INSIGHT

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For Professional Investors Only

Money Pit

A Letter to Investors

Morningstar Investment Management Australia

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"Assets collect risks around them in one form or another. Inventory is one risk, and accounts receivable is another risk."
– Michael Dell

All businesses face the ongoing challenge of generating cashflows in excess of their liabilities. If a business is insolvent and cannot meet its liabilities, it is no longer a 'going concern' and will face reorganization or liquidation. Nevertheless, profitability is not necessarily a prerequisite for a firm's ongoing survival. A firm can keep losing money if investors keep pumping it back in, often in the vain pursuit of growth opportunities that, for some reason, cannot be funded through existing profitable operations.

Some firms may even have the **duty** to continue unprofitable operations if they need to keep servicing their debt, to the detriment of equity holders. This is the unhappy scenario of 'debt deflation' on a micro level, in which excess debt begets excess production and forced sales through reduced prices. Lower prices require higher production volumes to meet the same existing debt burden, and the death spiral continues. Forced asset selling, or deleveraging, is a variation on the same theme, as is the current predicament of cash-strapped energy producers. While the logic of wealth maximisation suggests that they limit supply to compel higher prices, the need for immediate cashflows ultimately lowers the return on their assets, perhaps changing the nature of the assets in the process.

"We started the company by building to the customer's order. And interestingly enough, we didn't do it because we saw some massive paradigm in the future. Basically, we just didn't have any capital to mass-produce." – Michael Dell

Asset values and their power to generate profits are inextricably linked. Some would say that net profits provide the best handle to value the assets of a firm, since assets are only worth the cashflows they can generate. This is a useful concept, but it overlooks the overall convertibility of the assets, or how they would face liquidation. The very fact that assets may be relatively liquid would likely prevent their 'forced liquidation' in the first instance, and this risk should be considered in their valuation. Similarly, the more capital intensive a business is, the less valuable its capital actually is. If invested assets strain to generate profits as a going concern, they will likely strain to achieve satisfactory prices in liquidation.

This points to a duality between the profitability and liquidity of assets as they pertain to the risks of the equity holder. Both imply an ease of converting assets into cash and, in this sense, may act as substitutes for each other in the reduction of equity risk. Equity investors, as a rule, forego the safety of cash to make their investments. To the extent they can get it back, they might have their cake and eat it too.

Recognising this duality can lead to more investment opportunities with asymmetric payoffs skewed to the upside. The good ones may be less exciting or glamourous, unless you happen to like specialty chemicals or Pachinko balls. They often combine a modest upside with a very limited downside and can be fantastic investment opportunities since, while the equity risk is reduced, the participation in business or economic value-add is preserved.

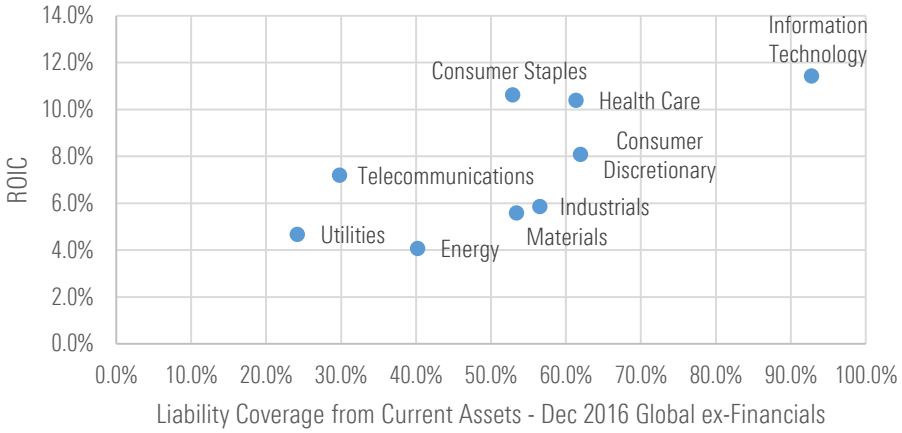
Some investors bemoan 'lazy balance sheets' with excess cash and lower return on assets, but they shouldn't overlook the downside protection that this liquidity inherently provides. 'Optimising' balance sheets by taking on more leverage to juice equity returns comes with its own risks. Only to the extent that operational and business risks can be eliminated can leverage be safely applied, and history is littered with investors who have gotten this balance wrong, with nothing left to show for it.

"When leverage works, it magnifies your gains. Your spouse thinks you're clever, and your neighbors get envious," explained Buffett in his 2010 shareholder letter. "But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade — and some relearned in 2008 — any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people."

