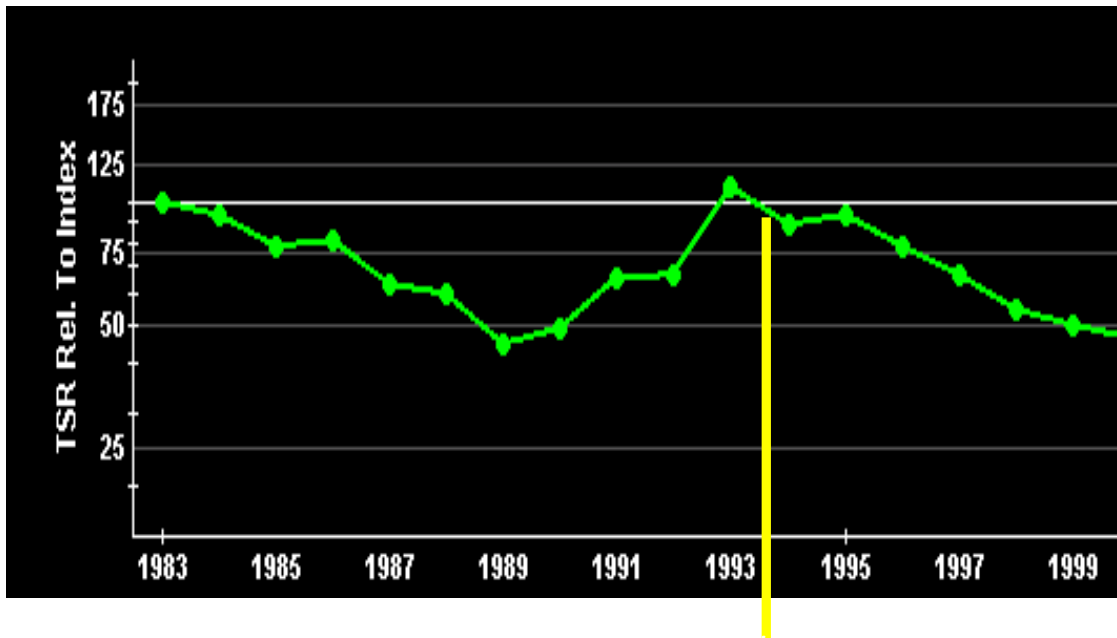
# What was the performance after article publication?

Briggs and Stratton was heralded for its EVA implementation...



# What was the performance after article publication?

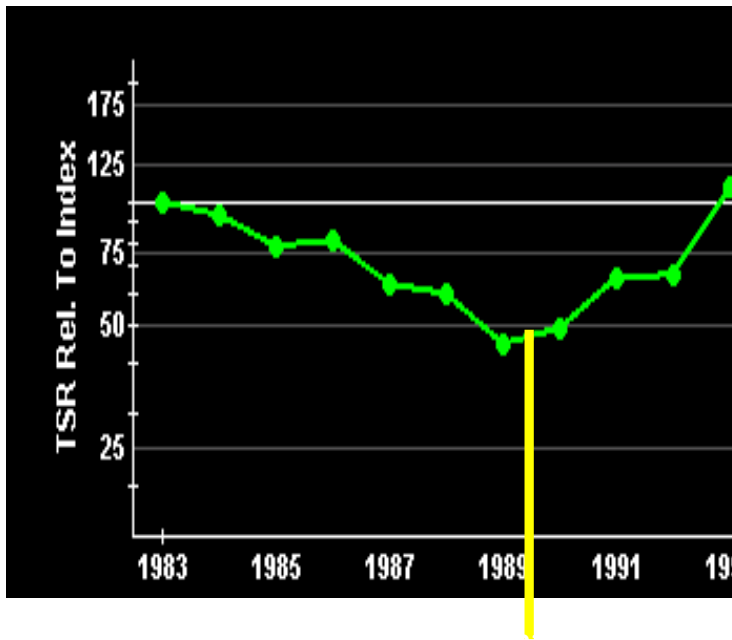
Briggs and Stratton was heralded for its EVA implementation...  
...which they stuck to for years...



