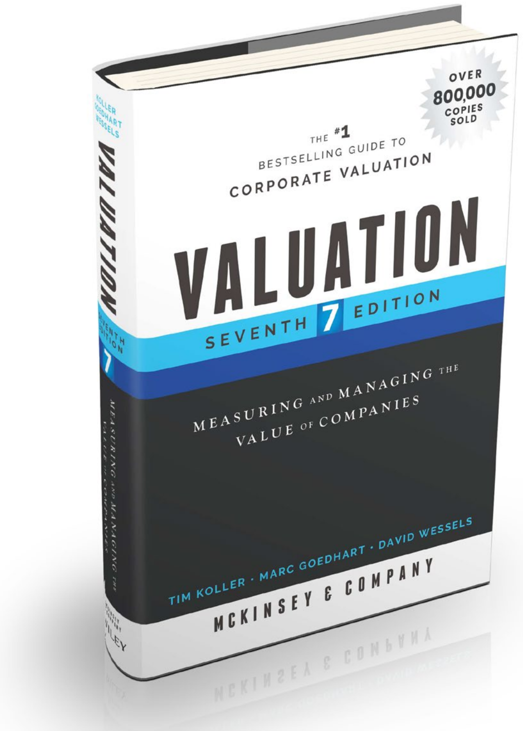
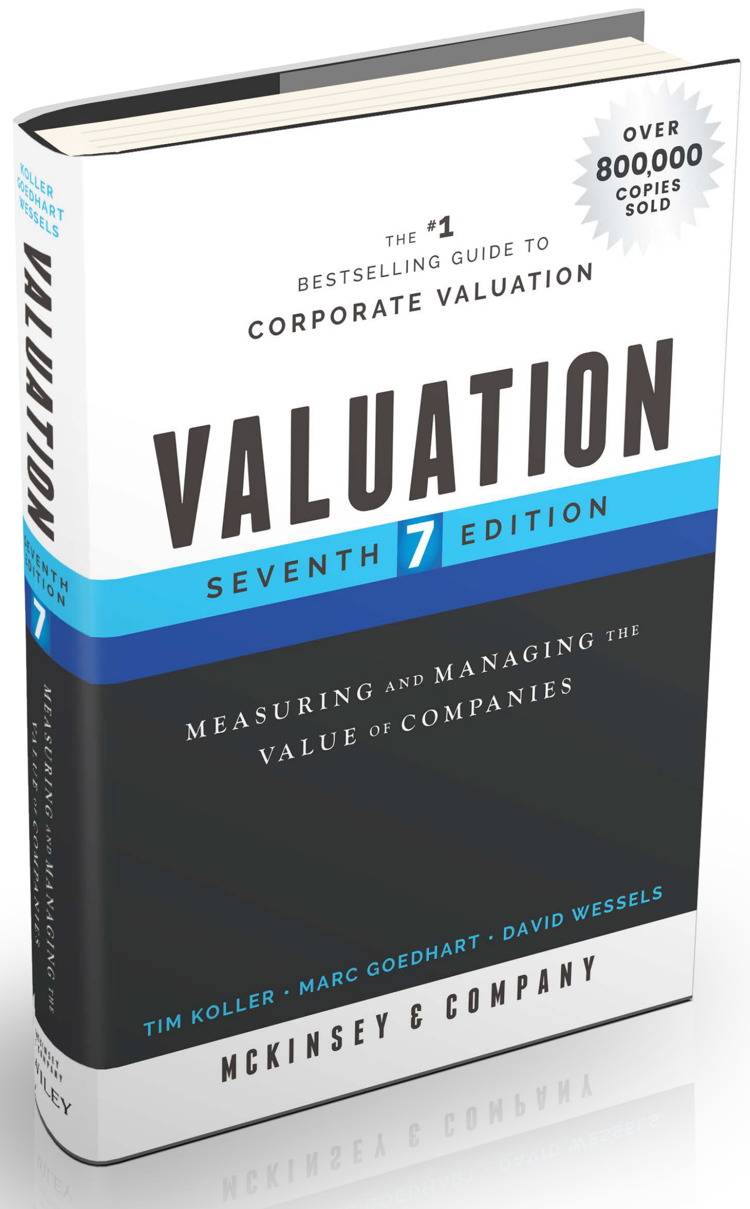
McKinsey & Company

