COMPANIES, FUNDING & THE CAPITAL MARKETS

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FinanceTalking

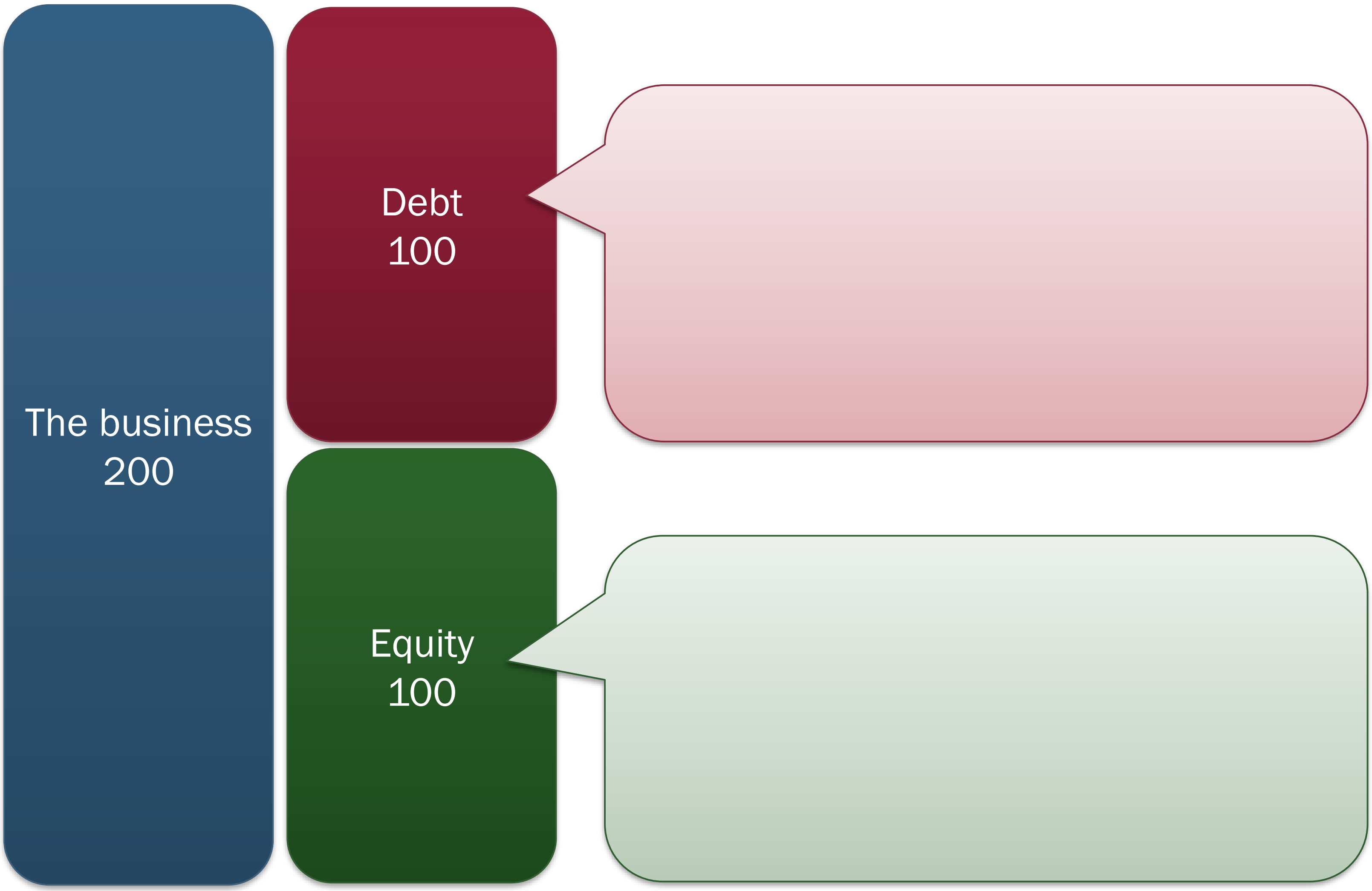
January 13, 2020

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?

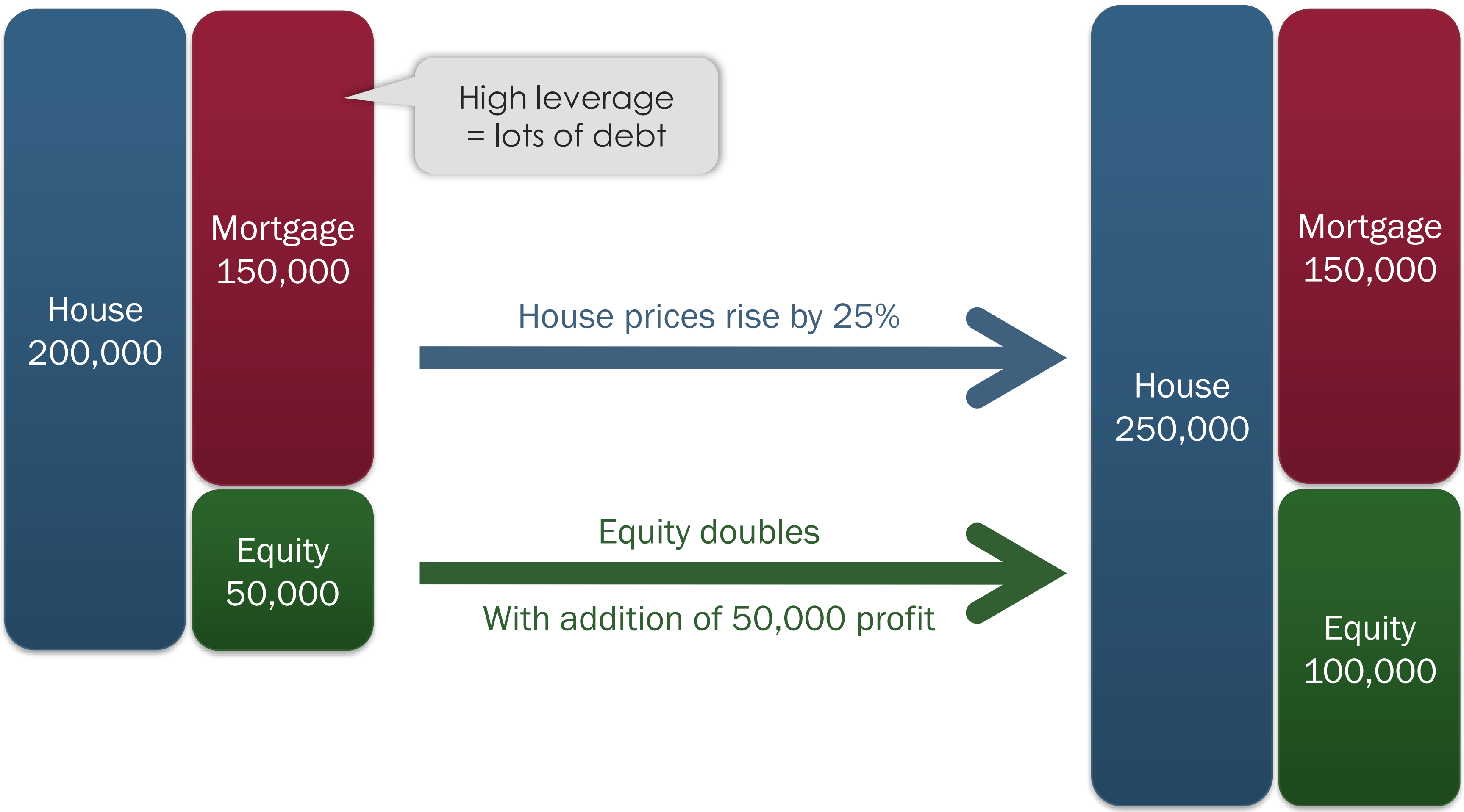
Funding Characteristics?