# Examples of Stern Stewart's EVA in practice

## Briggs and Stratton

Briggs and Stratton was heralded for its EVA implementation  
Articles, and Stern Stewart's marketing, spoke of EVA adoption  
Specifically, magazines in 1994 showed performance  
Massively outperforming the market

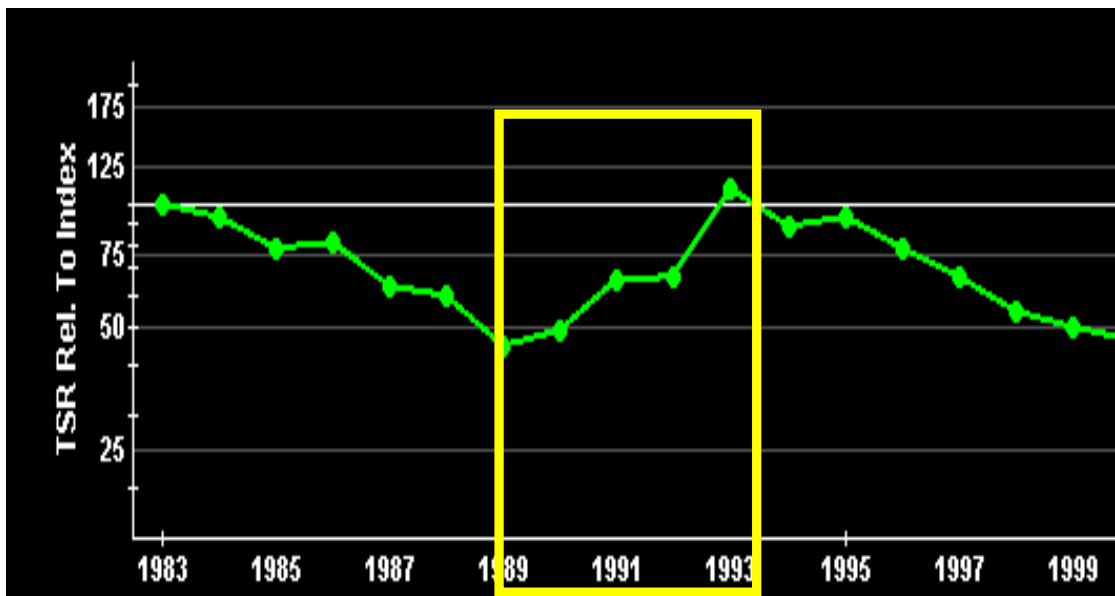


Is EVA “bad”? No, it must be recognized for its worth...

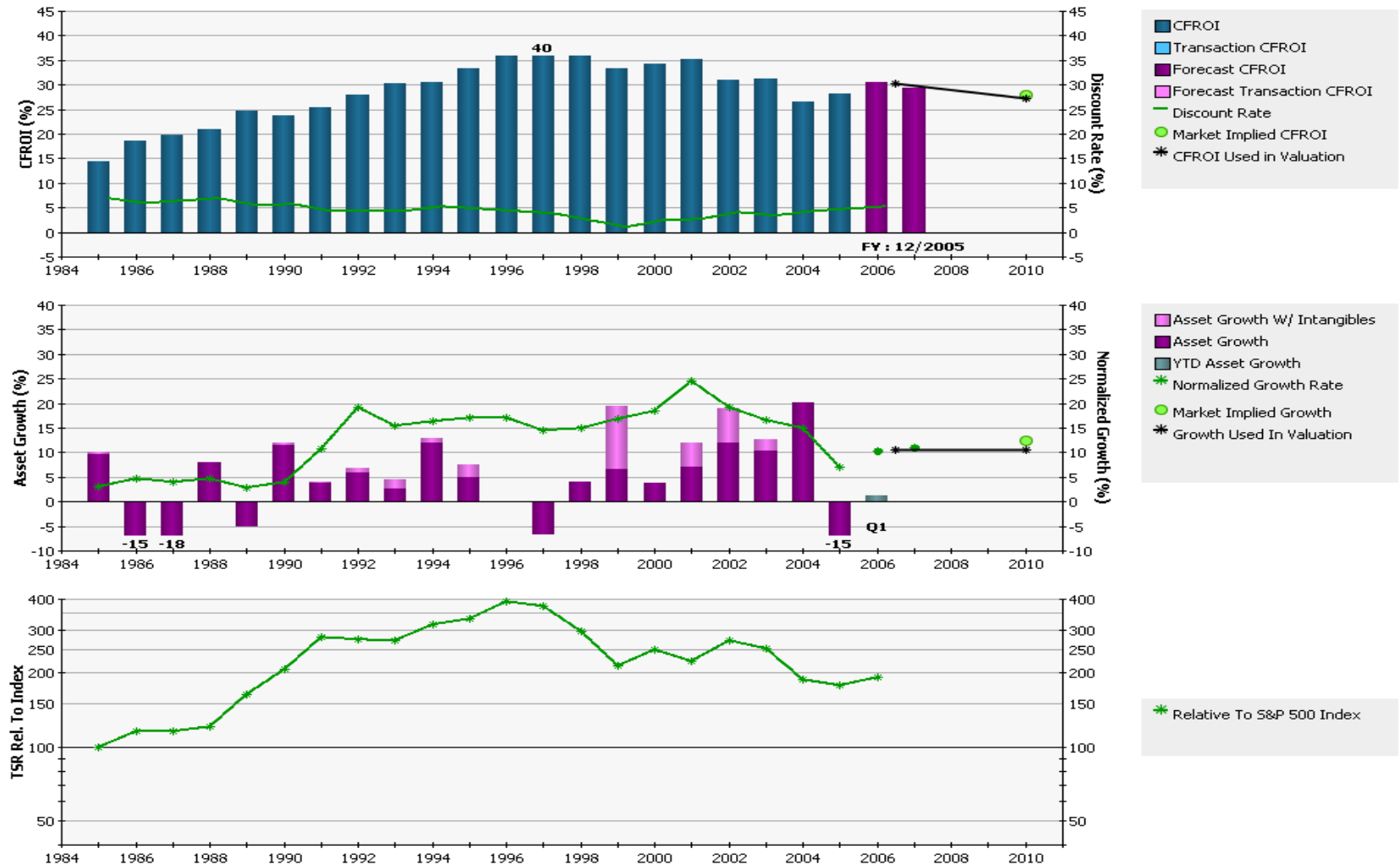
EVA is a particular metric for a particular behavior

