

# **CORPORATE VALUATION**

**FOR PORTFOLIO INVESTMENT**

**ANALYZING ASSETS,  
EARNINGS, CASH FLOW,  
STOCK PRICE, GOVERNANCE,  
AND SPECIAL SITUATIONS**

**ROBERT A. G. MONKS  
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**FOREWORD BY  
DEAN LeBARON**

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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ISBN 978-1-576-60317-8 (cloth); ISBN 978-0-470-88074-6 (ebk);  
ISBN 978-0-470-93675-7 (ebk); ISBN 978-0-470-93676-4 (ebk)

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

## Foreword

A SMALL FRACTION of cohorts who lived through the age of the Nifty 50 still tackle important problems. We don't know that the torch has been passed, as an earlier president reminded us. We forgo shuffleboard and leisure suits for writing and mounting platforms on issues that we believe to be important—where we can bring our personal experiences to bear and where our voices will remind others that we bring personal history, energy, and foresight to vexing problems. Bob Monks is the archetype of the group.

We will get to his capabilities shortly, but let us first examine Bob's courage to tackle a really big topic: the valuation of securities. It is as big a subject as they come, running in multidimensions from qualitative to psychological, from static to dynamic, from one dominant measure to a complex soup, and using measures that range from those that are internal to the observer to those determined by the markets. He categorizes the enduring tussles between momentum speculators and fundamental investors (as they often label themselves) and bravely wades into academe and critically tackles anyone, from Nobels to postdocs. Nothing escapes his attention.

Many investors aspire to universal skills, often proclaiming to be rotating specialized investors in the changing days of one valuation mode to another. In truth, most of us adopt a valuation scheme that is suited to the nature of our psyche. We search for nomenclature that proclaims its wisdom; we quest for indices that illustrate our brilliance; and we market . . . oh, we really market.

In *Corporate Valuation for Portfolio Investment*, Bob and his worthy coauthor (more later) cover the full range of valuation methods. We are

reminded how narrow most of our outlooks really are. Our normal style as investors in public securities, usually as fiduciaries investing for others, is to examine, select, implement, measure, and report . . . with some ingredient of hope and justification. But Bob's stamp on this book is clear. As in life, so in this book he goes to a rare and important next step. He adds the active behavior of someone who behaves as if he owns the entire business and sends a message to institutional shareholders who tend to rely on buying or selling to express their views to management.

He and I reached the same conclusion independently at about the same time, he as assistant secretary of labor for ERISA [Employee Retirement Income Security Act], and I while chairing a governance committee at the Securities and Exchange Commission. Back in the private sector we shared valuation insights, models, and spreadsheets. I went the next step in aggressively voting against directors who supported protective measures against shareholders and announced our actions—practices unheard of at the time. Bob started an investment management enterprise, the Lens Fund, to invest in potential target companies, announcing plans for some to improve their accountability to owners. Whereas institutional investors typically vote proxy statements with management, without even knowing the individual positions of directors receiving their endorsement, Bob makes his views known. He lays out a clear program.

He is an active investor in large publicly traded securities that need, but normally fail to get, attention from investors who take a position and then aggressively attempt to change companies in directions of greater value. Thus, his focus on valuation is a natural complement to his governance activities. He has to know how to start at a low enough price to provide a cushion for the time it takes to implement his approach. He is usually attracted to a yield sufficient to finance his efforts. He has to develop a cogent program that has not been adopted by the directors charged with just that job. And, finally, he has to have the credibility to make it work. The list of major companies who have felt his attention looks like a typical high-quality list, but the members of that list are better now in hindsight than when Bob and his staff first visited them.

Rarely do companies welcome the interference from someone who proposes to alter their clubby atmosphere. But his investment record is a clue that his ideas, when implemented, work. From its founding in 1992 until it became part of the Hermes Pensions Management group in 2000, activities of the Lens Fund were followed by such august publications as

*Barron's* and the *New York Times*. As noted in the *Times*: “Lens’s investing style pays. In six years of operation, through Dec. 30, 1998, it returned 25.1 percent a year, on average, compared with 20.5 percent for the Standard & Poor’s 500-stock index.” Well-known shareholder activists like Boone Pickens and Carl Icahn are disruptive and make their intentions to fire managements well-known. It is not surprising they would be met by vigorous objection. Bob Monks, on the other hand, comes in with a plan that can be implemented by the existing management. His proposal is more about accountability than disruption. He too meets with objection but less so than others storming the corporate gates with devastating firepower.

Bob’s colleague in this endeavor, Dr. Alexandra Reed Lajoux, brings her own long history to the quest for better approaches to corporate valuation. Alex, who has served as editor of a variety of influential business periodicals, is the lead author of *The Art of M&A* series of books and, through these and her many other writings, is an ardent proponent of the overarching principle of stewardship and long-term sustainable value creation.

Bob and Alex wrote in the Preface: “We wrote this book to advance world prosperity by explaining how to determine the value of corporate equity securities for the purpose of portfolio investment.” Together, with records of success improving corporate accountability in their hip pockets, they are ready to storm—tactfully—the barriers to full understanding of what constitutes sustainable value.

DEAN LEBARON  
Adventure Capitalist

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## Preface

WE WROTE THIS BOOK to advance world prosperity by explaining how to determine the value of corporate equity securities for the purpose of portfolio investment.