Compare debt and equity funding from the company's point of view



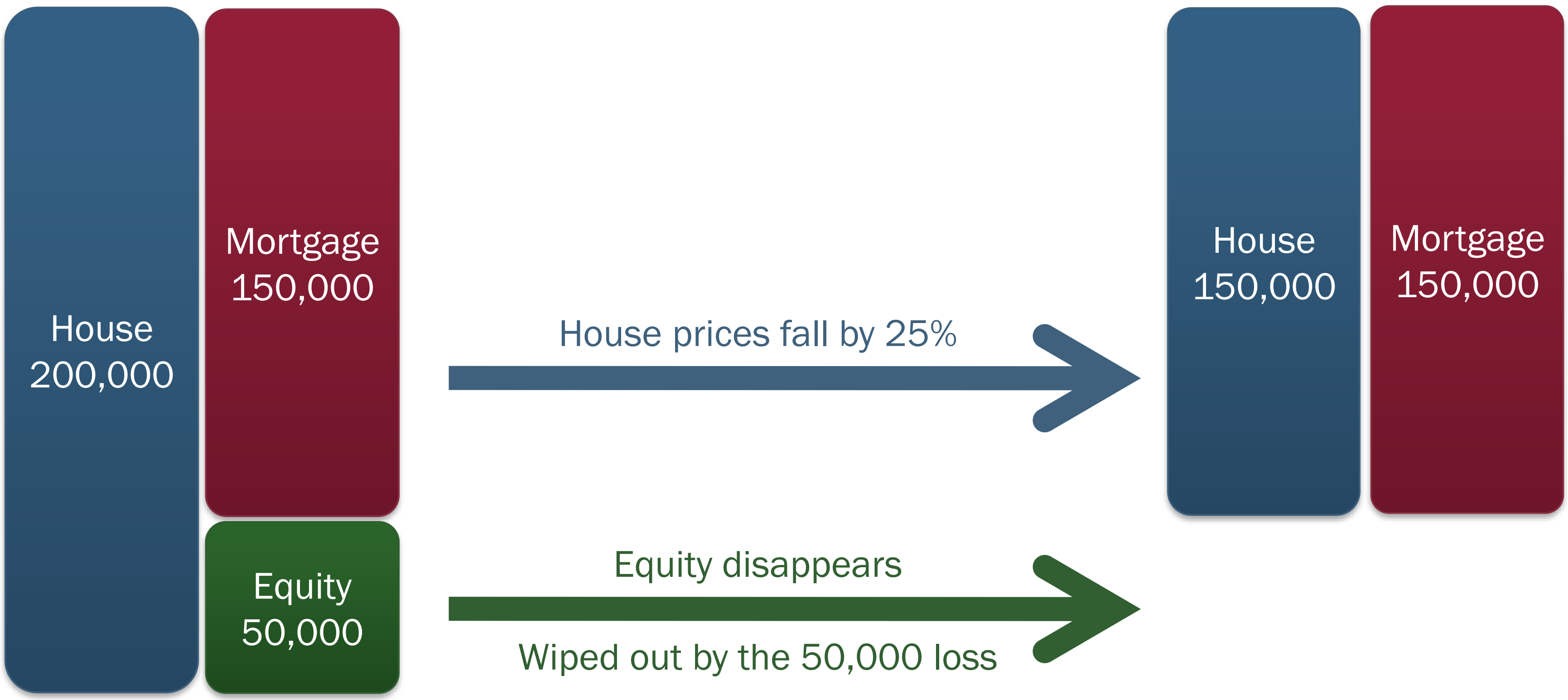
Leverage – How it Works 1

High leverage drives returns to shareholders up disproportionately in good times



Leverage – How it Works 2

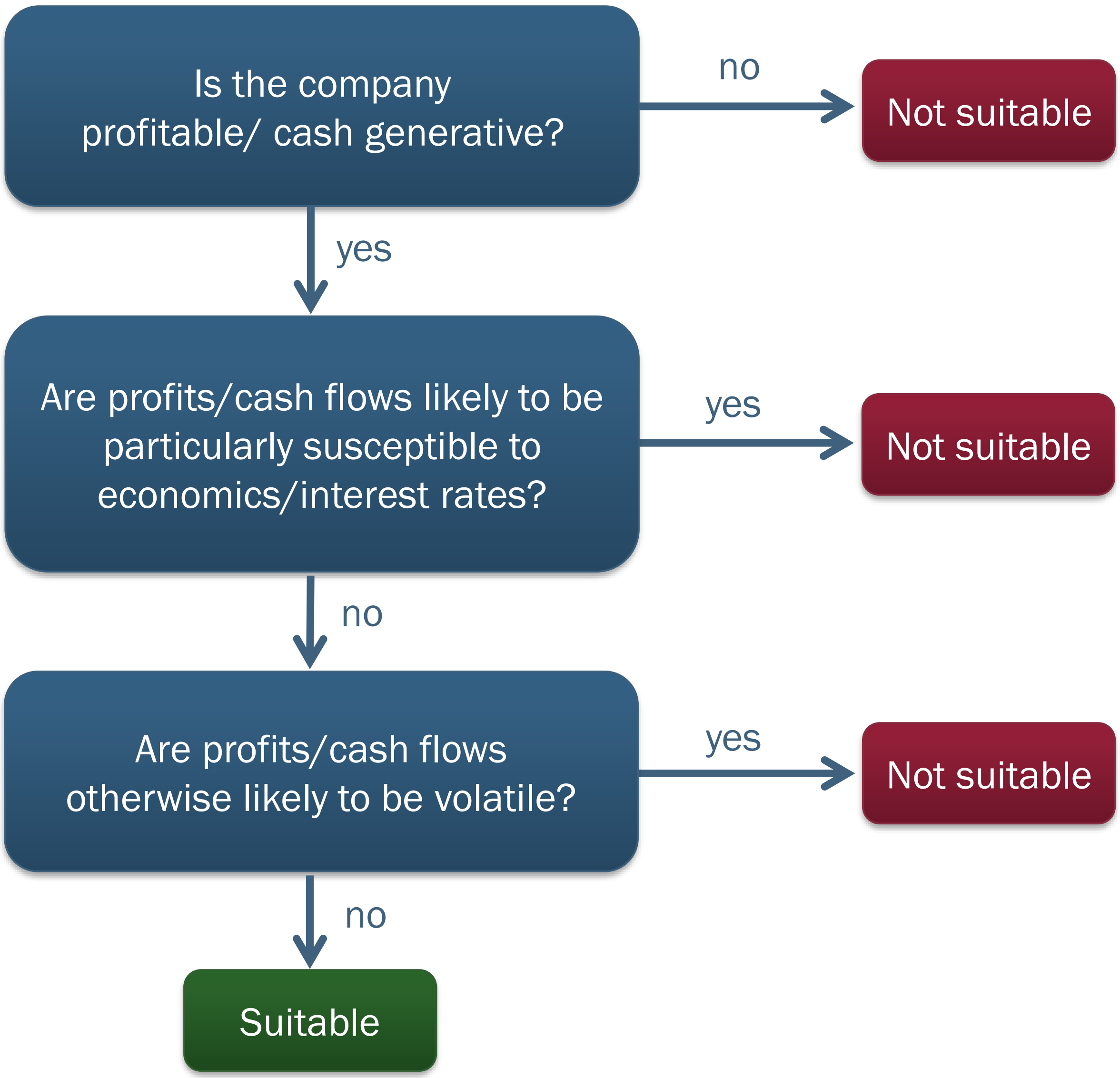
High leverage drives returns to shareholders down disproportionately in bad times



In which situation would you be most comfortable having a big mortgage?

- Employed
- Self-employed

Suitability for High Financial Leverage



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

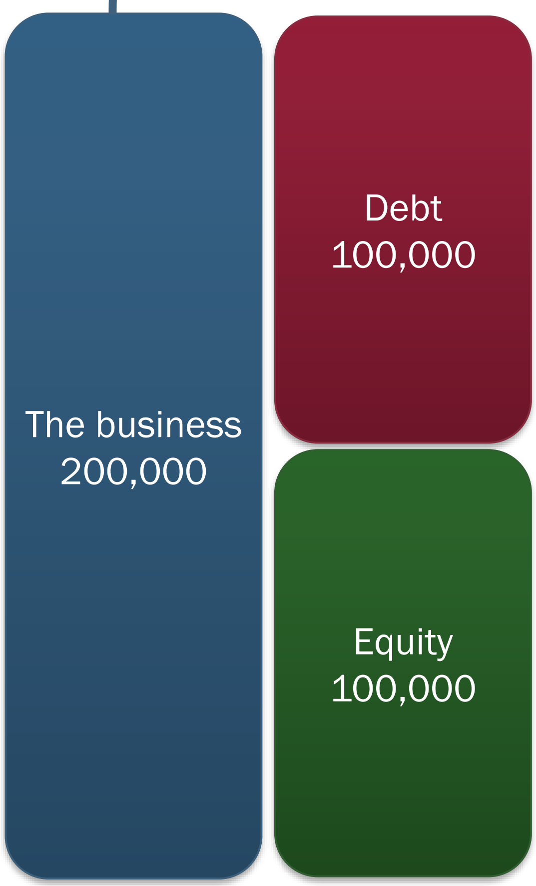
- Must be repaid
- Compulsory interest (tax deductible)
- Covenants
- Cheaper (lower risk for lender)

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



INCOME STATEMENT	
Revenue	100,000
- Expenses other than D&A	-70,000
-- Depreciation & amortization	-10,000
= Operating income	20,000
- Interest	-5,000
= Income before tax	15,000
-Tax @ 20%	-3,000
= Net income	12,000
EPS = net income/number of shares	$4
Dividend per share	$2

Remember shareholders also expect capital gains (Divis + gains = TSR)