EVA, or any metric, is no substitute for strategy

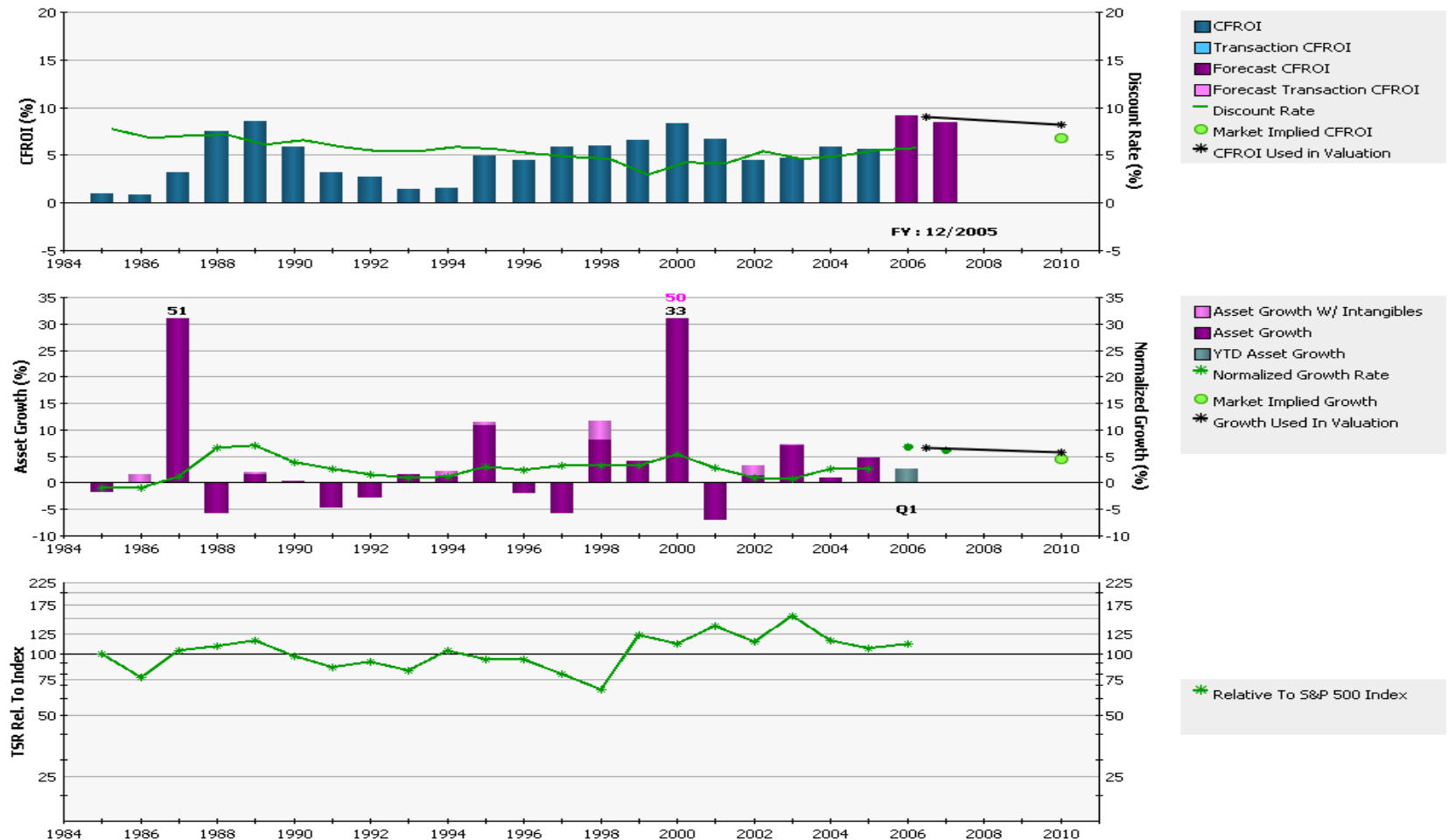
EVA is no substitute for planning execution