Valuation Perspectives

September 23, 2020

CAIA ASSOCIATION

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Agenda

Everlasting - Growth and ROIC drive cash flow and value

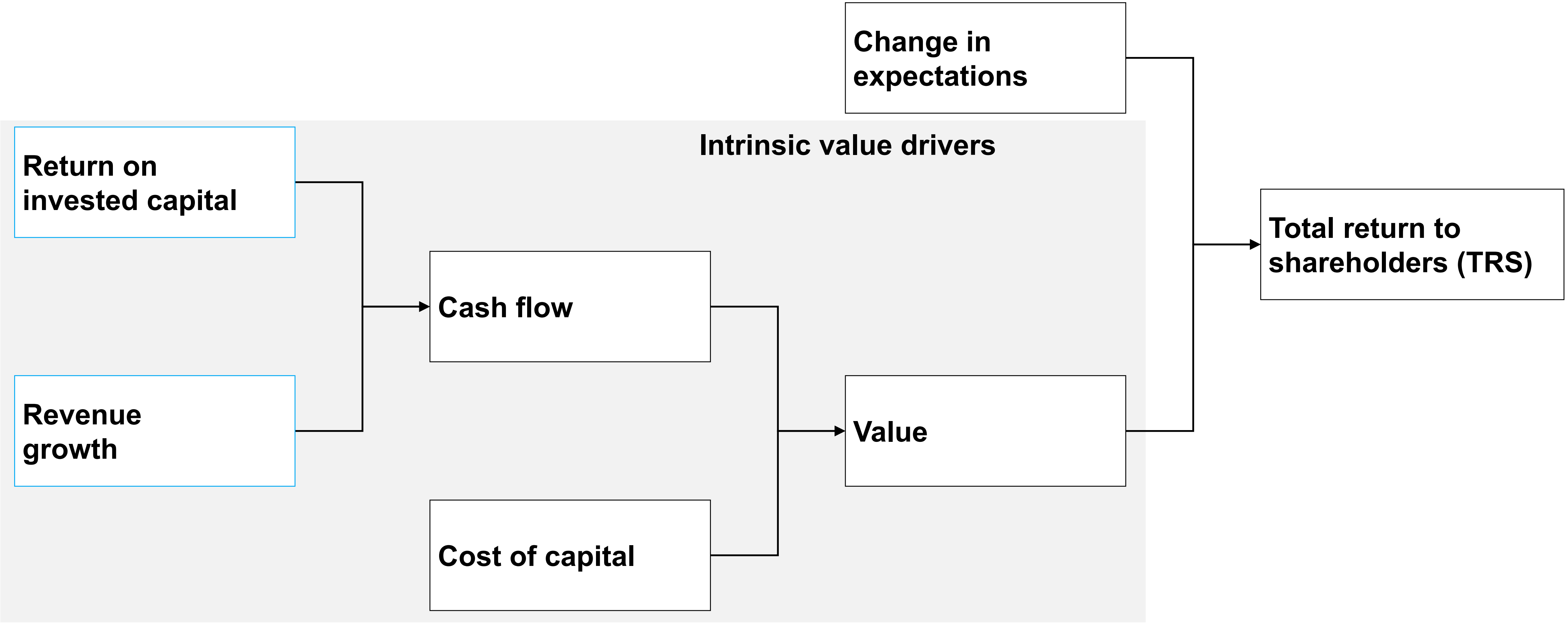
New – Digital

Everlasting/New – Long-term orientation wins

New - ESG

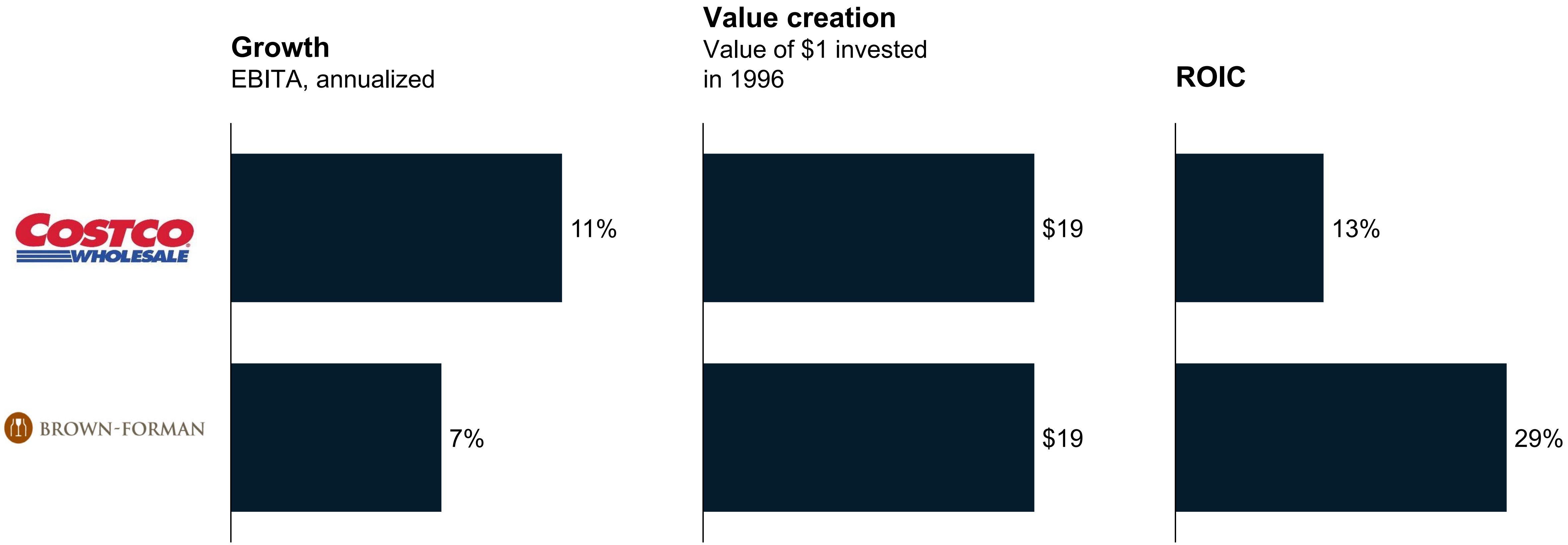
Stock market during the pandemic

Value creation driven by growth and ROIC



Two companies can create same value with different combinations of growth and ROIC