Question…

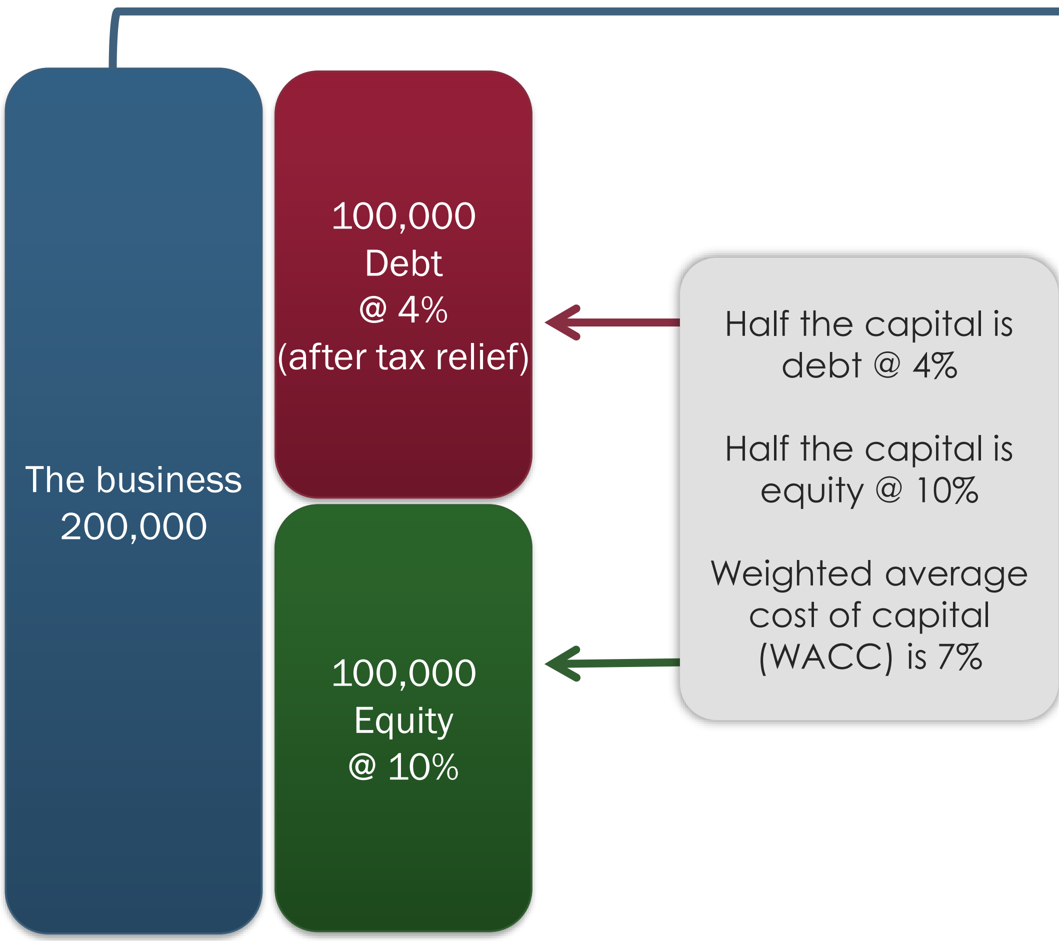
Would TSR (total stockholder return) of 12% in an average year be good enough?

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



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Value Creation

Does return on capital meet or beat the average cost of that capital?

The business
200,000

100,000
Debt
@ 4%

100,000
Equity
@ 10%

ROCE/ROIC

$$\frac{20{,}000}{200{,}000}$$

= 10% pre-tax

= 8% post-tax

ROCE is 8%
WACC is 7%
so the company is creating value
i.e. ROCE > WACC

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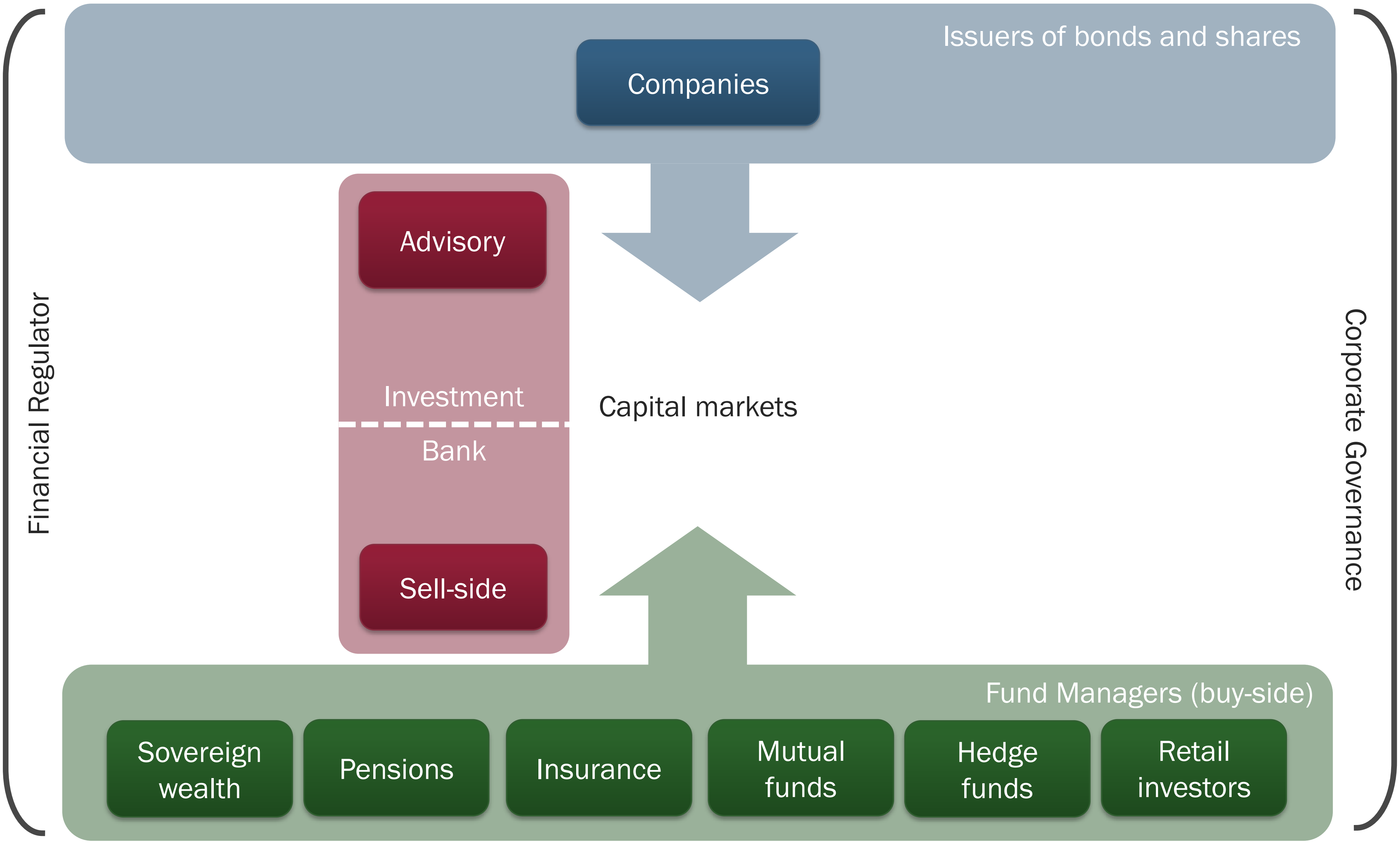
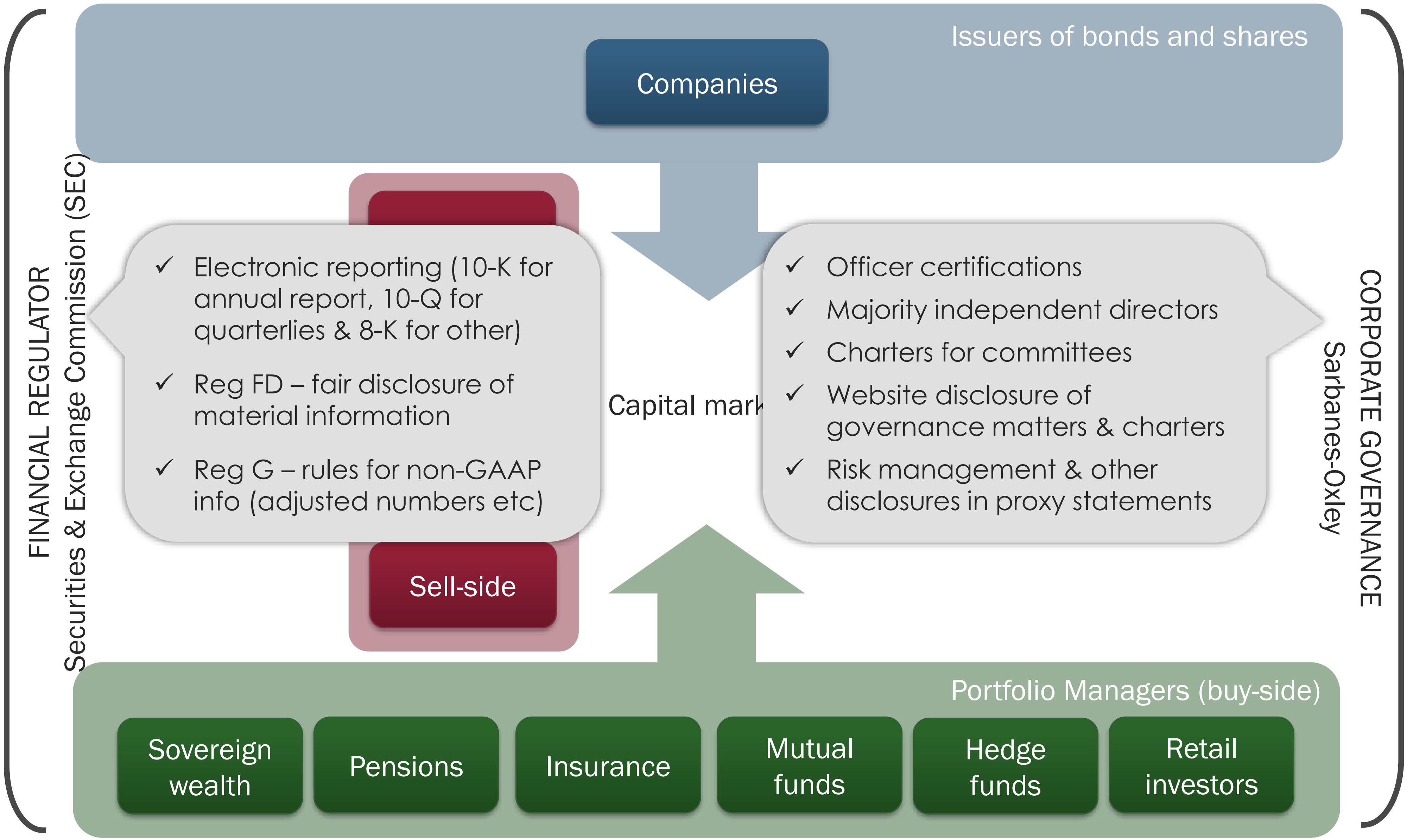
Summary – Funding & Shareholder Value