# KO - EVA and a growth mindset...



# AA - EVA and a growth mindset...



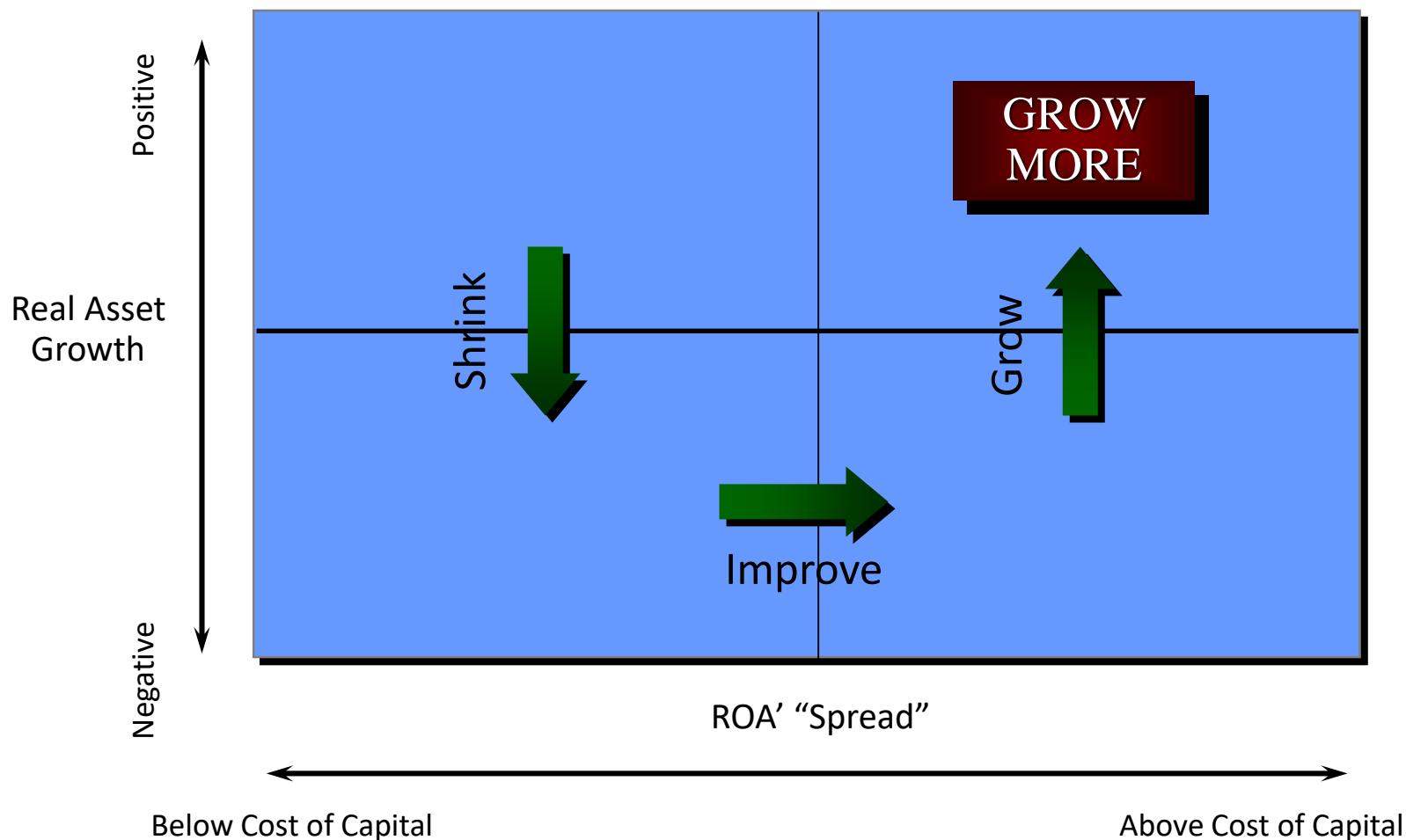
***“Take things as they are. Punch when you have to punch. Kick when you have to kick.”***