1996-2017



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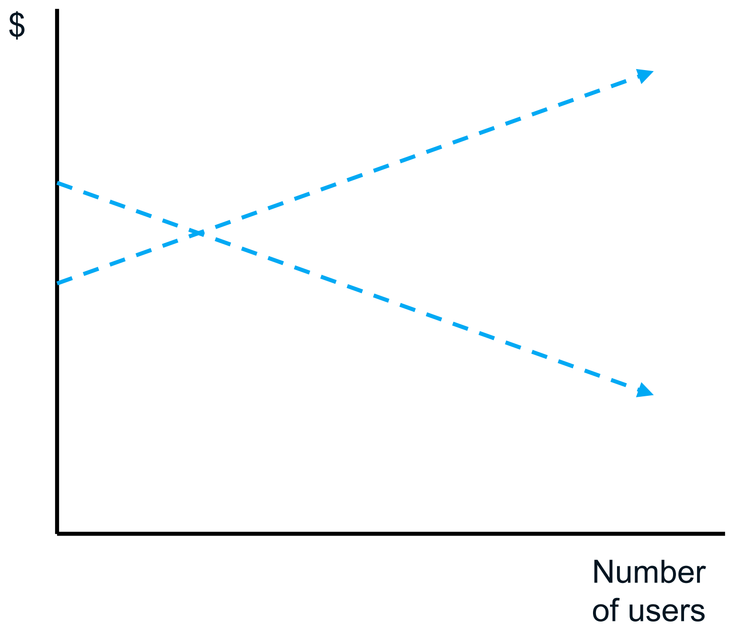
Digital: Two ways to create value

New, disruptive business models

Doing things better

Digital business models – ‘network effects’ still rare

‘Winner takes all’ economics



2 Increasing benefits per user

1 Decreasing costs per user

Uber Expedia

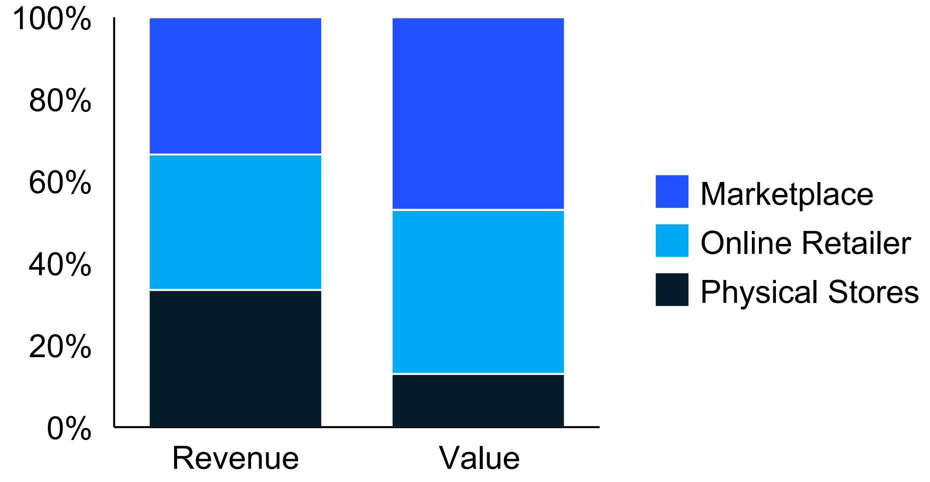
3 Sufficient competitive barriers
(e.g. switching costs)