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

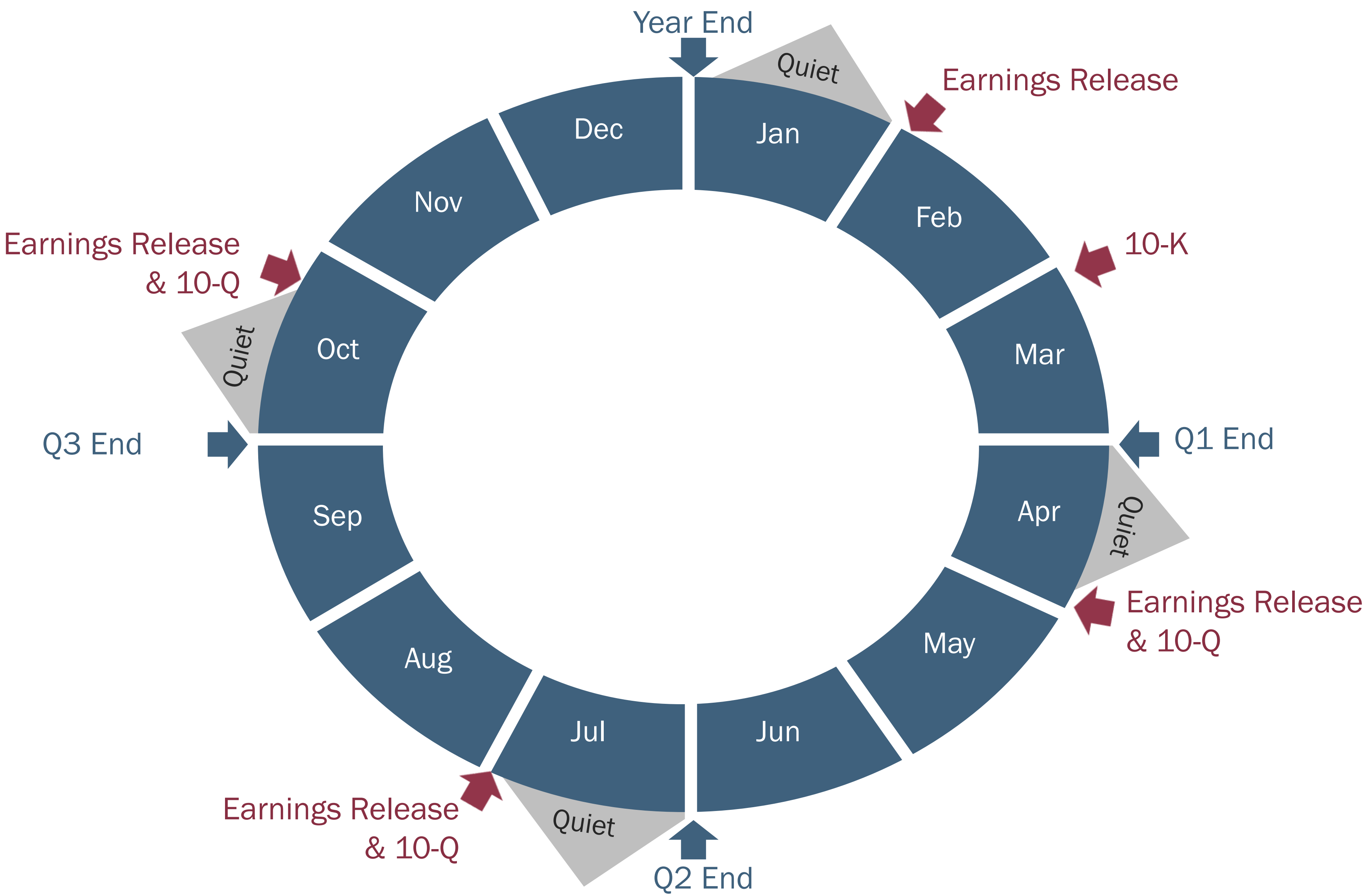
Capital Markets Big Picture



Key Regulations



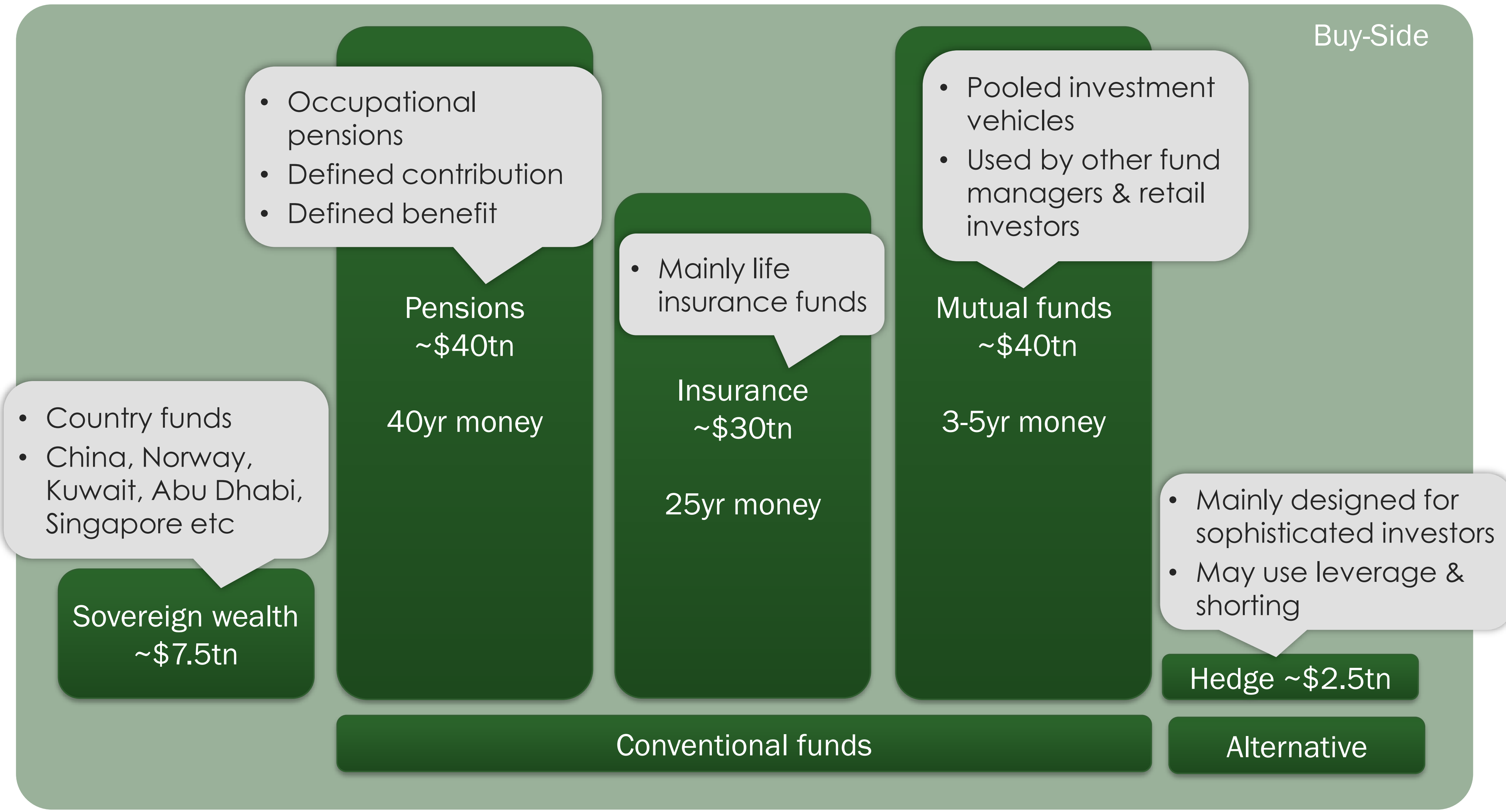
Financial Calendar



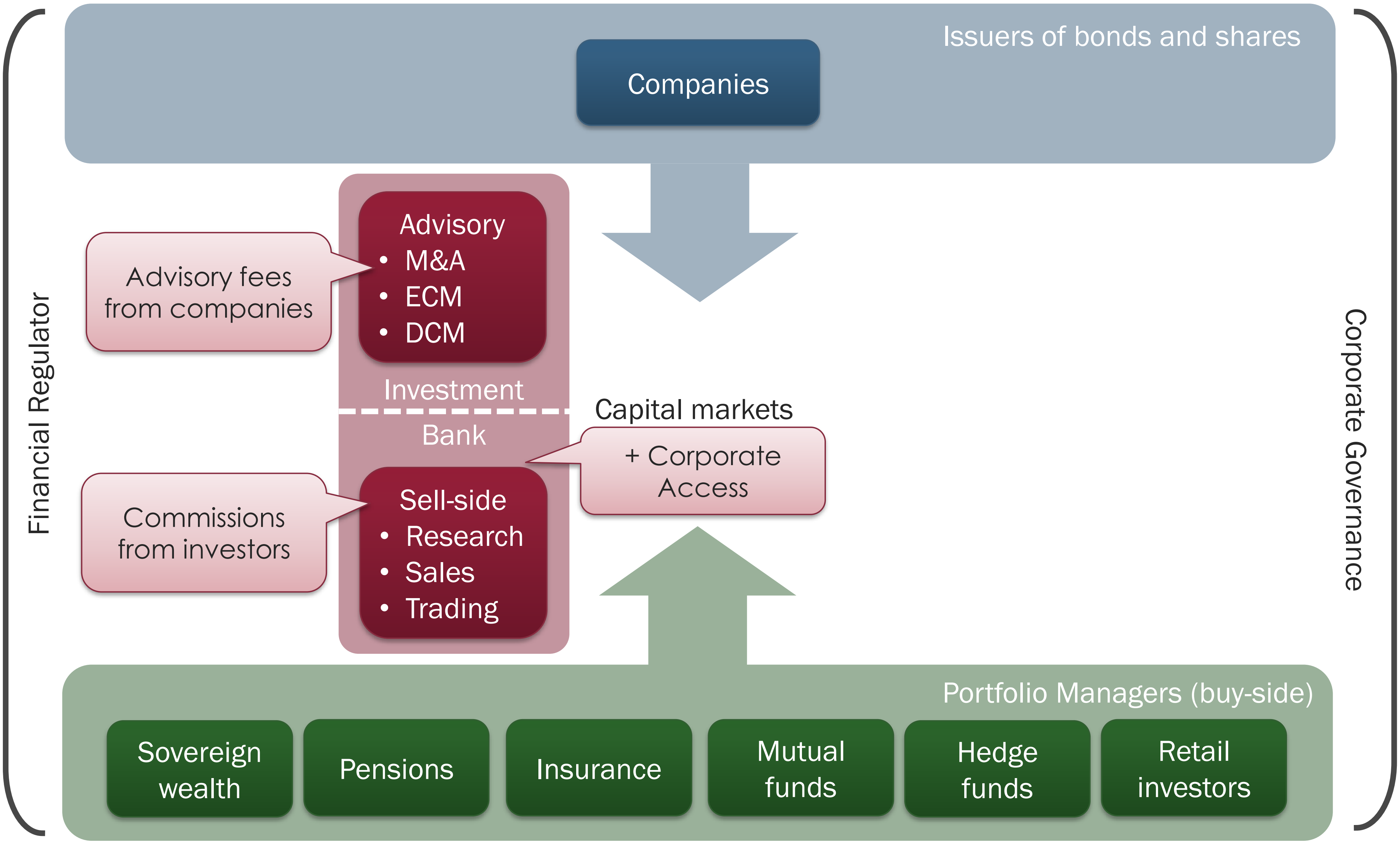
Your Investments

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?