***-- Bruce Lee***





# Consider growth strategies in context of ROAs



# Knowing When to Grow and Where

Mark L. Frigo, Editor	Strategic Management
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## W

### Growth Isn't Always Good: Knowing When and Where to Grow | By Mark L. Frigo

When and where should a business invest and grow? This is a challenge facing management today. The key is having the insight and discipline to grow in areas that will drive long-term financial value and concomitantly knowing where to disinvest.

One of the lessons from Return Driven Strategy is "Growth isn't always good." Here I will present some guidelines from Return Driven Strategy that can provide a way for management to ensure that investment decisions are truly moving the company in the right direction. I will also share some insights from organizations that have made the right moves and adjustments to growth strategies.

#### Strategy Should Drive Capital Investment

This is a reasonable premise. Yet how often do we see the reverse situation where management inadvertently lets capital expenditures drive strategy and the direction of the company? Why would this be the case? Competing proposals for capital expenditures will make reference to strategy, of course, but how well are capital expenditures evaluated with a rigorous attention to how the capital expenditure drives financial value creation through the strategy?

Another problem is that operating plans and budget targets, not strategy, many times inadvertently drive investment decisions that work against long-term financial value creation and the business strategy itself. Here we see business units seeking to grow or protect sales and market share despite the fact that returns are below the cost of capital.

#### Knowing Where to Grow

In my ongoing research about the application of Return Driven Strategy, I see what separates great companies from mediocre ones. Many mediocre companies chase growth at the expense of long-term value creation.

High-performance companies, in contrast, show the discipline to grow and shrink in the right areas as determined by the goal tenets of Return Driven Strategy: Fulfill Otherwise Unmet Customer Needs and Target and Dominate Increasing Market Segments. These companies continuously align their investments and product and service offerings to fulfill customer needs in the right market segments and earn a return on investment above the cost of capital. The ROI "spread" (return on investment minus the cost of capital) of a company will be driven by the degree of the "otherwise unmet" customer need, the size and growth potential of the targeted market segments, and the operational excellence to deliver the offering with returns in excess of the cost of capital.

Companies like General Electric, Wal-Mart, Johnson & Johnson, Danaher Corporation, and Harley Davidson have shown a fervent discipline to invest in the right market segments and pull back investments in other markets. These companies have demonstrated an understanding of the true drivers of value creation inherent in the business strategy.

December 2004 | STRATEGIC FINANCE 7

Knowing where to Grow, Shrink and Improve.....

What is needed?

1. *Understanding what business segments generate "positive spread" (Growth Strategy)*
2. *Understanding what business segments generate "negative spread" (Productivity Strategy)*

"I do not fear the man  
who practices  
10,000 kicks  
one time...

I fear the man  
who practices  
one kick  
10,000 times."

-- Bruce Lee



Find a Company:

🔍 Enter a ticker or company name to get started

Ticker ⬆	Company ⬆	Industry ⬆	Market Cap ⬆
SEHK:700	Tencent Holdings Limited	Internet Software and Services	1,145,027.1 (CNY)
PSE:SM	SM Investments Corp.	Industrial Conglomerates	706,602.1 (PHP)
AAPL	Apple Inc.	Technology Hardware, Storage and Peripherals	674,949.6 (USD)
PSE:JGS	JG Summit Holdings, Inc.	Industrial Conglomerates	531,482.9 (PHP)
GOOGL	Google Inc.	Internet Software and Services	514,152.7 (USD)
PSE:TEL	Philippine Long Distance Telephone Company	Wireless Telecommunication Services	482,668.6 (PHP)
MSFT	Microsoft Corporation	Systems Software	438,696.2 (USD)
SGX:Y92	Thai Beverage Public Company Limited	Distillers and Vintners	427,666.6 (THB)
SEHK:1	CK Hutchison Holdings Limited	Industrial Conglomerates	402,178.5 (HKD)
PSE:MER	Manila Electric Co.	Electric Utilities	370,815.5 (PHP)
XOM	Exxon Mobil Corporation	Integrated Oil and Gas	351,643.5 (USD)
PSE:AEV	Aboitiz Equity Ventures Inc.	Industrial Conglomerates	318,537.2 (PHP)
AMZN	Amazon.com Inc.	Internet Retail	309,087.6 (USD)
FB	Facebook, Inc.	Internet Software and Services	302,864.0 (USD)
GE	General Electric Company	Industrial Conglomerates	302,468.4 (USD)
PSE:GLO	Globe Telecom Inc.	Wireless Telecommunication Services	301,320.3 (PHP)
JNJ	Johnson & Johnson	Pharmaceuticals	282,006.9 (USD)
PSE:JFC	Jollibee Foods Corp.	Restaurants	221,416.1 (PHP)
BABA	Alibaba Group Holding Limited	Internet Software and Services	210,064.1 (CNY)
PFE	Pfizer Inc.	Pharmaceuticals	209,450.0 (USD)



