COMPANIES, FUNDING & THE CAPITAL MARKETS

David Yates
FinanceTalking
January 13, 2020
Companies & Funding

1. Imagine we’re starting a company. We need some money to get started. What are our options?

2. Now our business is up and running and profitable. What are our options now?
Funding Characteristics?
Compare debt and equity funding from the company’s point of view
Leverage – How it Works 1
High leverage drives returns to shareholders up disproportionately in good times

High leverage = lots of debt

House 200,000
Mortgage 150,000
Equity 50,000

House prices rise by 25%

House 250,000
Mortgage 150,000
Equity 100,000

Equity doubles
With addition of 50,000 profit
Leverage – How it Works 2

High leverage drives returns to shareholders down disproportionately in bad times.

House prices fall by 25%

Equity disappears
Wiped out by the 50,000 loss

In which situation would you be most comfortable having a big mortgage?
• Employed
• Self-employed
Suitability for High Financial Leverage

Is the company profitable/cash generative? 

- no → Not suitable
- yes → Are profits/cash flows likely to be particularly susceptible to economics/interest rates?

Are profits/cash flows likely to be particularly susceptible to economics/interest rates? 

- no → Are profits/cash flows otherwise likely to be volatile? 
- yes → Not suitable

Are profits/cash flows otherwise likely to be volatile? 

- no → Suitable
- yes → Not suitable

What makes profits volatile?

- High operational leverage (high fixed costs)
- Single large customer or supplier
- Susceptibility to raw material prices
- Dependency on key technologies or key people
- Weather or other factors such as politics
Question...

Leverage should be high in the following sector
Is this true or false?

1. Oil
2. Utilities
3. Real estate investment
4. Tobacco

a. True
b. False
c. It depends...
Funding Characteristics
Comparison of debt and equity funding from the company’s point of view

The business 200

Debt 100
- Must be repaid
- Compulsory interest (tax deductible)
- Covenants
- Cheaper (lower risk for lender)

Equity 100
- Permanent capital
- Dividends at directors’ discretion
- Votes (including board of directors)
- More expensive (more risk for investor)
How Profits Fit In…
How the providers of capital get their return

<table>
<thead>
<tr>
<th>INCOME STATEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
</tr>
<tr>
<td>- Expenses other than D&amp;A</td>
</tr>
<tr>
<td>-- Depreciation &amp; amortization</td>
</tr>
<tr>
<td>= Operating income</td>
</tr>
<tr>
<td>- Interest</td>
</tr>
<tr>
<td>= Income before tax</td>
</tr>
<tr>
<td>-Tax @ 20%</td>
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<tr>
<td>= Net income</td>
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<tr>
<td>EPS = net income/number of shares</td>
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<td>Dividend per share</td>
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The business: 200,000
Debt: 100,000
Equity: 100,000

Remember shareholders also expect capital gains (Dividends + gains = TSR)
Question...

Would TSR (total stockholder return) of 12% in an average year be good enough?

a. Yes probably

b. No definitely not
Weighted Average Cost of Capital (WACC)

From the business’s perspective, we need to measure returns against WACC.

The business is valued at 200,000.

100,000 Debt @ 4% (after tax relief)

Half the capital is debt @ 4%

Half the capital is equity @ 10%

100,000 Equity @ 10%

Weighted average cost of capital (WACC) is 7%.

INCOME STATEMENT

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Revenue</td>
<td>100,000</td>
</tr>
<tr>
<td>- Expenses other than D&amp;A</td>
<td>-70,000</td>
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<tr>
<td>-- Depreciation &amp; amortization</td>
<td>-10,000</td>
</tr>
<tr>
<td>= Operating income</td>
<td>20,000</td>
</tr>
<tr>
<td>- Interest</td>
<td>-5,000</td>
</tr>
<tr>
<td>= Income before tax</td>
<td>15,000</td>
</tr>
<tr>
<td>- Tax @ 20%</td>
<td>-3,000</td>
</tr>
<tr>
<td>= Net income</td>
<td>12,000</td>
</tr>
<tr>
<td>EPS = net income/number of shares</td>
<td>$4</td>
</tr>
<tr>
<td>Dividend per share</td>
<td>$2</td>
</tr>
</tbody>
</table>
Value Creation
Does return on capital meet or beat the average cost of that capital?