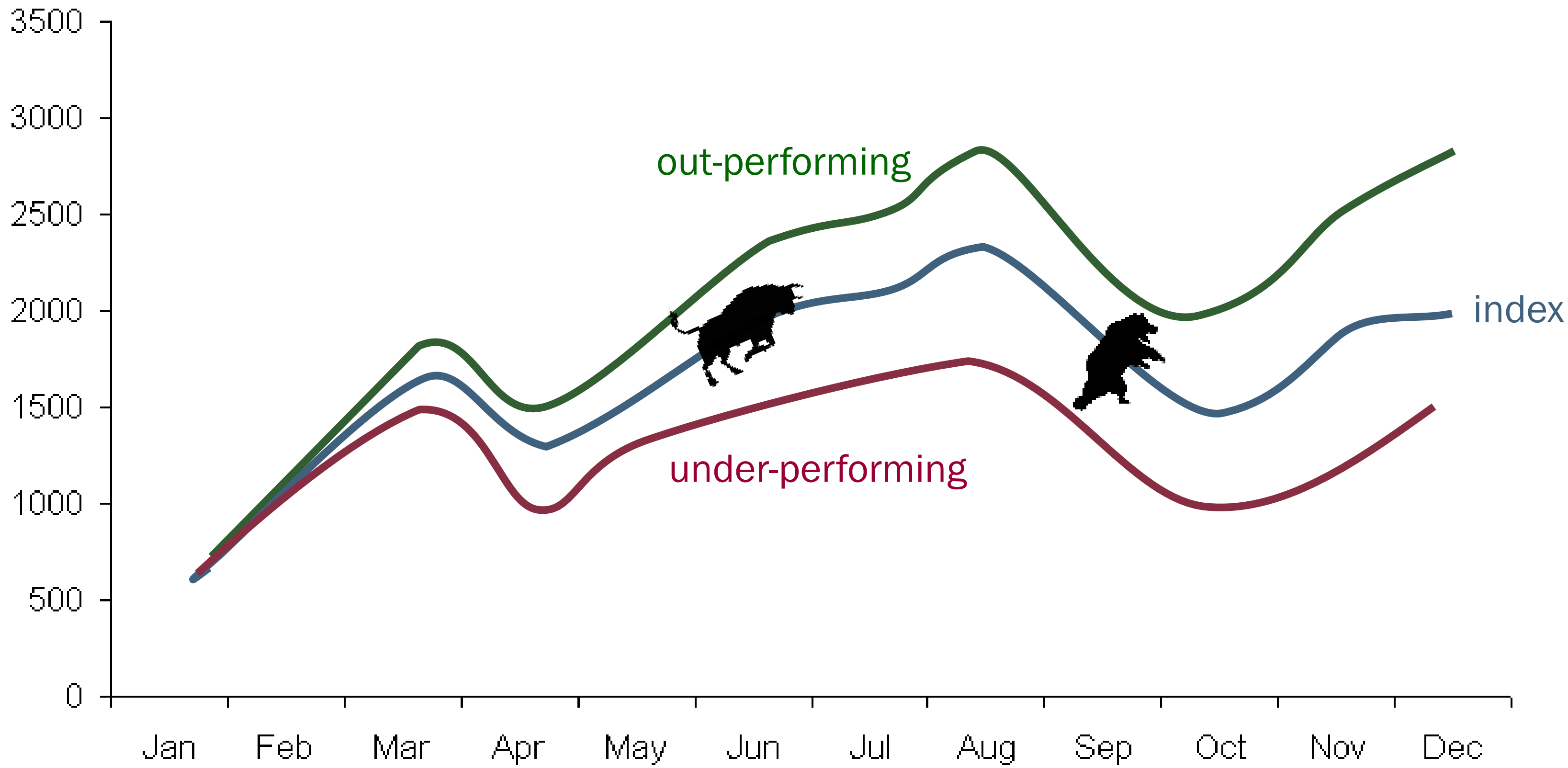
Institutional Investors $120tn



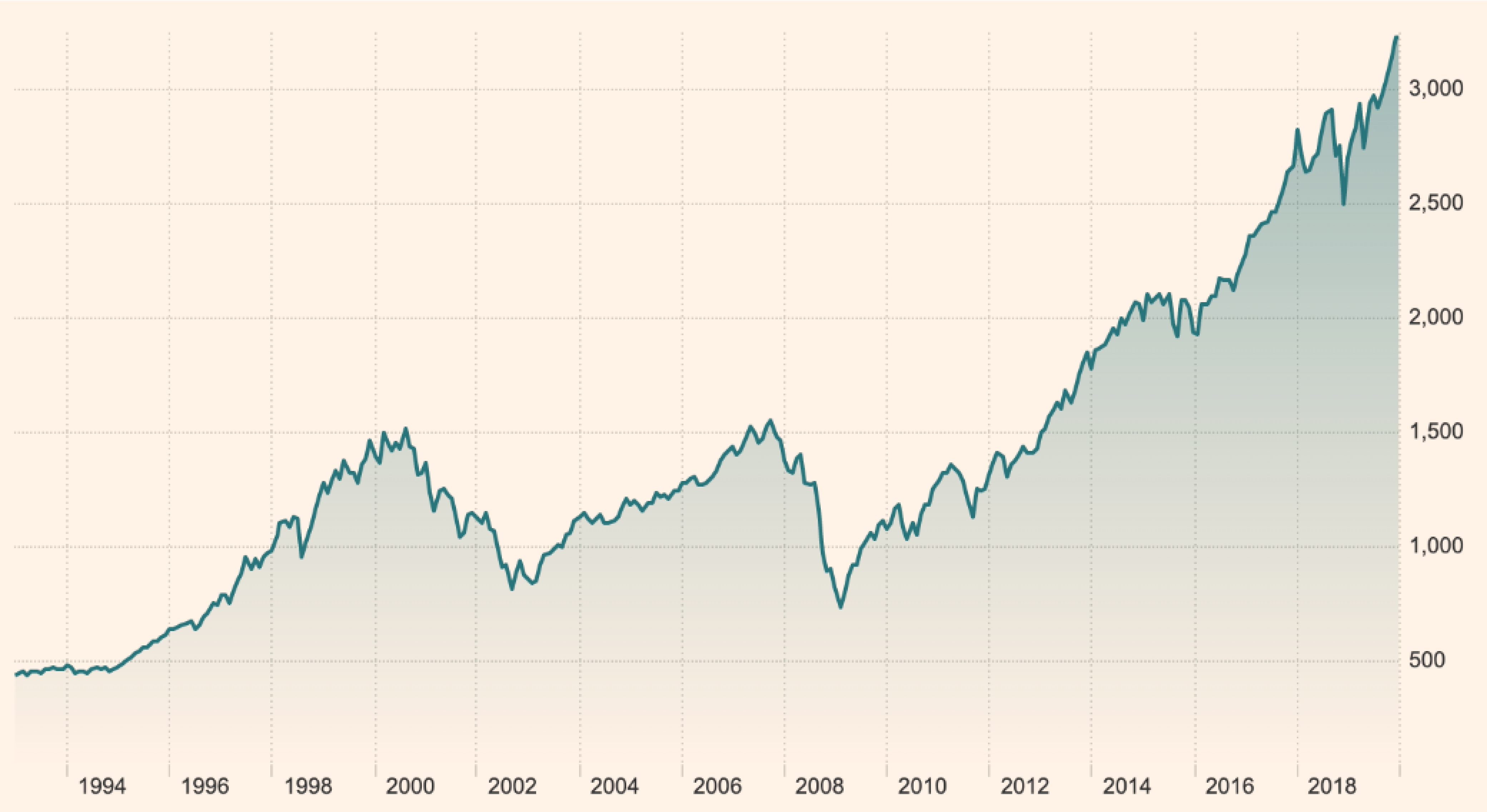
The Role of Investment Banks



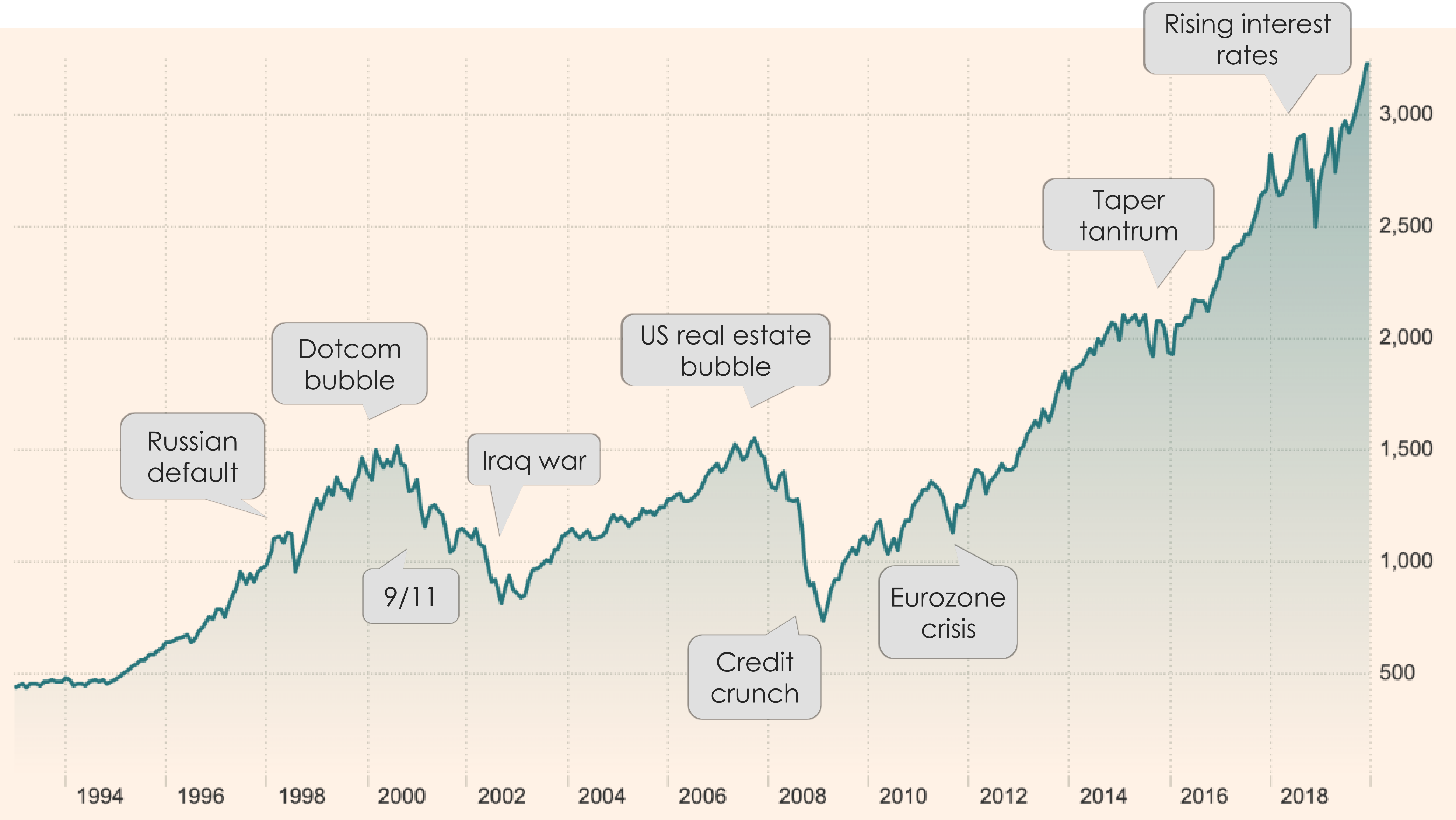
Indices & Jargon



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



Bubbles & Crashes



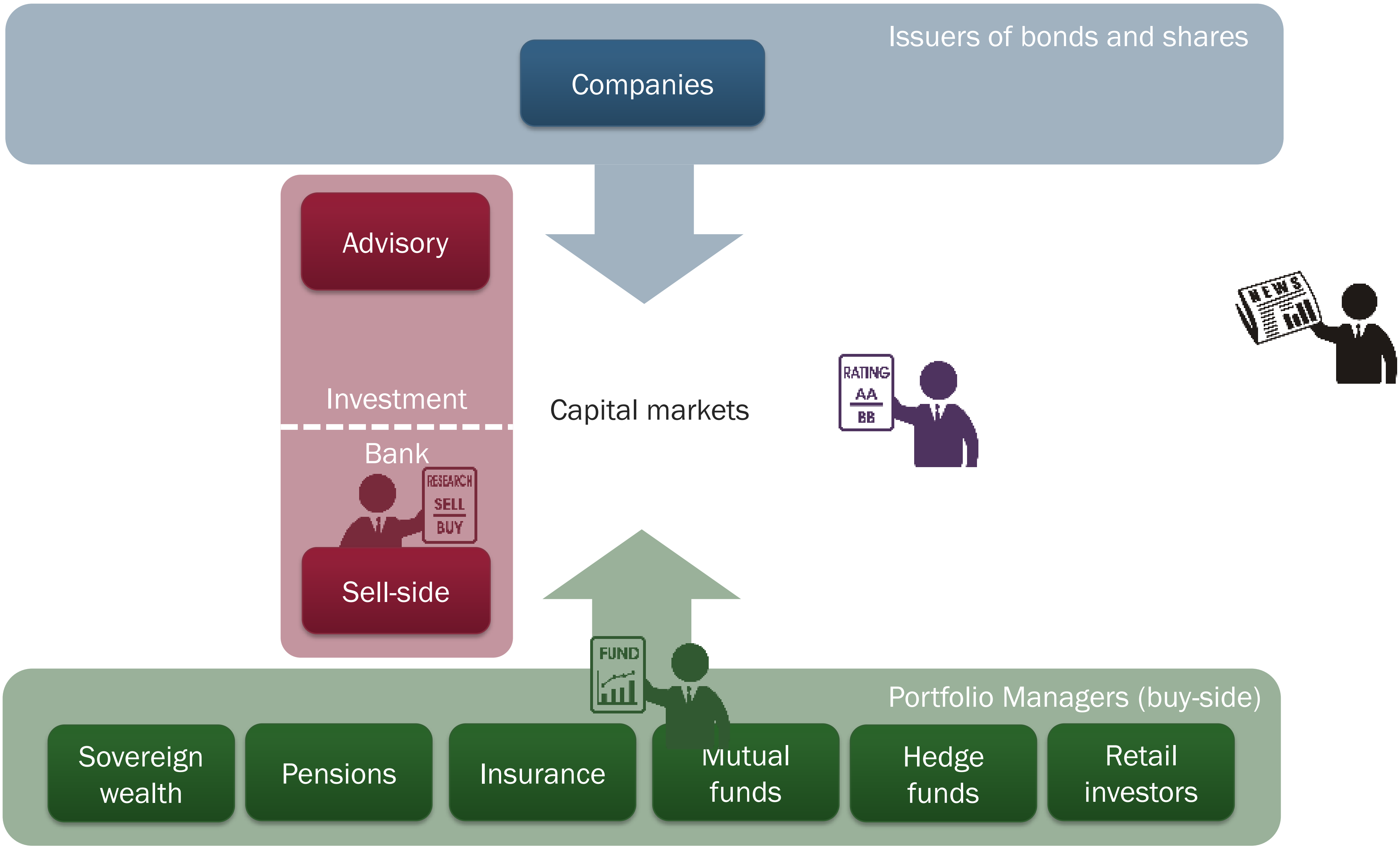
Question...

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

a. True

b. False

Financial Audiences



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

Example Research Report

Written by the sell-side for distribution to the buy-side

Pan Europe Retail

Super Stores Co

ABC BANK
January 2020