A number of recent changes have made this subject lava hot: international accounting conundrums, massive transformations making both forward and backward comparisons meaningless, low inflation with rumors of deflation, and—now—government-created assets and earnings! These volcanic trends have brought equity valuation nearly to a meltdown. Yet certain truths remain.

Equity capital provides two main benefits: a flexible funding option for companies and superior returns to investors compared to debt. But unless an investor can buy every stock and hold all stocks for decades, the long-term, general superiority of equity over debt is of little use. To take advantage of equity's power, investors must learn how to put *a precise value on a specific stock for a specific investment period*.

This book advocates a multidimensional approach to equity value, asserting that value exists only in specific temporal and situational contexts. This said, the “default setting” for investment appropriately remains an intelligent investor considering public equity securities as a choice among alternatives.

Corporate valuation for portfolio investment means determining the present value of future worth. There are two main sources of information about the worth of a stock: financial reports and the stock's current trading price.

Financial reports contain riddles that must be decoded by the valuation-minded investor. The first step in valuation for investment is to bridge the gap between current valuation in financial reports and the future value of the company for investment purposes. Despite the work of numerous groups to reform generally accepted accounting principles (GAAP) and their global equivalent, international financial reporting standards (IFRS), financial reports remain only dim mirrors of company value. Sources of complexity in GAAP/IFRS accounting include variation in accounting models, scope exceptions, mixed attributes, and bright line standards.

All this requires reading between the lines. And the main message is that equity securities are difficult to value in part because both companies and the markets that trade in their equity are living human systems prone to self-deceptive traits that militate against pure valuation logic.

Paradoxically, however, human nature, which makes the valuation of equity so difficult, is also the fundamental reason for the superiority of equity. Value-minded investors can put a financial value on the greatest contributor to securities' value: long-term corporate action based on vision. To do so, however, requires a multifaceted approach to valuation, including both respect for quantitative fundamentals and an appreciation for qualitative complexity.

This book, intended for the professional investor building an investment portfolio that includes equity, takes the reader through a range of approaches, including those primarily based in assets, earnings, cash flow, and securities prices, as well as hybrid approaches. It also discusses the importance of qualitative measures that we call "governance" (going well beyond GAAP/IFRS) and addresses a variety of special situations in the life cycle of businesses, ranging from initial public offerings to bankruptcies.

In the process, the book offers formulas, checklists, and models that we and others have found useful in making equity investments. As long as investors thoughtfully use a variety of tools to make their investments, corporate securities will continue to generate wealth for their owners and for society at large.

# Acknowledgments

MANY INDIVIDUALS HELPED us write our tome; the chapter endnotes name them. But special acknowledgment goes to those who corresponded with us and/or consented to be interviewed during the actual writing of this book (January 2008–June 2010).

Matthew Bishop, bureau chief for *The Economist*, New York

Steve Brown, founding partner and chief investment officer, Governance for Owners, London

Paul Druckman, chairman, Executive Board of The Prince's Accounting for Sustainability Project, London, United Kingdom

Robert Ferris, executive managing director, RFLBinder, New York

Phillips Johnston, analyst, Dawson Herman Capital, New York

John P. M. Higgins, president and chief investment officer, Ram Trust Services, Portland, Maine

Dean LeBaron, founder, Batterymarch Financial Services, Geneva, Switzerland

Rocky Lee, partner and head of Asia Venture Capital and Private Equity, DLA Piper, Hong Kong

Colin Meyer, dean, Saïd School of Business, Oxford University

Deborah Hicks Midanek, principal, Solon Group, New York

Lester Myers, professorial lecturer, Georgetown University

Mark Mills, director, Generation Management, London

Paul Pacter, IASB, Hong Kong and London

Al Rappaport, cofounder, LEK-Alcar Consulting Group, La Jolla, California



Anthony Riha, vice president, Bowne Asia, Beijing  
George Soros, founder, Soros Fund Management, New York  
Allen Sykes, economist and author, London  
Raj Thamotheram, senior adviser, Responsible Investment, AXA  
Investment Managers (AXA IM), Paris  
Simon Thomas, chief executive, Trucost, London  
Stephen Young, executive director, Caux Round Table

We would also like to acknowledge the encouragement and guidance that we received from the Bloomberg Press team that launched this project, including JoAnne Kanaval, Stephen Isaacs, Mary Ann McGuigan, and Fred Dahl. We also thank the professionals of John Wiley & Sons, including Bill Falloon, Emilie Herman, Tiffany Charbonier, and Todd Tedesco. Artist Mary Graham ([mary@oakinsights.com](mailto:mary@oakinsights.com)) helped illustrate some of the concepts we discuss in Exhibits 2.1, 5.1 through 5.11, and 6.1. We are grateful for her unique combination of mathematical, artistic, and technical genius. The contributions of these individuals, as well as many others, prove an important point: published books convey knowledge at a level the blogosphere will never match.

Bob extends special thanks to his colleagues Nell Minow, Ric Marshall, Sylvia Aron, and Christine De Santis for their usual superb help.

Alexandra thanks her family, friends, and colleagues past and present at the National Association of Corporate Directors.

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Published simultaneously in Canada.

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ISBN 978-1-576-60317-8 (cloth); ISBN 978-0-470-88074-6 (ebk);

ISBN 978-0-470-93675-7 (ebk); ISBN 978-0-470-93676-4 (ebk)

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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