The business 200,000

100,000 Debt @ 4%

200,000

20,000

= 10% pre-tax

= 8% post-tax

ROCE is 8%

WACC is 7%

so the company is creating value i.e. ROCE > WACC

100,000 Equity @ 10%

INCOME STATEMENT

| Item                                      | Amount  
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Summary – Funding & Shareholder Value

1. Corporate funding comes from a mixture of equity and debt
   ✓ Equity is more expensive because shareholders require more return to compensate them for the risk they’re taking
   ✓ Debt is cheaper and interest is tax deductible

2. Weighted Average Cost of Capital
   ✓ WACC is the average of the costs of equity and debt, weighted according to the proportions from each source
   ✓ WACC is influenced by financial leverage

3. To create value, companies must make a return on capital that is higher than the cost of that capital
   ✓ TSR must meet or beat cost of equity
   ✓ After tax ROCE must meet or beat WACC
   ✓ Shows investors (in equity and debt) are being rewarded for the risk they’re taking
Capital Markets Big Picture

Issuers of bonds and shares

Companies

Advisory

Investment

Bank

Sell-side

Capital markets

Financial Regulator

Corporate Governance

Fund Managers (buy-side)

Sovereign wealth

Pensions

Insurance

Mutual funds

Hedge funds

Retail investors
Key Regulations

Companies

Issuers of bonds and shares

Capital markets

FINANCIAL REGULATOR

Securities & Exchange Commission (SEC)

FINANCIAL REGULATOR

✓ Electronic reporting (10-K for annual report, 10-Q for quarterlies & 8-K for other)
✓ Reg FD – fair disclosure of material information
✓ Reg G – rules for non-GAAP info (adjusted numbers etc)

Sell-side

✓ Officer certifications
✓ Majority independent directors
✓ Charters for committees
✓ Website disclosure of governance matters & charters
✓ Risk management & other disclosures in proxy statements

CORPORATE GOVERNANCE

Sarbanes-Oxley

Portfolio Managers (buy-side)

Sovereign wealth
Pensions
Insurance
Mutual funds
Hedge funds
Retail investors

Portfolio Managers (buy-side)
Your Investments

1. How many of you save or invest?
2. Where do you put your savings or what do you invest in?
3. Do you have a pension?
4. Do you have any life insurance?
5. Where does your pension and life insurance money go?
Institutional Investors $120tn

- Sovereign wealth ~$7.5tn
  - Country funds
  - China, Norway, Kuwait, Abu Dhabi, Singapore etc

- Pensions ~$40tn
  - 40yr money
  - Occupational pensions
  - Defined contribution
  - Defined benefit

- Insurance ~$30tn
  - 25yr money
  - Mainly life insurance funds

- Mutual funds ~$40tn
  - 3-5yr money
  - Pooled investment vehicles
  - Used by other fund managers & retail investors

- Conventional funds

- Hedge ~$2.5tn

- Alternative

- Mainly designed for sophisticated investors
- May use leverage & shorting
The Role of Investment Banks

Issuers of bonds and shares

Companies

Investment Bank

Advisory
- M&A
- ECM
- DCM

Sell-side
- Research
- Sales
- Trading

Capital markets

+ Corporate Access

Financial Regulator

Advisory fees from companies

Commissions from investors

Sovereign wealth
Pensions
Insurance
Mutual funds
Hedge funds
Retail investors

Corporate Governance

Portfolio Managers (buy-side)
Indices & Jargon

out-performing

under-performing

index
S&P 500 Performance (ft.com January 2020)
Question...