Hi alpha

Analyst: Caroline Muir
Specialist Sales: Fred Red

Long term growth

Recommend

Market Cap: 700m

REASON FOR REPORT
Full year earnings

Forecast

RECOMMENDATION
BUY

CURRENT PRICE
6.25

TARGET PRICE
8.50

Value

Summary Forecasts

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

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.

What Analysts Want

Pan Europe Retail

Super Stores Co

ABC BANK
January 2020

Hi alpha

Analyst: Caroline Mui
Specialist Sales: Fred

To be seen to be right

Market Cap: 700m

REASON FOR REPORT	RECOMMENDATION	CURRENT PRICE	TARGET PRICE
Full year earnings	**BUY**	**6.25**	**8.50**

Summary Forecasts

m	2019A	2020E	2021E	2022E
Sales	2,550	2,933	3,372	3,878
EBITDA	106.5	122.5	141.6	162.9
EBIT	76.5	88.0	101.2	116.3
EPS	0.42	0.48	0.56	0.64

- Clear communication of the business model and its drivers
- Clear communication of numbers
- Answers to questions including detail on the numbers - fast

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 ... was still very strong. We continue to see lots of potential for this ne... erseas markets.

Access to senior management

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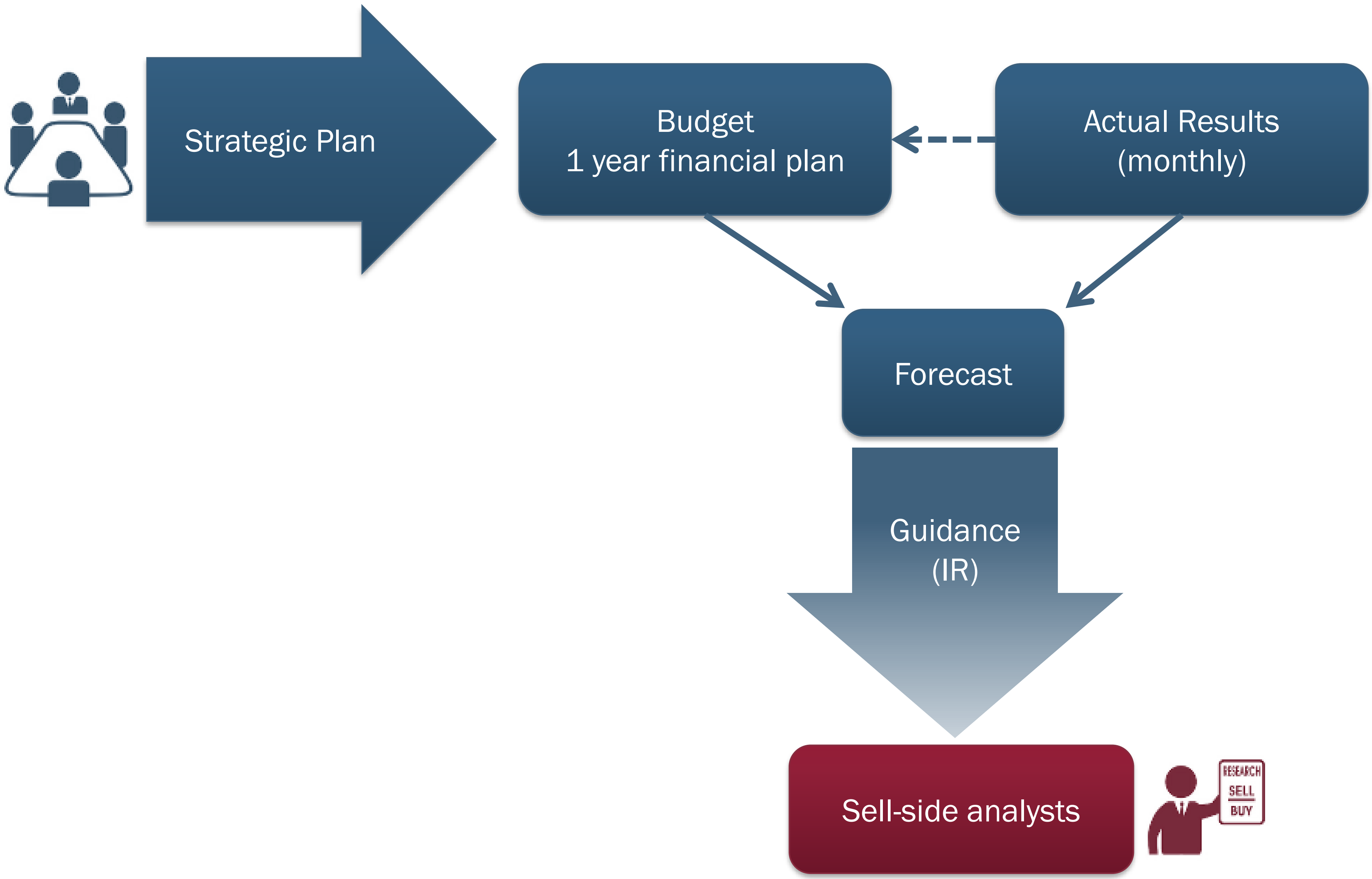
News or an angle that will make money for clients