# Why Bruce Lee Would Have Been Great in Finance

**Professor Joel Litman**  
**March 2016**

**Valens Securities, Inc. and The Institute of Strategy & Valuation**  
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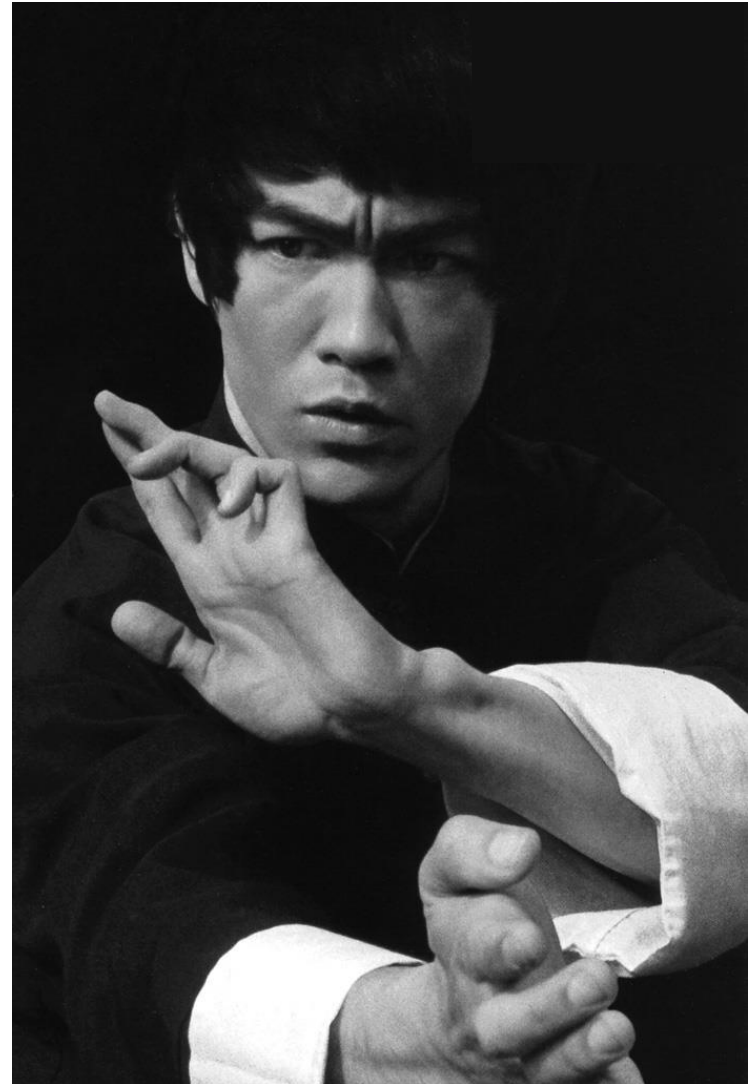
# The 8th Wonder of the World