Microsoft FACEBOOK

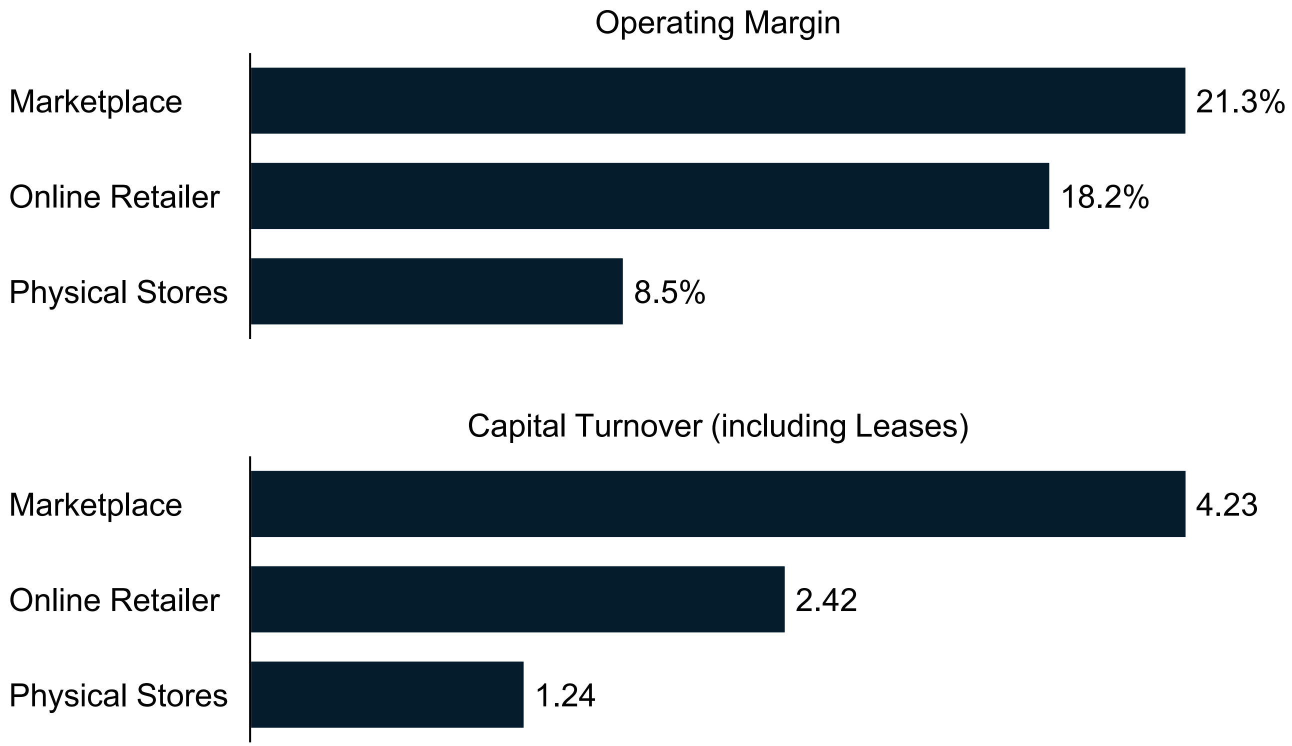
Digital business models may have vastly different economics than traditional models

Revenue and Value Split by Business Model

Sample Company



Value Drivers by Business Model



Valuing Fast Growing Companies

Use DCF with scenarios

Start from the future

Weight the value of the scenarios, but you will be wrong

Multiples can be dangerous

Four ways digital can create value from doing things better

Cost reduction

Improved customer experience

New revenue sources

Better decision making

Examples

Cost reduction
- Predictive maintenance
- Robotic Process automation (RPA)

Improved customer experience
- One click purchase
- 15 min mortgage approval

New revenue sources
- Data monetisation
- Subscription
- Marketplace

Better decision making
- Precision customer targeting
- Data-driven innovation

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Companies that improve short-term earnings by diminishing their value proposition destroy long-term value

	Context and short-term temptation	Long-term consequence
Big box retailer	To meet short-term earnings targets, CEO cut front-line sales force, reducing headcount and training	Stock price plummeted, and customers fled to major competitor
High tech	Industry leader announced investment in novel technology ahead of peers, but failed to back it up with real capital investment	Despite early advantage, company was beaten handily by competitors who invested more aggressively
Consumer staples	Tried to supercharge earnings growth by improving gross margins for multiple years in a row	Lost brand equity and had to make major re-investments to catch back up with competitors
Apparel	Premium fashion company tried to maintain strong growth by reducing quality of products and added large number of outlet stores which diluted brand	Despite initial sales success, eventually destroyed its premium perception Alienated core customer base and sales plummeted

We identified four behaviors that long-term companies embrace, as well as three temptations that they avoid

Behaviors to embrace

- **A** Investing sufficient capital and talent in large, risky initiatives to achieve a winning position
- **B** Constructing a portfolio of strategic initiatives that delivers returns exceeding the cost of capital
- **C** Dynamically allocating capital and talent – via divestitures, if needed – to businesses and initiatives that create the most value
- **D** Generating value for employees, customers, and other stakeholders, as well as shareholders

Temptations to avoid

- **E** Starving growth investments due to short-term challenges, such as temporary earnings deviations from plans or poor performance in other parts of the company
- **F** Improving earnings by cutting costs in areas essential to the company’s competitive position, such as customer service and R&D
- **G** Artificially reducing the natural volatility in revenue and earnings

Achieving a long-term orientation requires action from the board and the top management team

Seven steps towards a long-term orientation

Long-term **boards of directors**…	1	Ensure strategic investments are fully funded each year and have the appropriate talent assigned to them
	2	Evaluate the CEO on the quality of strategy and its execution, company's culture and the strength of its management team – not just financial performance
	3	Structure executive compensation over longer time horizons – including time after they leave the company
Long-term **CEOs/ executives**…	4	Personally ensure strategic initiatives are funded properly, staffed properly, and protected from short term earnings pressure
	5	Adapt their management system to encourage bold risk taking and eliminate biased decision making
	6	Proactively identify and engage long-term investors – and have the courage to ignore short-term shareholders and other members of the investment community
	7	Demonstrate the link between financial and non-traditional metrics to avoid short term tradeoffs

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Five ways that ESG creates value

1	**Top-line growth**	Sustainable products
2	**Cost reduction**	Energy efficiency/water usage/packaging
3	**Regulatory relief**	License to operating/regulatory hurdles
4	**Productivity uplift**	Employees with sense of purpose stay longer and more productive
5	**Investment/ CAPEX**	Investment in new technologies/avoiding investments that may be stranded

Long-term companies link financial and non-traditional metrics to prevent short term tradeoffs