A sell-side analyst invests in your company’s shares.

a. True
b. False
Financial Audiences

Issuers of bonds and shares

Companies

Capital markets

Investment Bank

Advisory

Sell-side

Portfolio Managers (buy-side)

Sovereign wealth
Pensions
Insurance
mutual funds
Hedge funds
Retail investors
The Buy-Side
Portfolio managers & buy-side analysts expect regular access to senior management

From the shares:
- Return on investment
  - Dividends
  - Capital gains
- Liquidity
  - Size
  - Free float

From the company:
- Information to justify the investment decision

Growth, income or value?
Top-down or bottom up?
Active or passive? Or activist?
The Sell-side
Sell-side analyst and sales team expect regular access to senior management

Who?
- Often accountants or industry specialists
- Sector specialist – researches your company & competitors

What?
- Number focussed (must forecast at least 3 years) in order to value the business
- News creates an opportunity to recommend shares as buy or sell & generate commissions

MiFID* II in Europe required research to be explicitly paid for rather than given away from 2018 (fewer analysts on the sell-side, less research being distributed)

* Markets in Financial Instruments Directive
Super Stores Co

Pan Europe Retail

ABC BANK
January 2020

Hi alpha
Long term growth

REASON FOR REPORT
Full year earnings

Summary Forecasts

<table>
<thead>
<tr>
<th>m</th>
<th>2019A</th>
<th>2020E</th>
<th>2021E</th>
<th>2022E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>2,550</td>
<td>2,933</td>
<td>3,372</td>
<td>3,878</td>
</tr>
<tr>
<td>EBITDA</td>
<td>106.5</td>
<td>122.5</td>
<td>141.6</td>
<td>162.9</td>
</tr>
<tr>
<td>EBIT</td>
<td>76.5</td>
<td>88.0</td>
<td>101.2</td>
<td>116.3</td>
</tr>
<tr>
<td>EPS</td>
<td>0.42</td>
<td>0.48</td>
<td>0.56</td>
<td>0.64</td>
</tr>
<tr>
<td>DPS</td>
<td>0.21</td>
<td>0.24</td>
<td>0.28</td>
<td>0.32</td>
</tr>
<tr>
<td>P/E</td>
<td>15</td>
<td>13</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Yield</td>
<td>3.4%</td>
<td>3.8%</td>
<td>4.5%</td>
<td>5.1%</td>
</tr>
</tbody>
</table>

Summary

Super Stores results came in at the top of expectations as usual and although there was no upgrade for 2020, management’s body language was relaxed and confident.

International growth is accelerating and UK LFL was still very strong. We continue to see lots of potential for this new format both here and in overseas markets.

It is early days in the new Asian markets, but Super Stores’ low risk approach of partnering local businesses has worked in Taiwan and the early signs from China are promising.

Super Stores’ discount model should prove defensive in current market conditions – the UK MD confirmed that they are already seeing shoppers switch from conventional supermarkets – and we think the margin is sustainable given their very low cost operating model.

Super Stores currently trades at a slight premium (based on 2020 P/E) to its pan-European peer group but emerging markets exposure will help the company to grow at a more rapid rate than its peers. We believe that this would justify a 10% premium to its peers. Our DCF valuation also supports our 12-month price target of 8.50.

IMPORTANT DISCLOSURES ARE INCLUDED IN THE APPENDIX AT THE END OF THIS REPORT
**Super Stores Co**

**REASON FOR REPORT**

**RECOMMENDATION**

**CURRENT PRICE**

**TARGET PRICE**

**BUY**

**6.25**

**8.50**

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**Summary**

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**What Analysts Want**

- Clear communication of the business model and its drivers
- Clear communication of numbers
- Answers to questions including detail on the numbers - fast
- To be seen to be right
- Access to senior management
- News or an angle that will make money for clients
The Role of Guidance
Guidance is a key element of managing market expectations

- Strategic Plan
- Budget: 1 year financial plan
- Actual Results: (monthly)
- Forecast
- Guidance: (IR)
- Sell-side analysts
Monitoring Consensus – A Key Part of IR

Consensus = average of sell-side analysts’ forecasts

Merck is covered by several renown sell-side analysts who make financial projections on the company. Merck authorizes VARA Research to compile an accurate and up to date consensus of these various projections that are published once per quarter. Merck does not endorse these estimates and the figures are gathered independently by VARA Research.