# 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

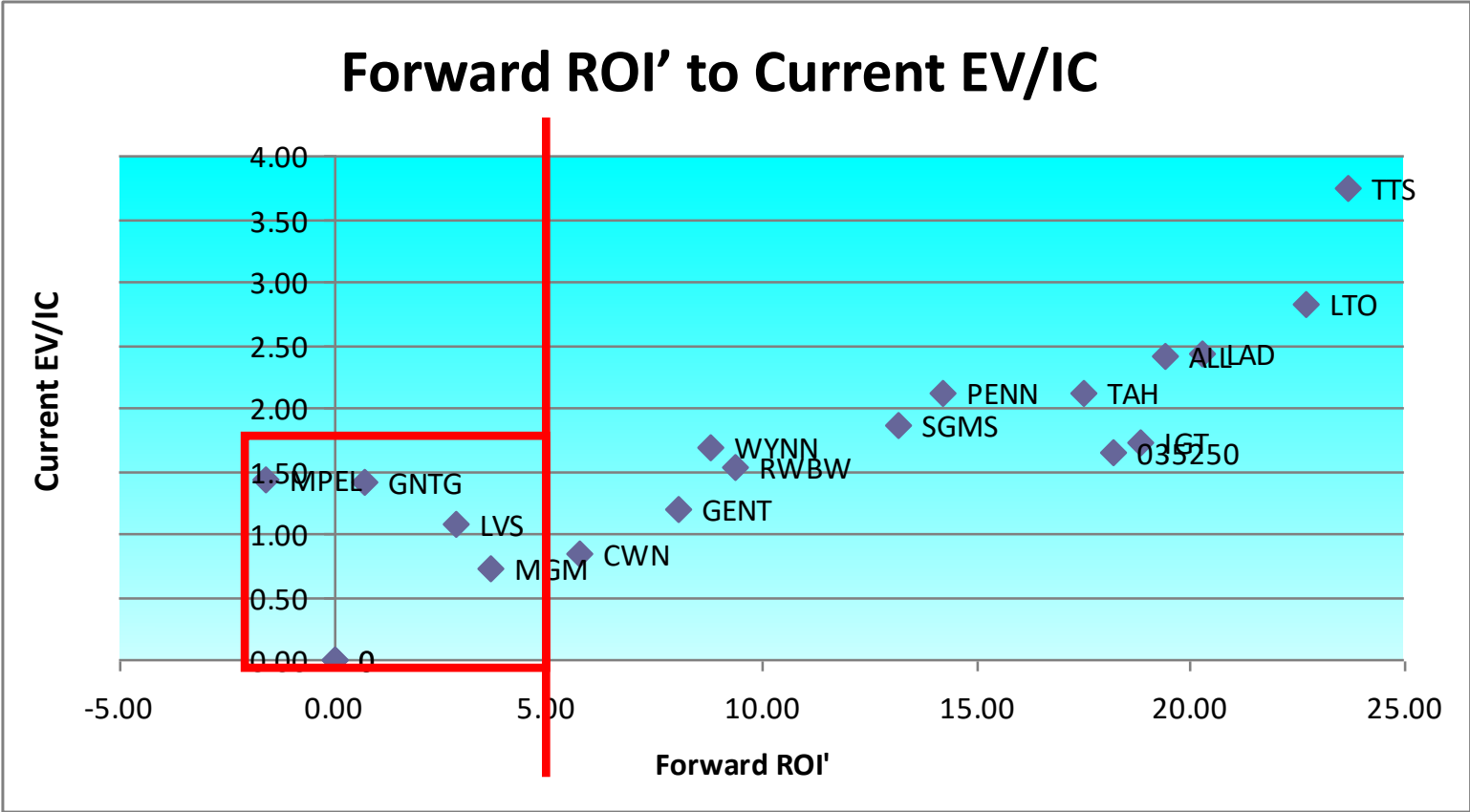
"Absorb what is useful,  
discard what is not, add  
what is uniquely your own"