Companies should focus on the most material metrics

Companies should make investments and report based on the metrics that are core to their business

Combining both financial and non-traditional metrics prevent short term tradeoffs that compromise long term strategy

Each company must decide their own non-traditional metrics that are core to their business

Illustrative – Not Exhaustive

	Company metrics
Chemical company	Carbon emissions Plastic production Safety incidents
Apparel company	Supply chain working conditions Living wages in supply chain Use of recycled raw materials
Beverage manufacturer	Water usage Plastic usage Added sugar in products

Source: “Investors and Companies Can Drive ESG Metrics Forward Together” (2020) from FCLT; “Driving the Conversation: Long-term Roadmaps for Long-Term Success” (2019) from FCLT; “Corporate Sustainability: First Evidence on Materiality”

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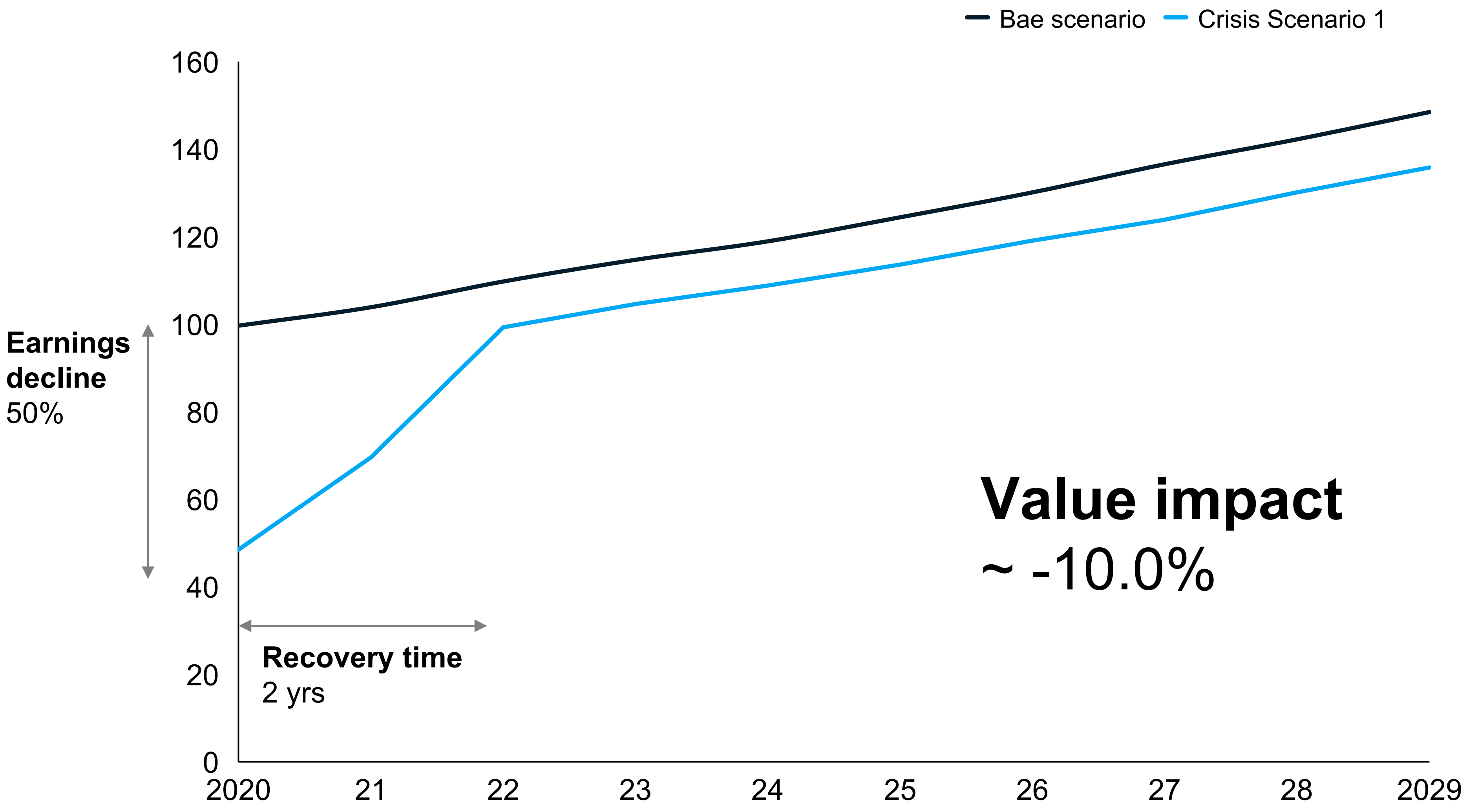
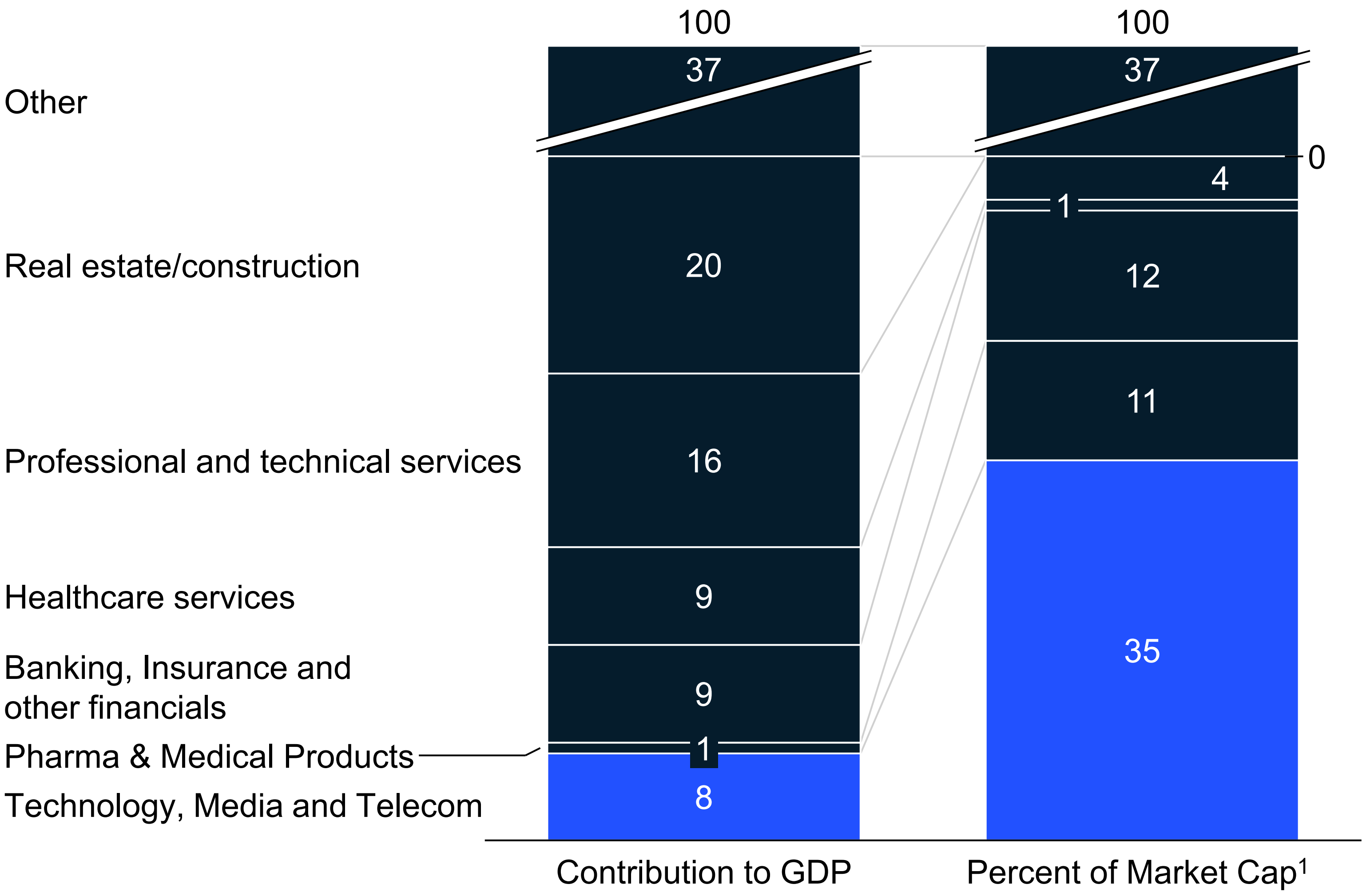
The COVID stock market – it is still about the long term