Perhaps the best-known examples of the conservative application of these principles were Benjamin Graham's 'net-net' working capital bargains. In these cases, the discounted **current assets** of the firm (cash and other assets that are expected to be converted to cash within a year) exceed **total liabilities** by more than the market price, netting the investor a near-term positive payoff with very little downside risk. Investors 'welcome back' their capital nearly as soon they part with it, which is certainly not the case for equity investors in general. By design, these investments are immune to heroic assumptions about the profitability of long-duration assets. The farther into the future they extend, the more these 'assets collect risks around them in one form or another' from many directions: technological obsolescence, changing consumer preferences, and changing competitive landscape.

While there are certainly fewer 'net-net' investments around today, we can apply the same principles to gauge the current landscape for equities in terms of their fundamental risks and valuations. We can also add the dimension of profitability as an offset to balance sheet risk in the form of current-asset liability coverage. Ideally, lower current-asset liability coverage is compensated by higher levels of profitability as measured by return on invested capital ("ROIC"), and vice versa. However, in looking at the global sectors of today in Figure 1 (ex-Financials, as at 31 December 2016), if anything, the reverse appears to be true.

Figure 1: Global Sector Current-Assets Liability Coverage by ROIC (Trailing)



Source: Morningstar Investment Management

Sectors with lower balance-sheet risk off to the right, like Information Technology, also happen to have higher profitability levels in terms of their ROIC. What's more, including balance sheet 'cash drag' by looking at return on assets ('ROA') instead of ROIC does not change these results at all.

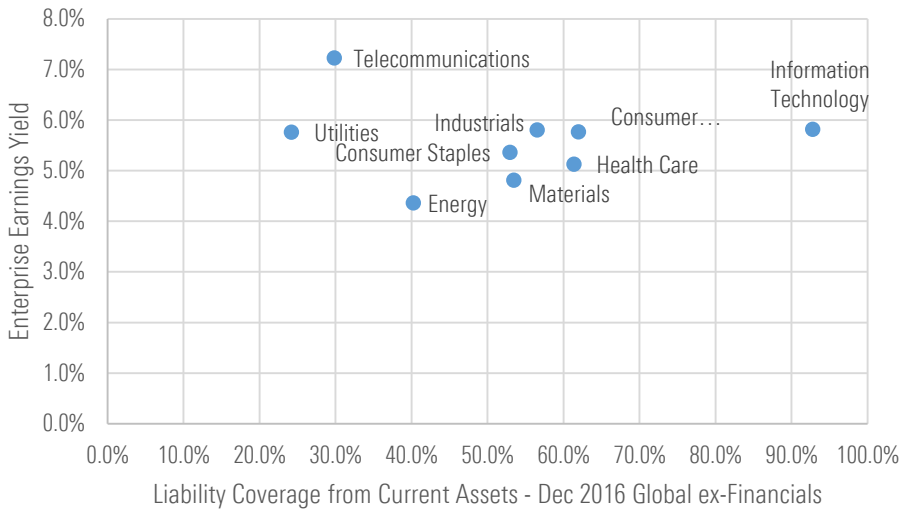
Given the depressed commodity prices of recent years, the lower ROIC's of the Energy and Materials sectors come as no surprise. While cyclicality punishes their current headline profitability, one could argue that the current scenario is exactly the type that equity investors should be most cognizant of. Similarly, the relatively favourable Consumer, Health Care, and Information Technology sectors show why investors may hold a preference for them. They are much less cyclical, so their current elevated profitability levels are relatively true-to-label and critical for the investor to consider.

"Growth and risk go together." – Stephen Penman

In reality, fundamental risks around profitability and liquidity usually do not offset each other in individual companies or sectors to make the investor's life more simple; rather, they tend to concentrate around particular business models and industries. But these sharp differences in fundamental risks are 'ok' as long as they are priced into the market. If 'strike one' is too much balance sheet leverage, and 'strike two' is low or cyclical profitability, then 'strike three' should be cheap valuations, or higher earnings yields, imposed by the market to compensate investors.

In Figure 2, replacing ROIC with the trailing enterprise earnings yield (EBIT/EV) on the y-axis, there is some convergence, but a discerning investor would likely prefer to see more downward sloping data to compensate heightened fundamental risks prevalent on the left. The relative 'flatness' of the data is likely due to reversion or embedded growth expectations for cyclicals. While certainly possible, the riskiness associated with this outcome should come at a fairer price in our judgement.