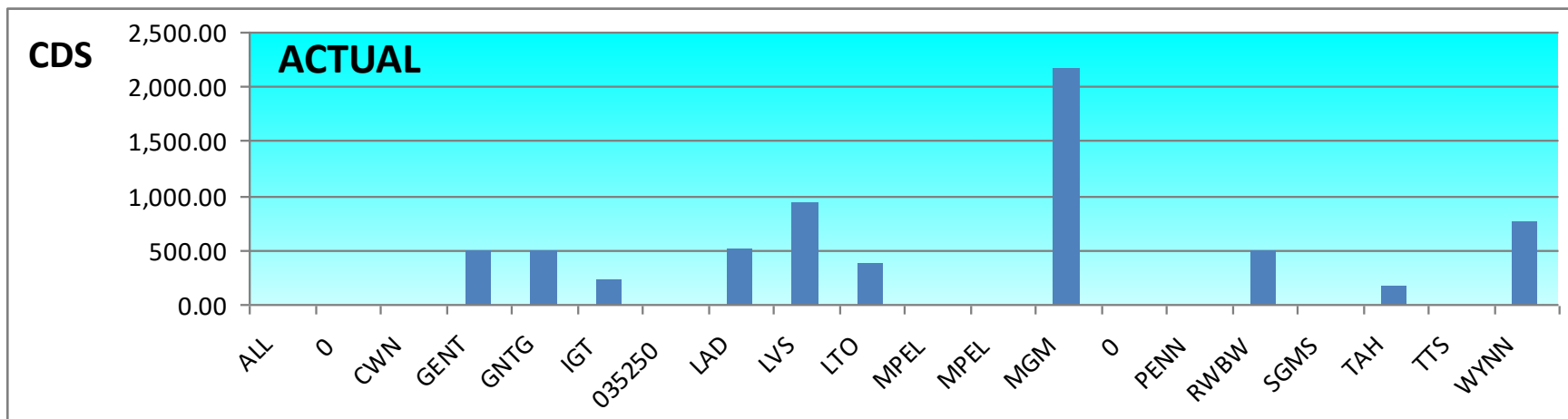
-- Bruce Lee

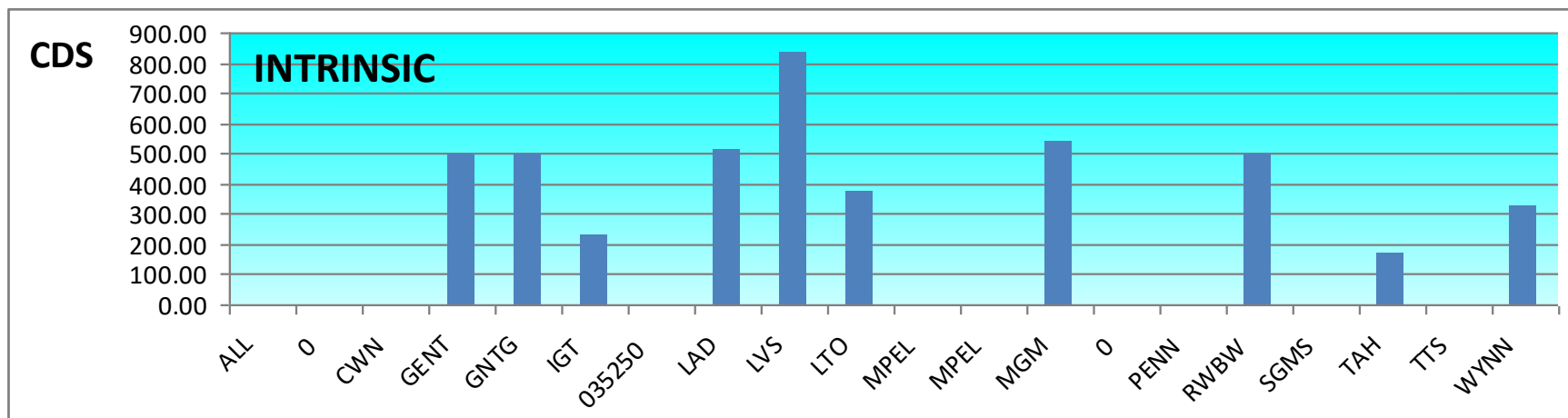


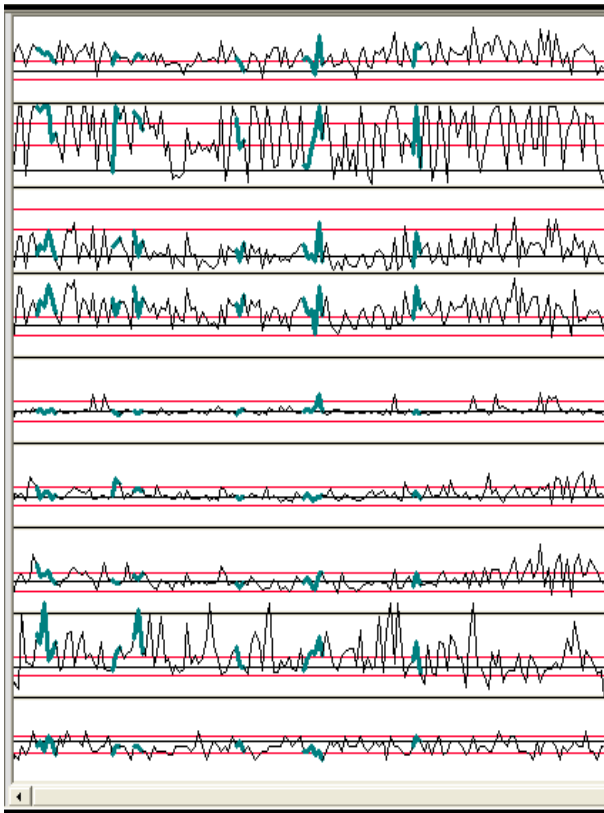


# Global Casinos (Oct 2008): Difference in variables









CEO and COO, Fall 2008:

Highly, highly questionable:

*“...attendance overall is up...”*

*“...penthouses have high demand...”*

*“...increase in ferry usage...”*

*“...no liquidity problems...”*



3/13/09

120  
105  
90  
75  
60  
45  
30  
15  
0