Even significant short-term earnings decline has limited impact on market value

US stock market composition different than real economy

Percent

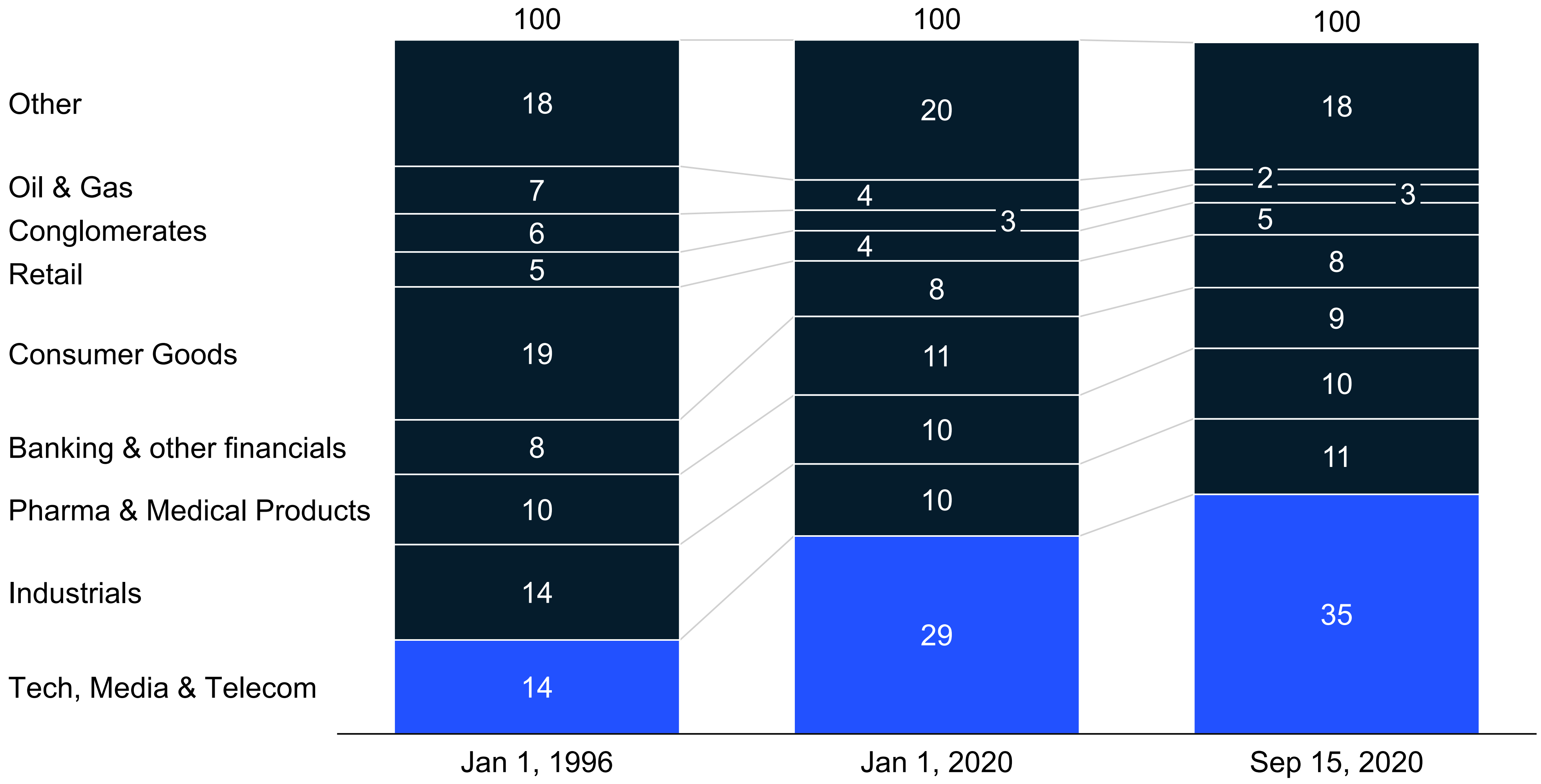


1. Largest 1000 US companies, as of September 15, 2020

Source: S&P Global, Corporate Performance Analytics

TMT has become the largest sector in the US stock market over the past 25 years; it now accounts for 35% of the market

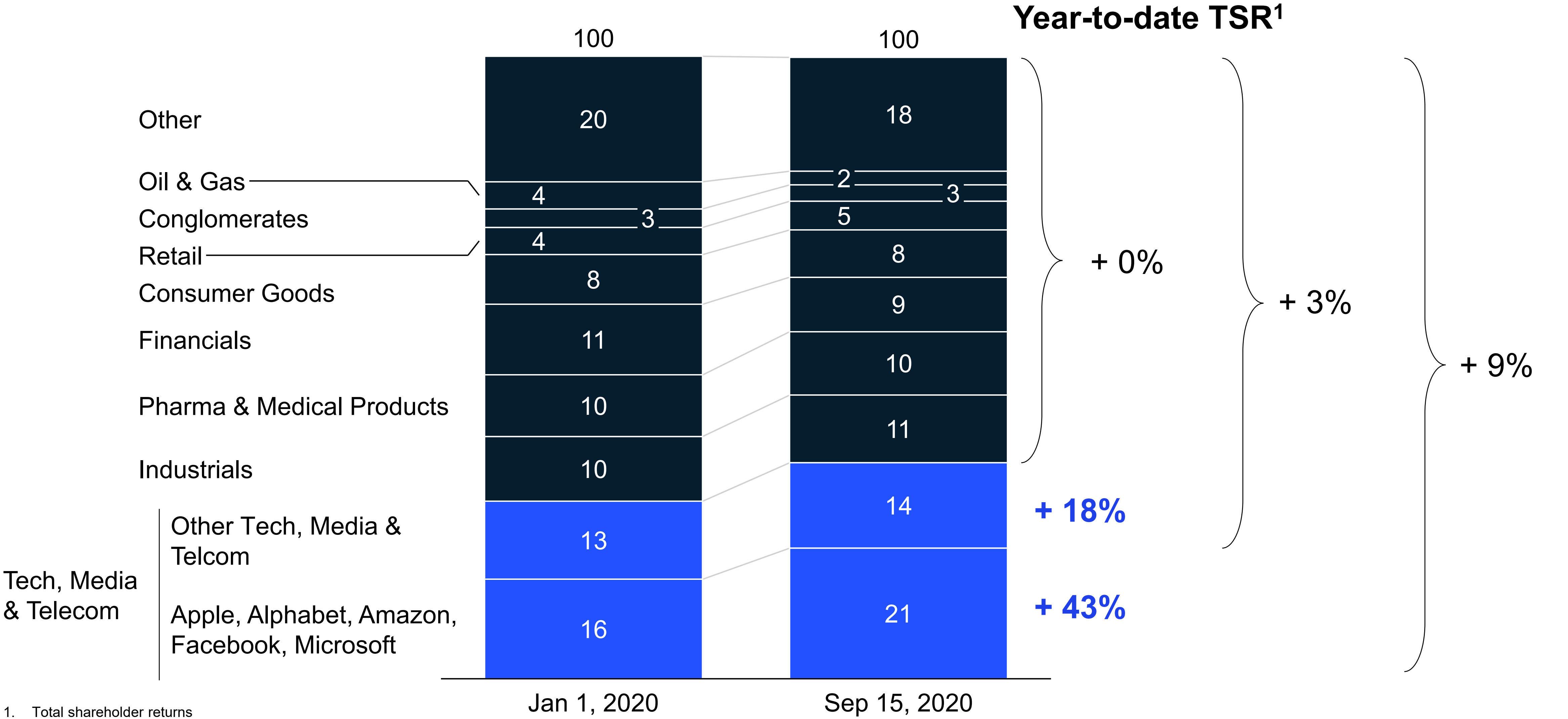
Share of industries as percent of total market cap, top 1000 US companies