PPENDIX AT THE END OF THIS REPORT

The Role of Guidance

Guidance is a key element of managing market expectations



Monitoring Consensus – A Key Part of IR

Consensus = average of sell-side analysts' forecasts

Published by Bloomberg, FactSet, Reuters, Zachs etc

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)

in € Million	High	Mean	Low
Net sales	16,139.9	**16,004.6**	15,805.0
EBITDA (pre one-time items) 1)	4,402.3	**4,322.1**	4,275.2
EPS (pre one-time items) 1)	€ 5.76	**€ 5.66**	€ 5.56

Source: https://www.merckgroup.com/en/investors/shares-and-bonds/analysts-and-consensus.html

Question…

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

a. True

b. False

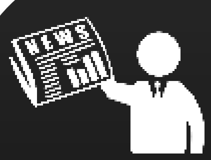
Earnings Releases

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

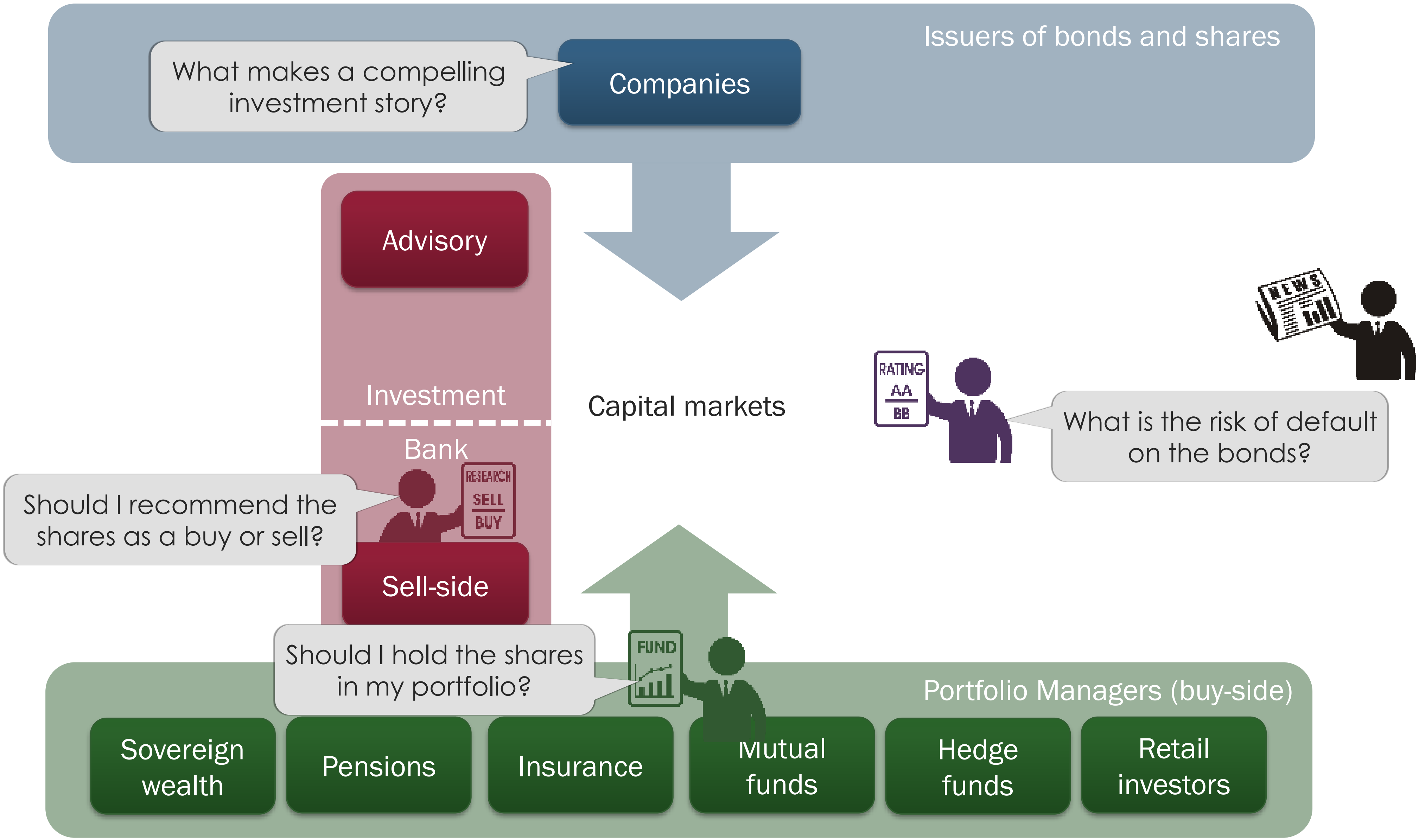
- Are earnings in line with my forecast
- What's the company saying about the future and how does this affect my model?
- How is the share price reacting and is there an opportunity for a recommendation?



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



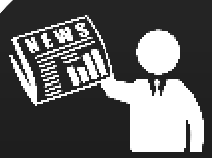
Requirements of Key Audiences

Fund manager

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

Analyst

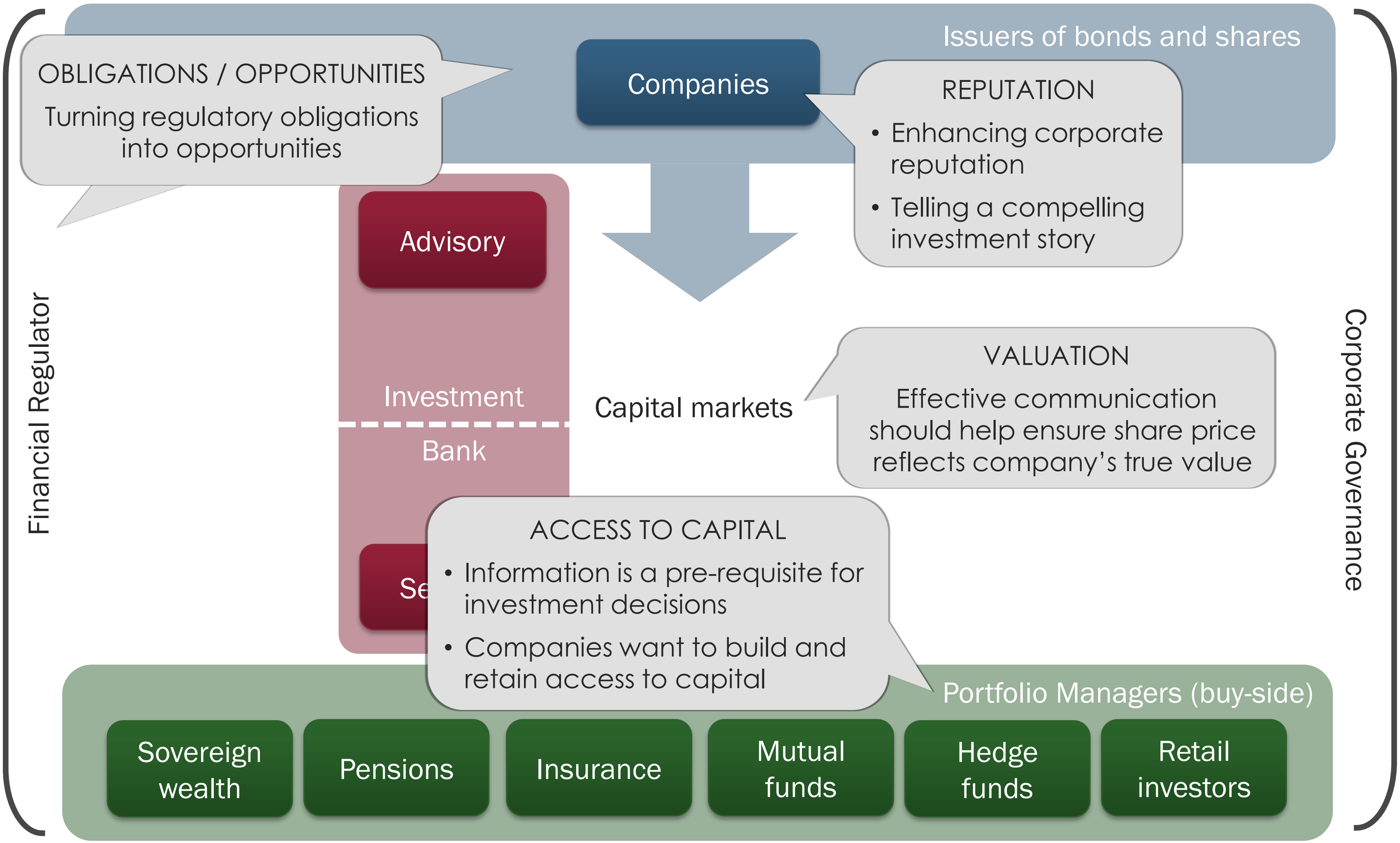
- An angle to earn commissions
- Guidance on key inputs to valuation models
- Management who deliver on promises



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



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?

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