DATA 2017 UPDATE 7: OF GOOD AND BAD BUSINESSES

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What is a "good" business?

- If asked to describe a successful business, most people will tell you that it is one that makes money and that is not an unreasonable starting point, but it is not a good ending point.
- For a business to be a success, it is not just enough that it makes money but that it makes enough money to
 - compensate the owners for the capital that they have invested in it,
 - the risk that they are exposed to and
 - the time that they have to wait to get their money back.

Measuring Investment Returns

What you are hoping to measure
Sustainable operating earnings from
existing investments

What you are end up measuring

Last year's accounting operating profits

for the business

Operating Income

Χ

(1- tax rate)

Book Value of Equity + Book Value of Debt - Cash & Marketable Securities

What you are hoping to measure Capital invested in existing projects What you are end up measuring
Accounting-adjusted value of business

The limitations of ROIC

Abnormal earnings

Last 12 months might have been unusally good or bad

Accounting Issues

Operating income can be skewed by accounting misclassification (leases and R&D) and by unusual expenses/income.

Computed as operating income in most recent 12 months, net of the effective tax rate paid during those 12 months

Life Cycle Effect

Current earnings are not indicative of long term earnings potential for young & infrastructure firms

Return on Invested Capital =

Accounting Write offs

Writing off mistakes can reduce invested capital & make it look better than it should.

After-tax Operating Income

Capital Invested in existing assets

Invested Capital = Book value of equity + Book value of debt - Cash & Cross holdings

Inflation

This is your proxy for returns

made on existing assets and

for continuing returns from

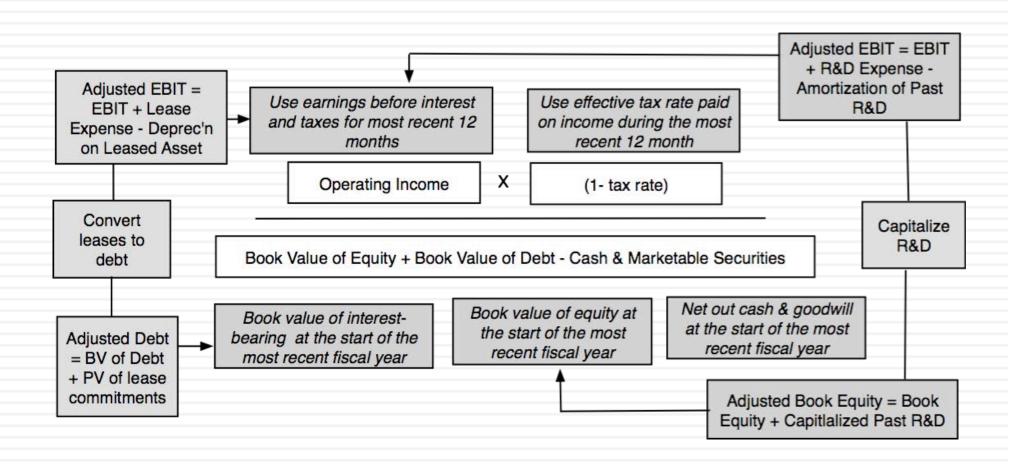
those assets

If asset book value is not adjusted for inflation, capital invested in older assets will be understated.

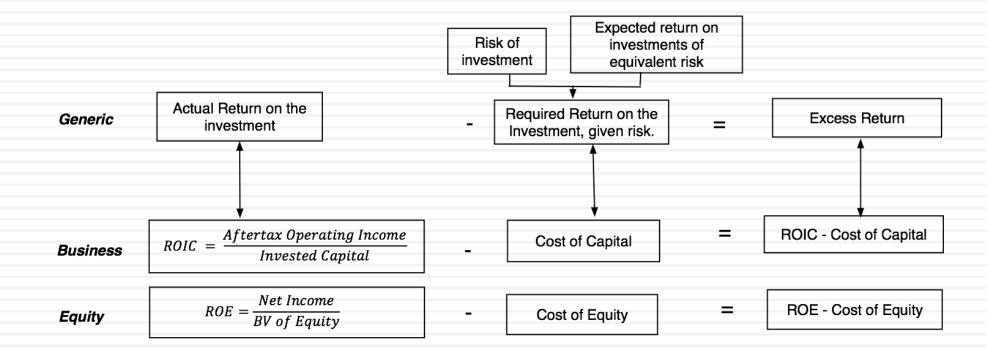
Accounting misclassification

When capital expenses (R&D) and financial expenses (leases) are miscategorized as operating expenses, invested capital will be understated.