Source: S&P Global, Corporate Performance Analytics

Mega-caps driving US stock market returns since January 1

Share of industries as percent of total market cap, top 1000 US companies



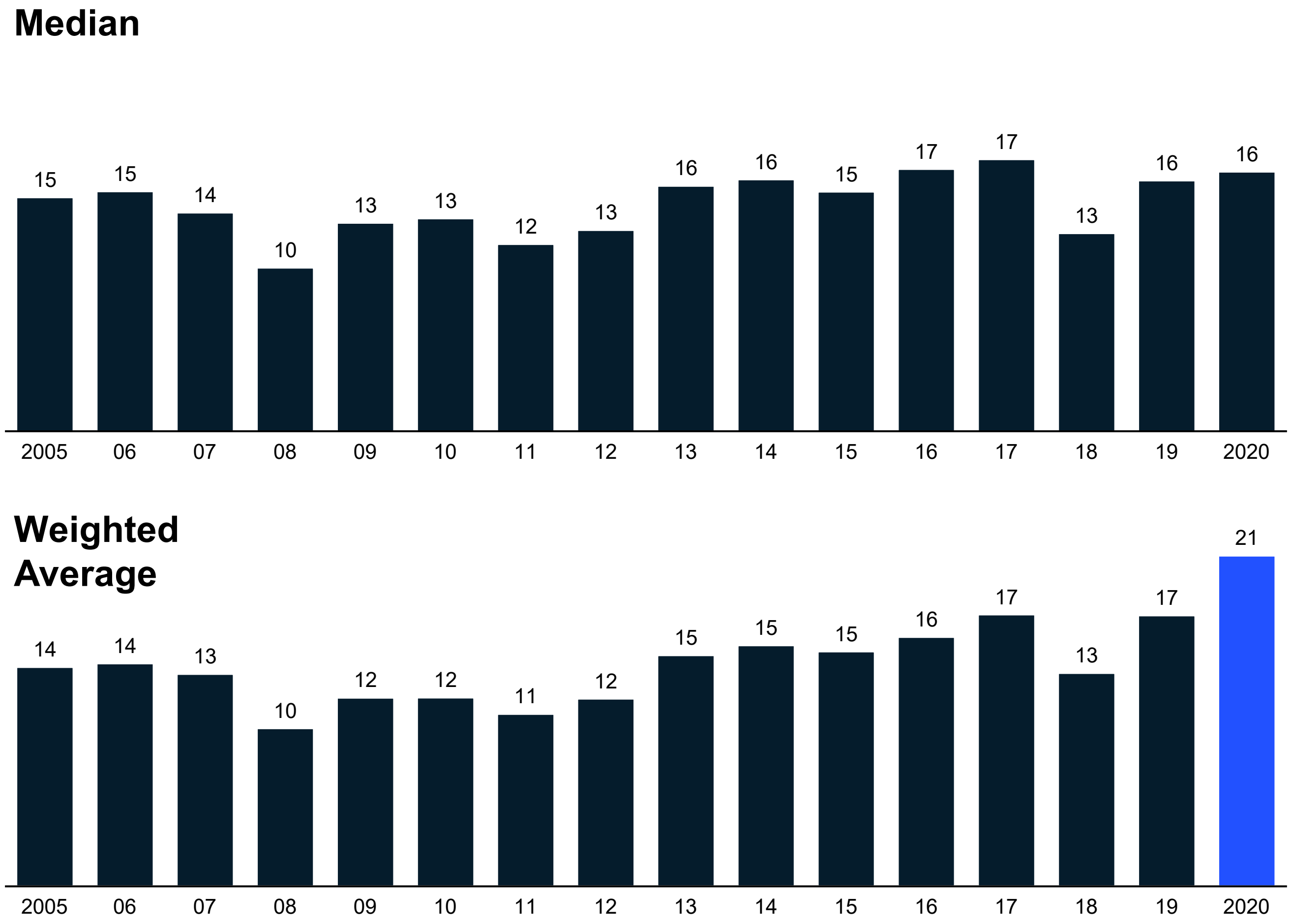
1. Total shareholder returns

Source: S&P Global, Corporate Performance Analytics

Impact of handful of large companies on aggregate P/E ratios

Median and average P/E ratios, large US companies, FY+2

AS OF SEP 4, 2020



Source: Corporate Performance Analytics, S&P Global