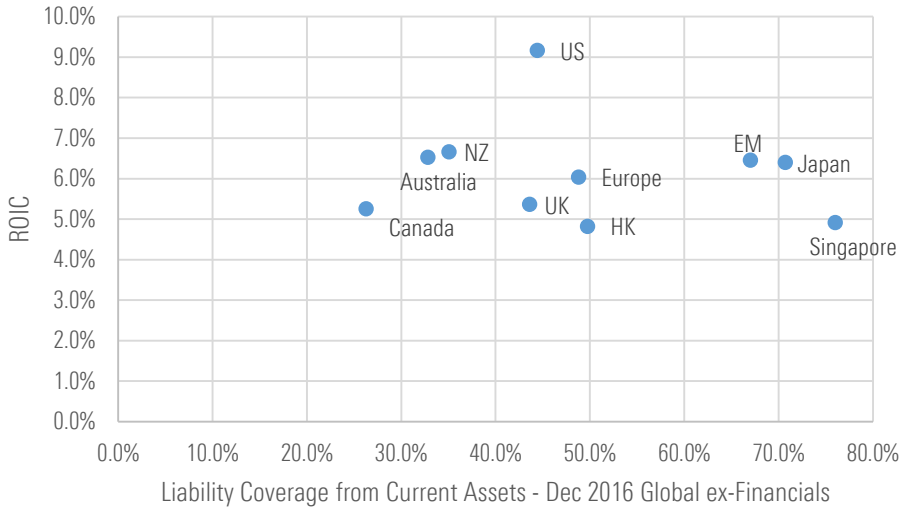
Figure 2: Global Sector Current-Assets Liability Coverage by Enterprise Earnings Yield (Trailing)



Source: Morningstar Investment Management

The same metrics viewed at a regional level (ex-Financials) in Figures 3 and 4 uncover some interesting results. Investors can identify where fundamental risks **are** offsetting, as in the case of the US with higher profitability, or in Japan and Singapore with lower balance sheet risk, and where they appear to compound each other, as in Australia and Canada. These results are a restatement of Figures 1 and 2 as they reflect the various sector concentrations among the regions, but they do introduce some important questions for investors to consider. Namely, is the current cyclically depressed profitability of the Energy and Materials sectors matched by a 'temporariness' in the elevated profitability of the Consumer, Health Care, and Information Technology sectors prevalent in the US? Or are these sectors, with the US as an example, more profitable in an enduring way?

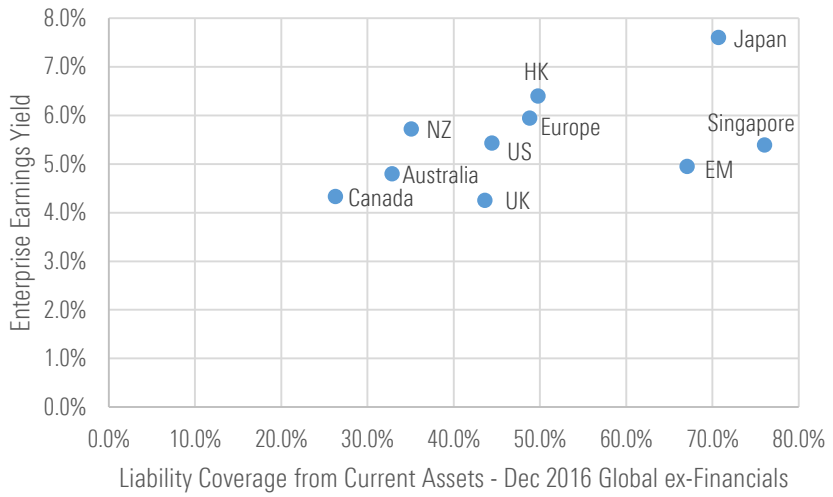
Figure 3: Regional Current-Assets Liability Coverage by ROIC (Trailing)



Source: Morningstar Investment Management

The enterprise earnings yield shown in Figure 4 is, again, **not** an illustration of the market pricing in fundamental risks. If it were pricing in balance sheet risk by this measure, the data would be downward sloping and Japan would have a lower earnings yield than the other regions. In contrast, Japan is a standout in terms of both low balance sheet risk and high earnings yield (i.e., cheapness). Based on trailing numbers, this analysis of course doesn't include any forward views on the Japanese yen or other factors.

Figure 4: Regional Current-Assets Liability Coverage by Enterprise Earnings Yield (Trailing)



Source: Morningstar Investment Management

Equity investors assume fundamental risks and should be aware of their relative severity in their investments. If and when prevailing market prices permit them to capture most of the upside they expect from their equity investments, while severely limiting their downside, investing first principles should be their guide. Almost by definition, these opportunities are unlikely to be headline-grabbing growth stories that lead to exciting narratives and visions of the future. With only few exceptions, the future is where today's profitable assets rapidly 'collect risks around them in one form or another'.

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