VARA CONSENSUS EXPECTATIONS FOR FULL YEAR 2019
(AS OF NOVEMBER 2019)

<table>
<thead>
<tr>
<th>in € Million</th>
<th>High</th>
<th>Mean</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>16,139.9</td>
<td>16,004.6</td>
<td>15,805.0</td>
</tr>
<tr>
<td>EBITDA (pre one-time items) 1)</td>
<td>4,402.3</td>
<td>4,322.1</td>
<td>4,275.2</td>
</tr>
<tr>
<td>EPS (pre one-time items) 1)</td>
<td>€ 5.76</td>
<td>€ 5.66</td>
<td>€ 5.56</td>
</tr>
</tbody>
</table>

The first question analysts and investors will ask themselves around earnings is: “Were results better or worse than last year?”

a. True

b. False
Earnings Releases

Fund manager

- Are earnings in line with consensus?
- What’s the company saying about the future?
- Should I adjust my position in the stock?

Analyst

- Are earnings in line with my forecast?
- What’s the company saying about the future and how does this affect my model?
- How is the share price reacting and is there an opportunity for a recommendation?

Media

- Are earnings in line with consensus?
- What’s the company saying about the future?
- How’s the share price reacting and what are others saying?
- Is there a good story?
Key Audience Perspectives

Issuers of bonds and shares

- What makes a compelling investment story?

Companies

Capital markets

- What is the risk of default on the bonds?

Sovereign wealth
- Should I recommend the shares as a buy or sell?

Pensions
- Should I hold the shares in my portfolio?

Insurance

Sell-side

Advisory

Bank

Portfolio Managers (buy-side)

- Mutual funds
- Hedge funds
- Retail investors
Requirements of Key Audiences

**Fund manager**
- Returns high enough to compensate for the risk
- Information that justifies the investment decision
- Management who deliver on promises

**Analyst**
- An angle to earn commissions
- Guidance on key inputs to valuation models
- Management who deliver on promises

**Media**
- A good story
- Has the company met market expectations?
- What is the company saying about the outlook?
The Role of IR in the Capital Markets

OBLIGATIONS / OPPORTUNITIES
- Turning regulatory obligations into opportunities

Companies

Issuers of bonds and shares

REPUTATION
- Enhancing corporate reputation
- Telling a compelling investment story

Valuation
- Effective communication should help ensure share price reflects company's true value

ACCESS TO CAPITAL
- Information is a pre-requisite for investment decisions
- Companies want to build and retain access to capital

Capital markets

Sovereign wealth
Pensions
Insurance
Mutual funds
Hedge funds
Retail investors

Portfolio Managers (buy-side)

Advisory

Investment Bank

Corporate Governance

Financial Regulator
Summary – Capital Markets

1. **Investors**
   - ✓ Investment funds come mainly from pensions, insurance & mutual funds
   - ✓ Portfolio managers allocate their capital to the investments that give the best return for the perceived risk
   - ✓ Sell-side analysts are key influencers but there are also increasing numbers of buy-side analysts

2. **Sell-side analysts**
   - ✓ Forecast, value and recommend
   - ✓ Need guidance to help with forecasting
   - ✓ Consensus = average of analysts’ forecasts
   - ✓ Managing consensus is a key part of IR

3. **Communications opportunities**
   - ✓ Main opportunities are around the financial calendar
   - ✓ Investors and analysts expect access to senior management via earnings presentations, investor roadshows, capital markets days etc
Questions...

• What can you do to keep learning?
COMPANIES, FUNDING & THE CAPITAL MARKETS

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