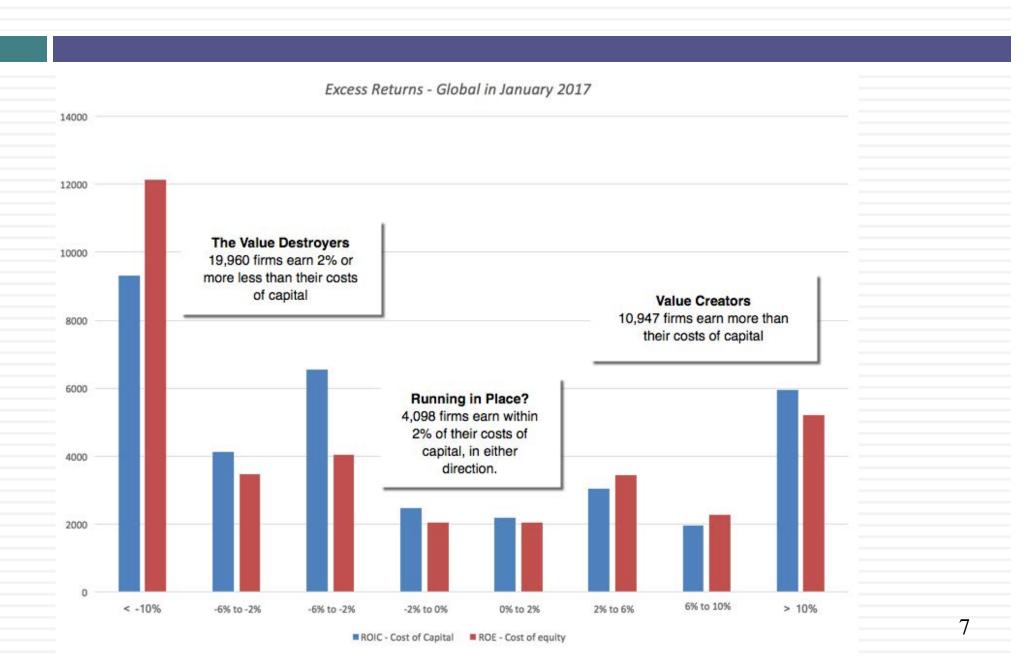
Estimation Details



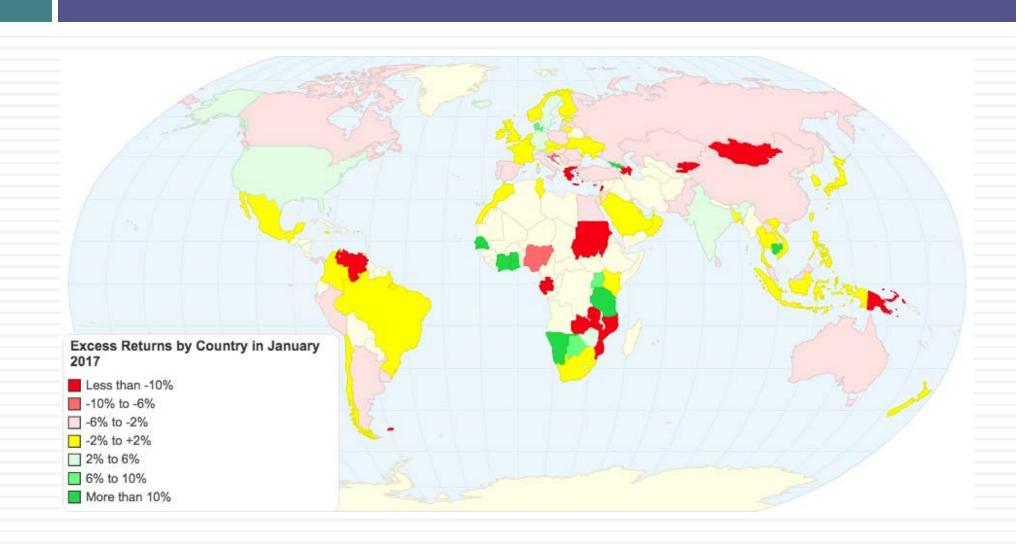
Excess Return Measures



Excess Returns: The Distribution



Excess Returns: A Global Perspective



Excess Returns: Regional Differences

| Sub Group | Number of firms | Cost of Capital | ROIC | ROIC - Cost of Capital | % of firms with ROIC>WACC | |
|---------------------------|-----------------|-----------------|--------|------------------------|---------------------------|--|
| Africa and Middle East | 1,742 | 9.38% | 7.08% | -2.29% | 36.02% | |
| Australia & NZ | 1,527 | 7.67% | 4.98% | -2.69% | 28.35% | |
| Canada | 2,601 | 7.89% | 3.14% | -4.76% | 15.88% | |
| China | 4,793 | 8.05% | 5.74% | -2.31% | 38.84% | |
| EU & Environs | 4,812 | 8.07% | 8.88% | 0.81% | 42.92% | |
| Eastern Europe & Russia | 491 | 9.90% | 7.70% | -2.19% | 33.98% | |
| India | 2,966 | 9.55% | 13.56% | 4.01% | 39.84% | |
| Japan | 3,487 | 7.83% | 7.37% | -0.46% | 51.73% | |
| Latin America & Caribbean | 748 | 9.28% | 7.90% | -1.38% | 42.92% | |
| Small Asia | 7,500 | 9.06% | 7.55% | -1.50% | 35.18% | |
| UK | 1,193 | 8.04% | 8.06% | 0.02% | 44.42% | |
| United States | 6,125 | 7.54% | 10.23% | 2.69% | 42.40% | |

Across Industries: Bad Businesses

| | "Worst" Businesses in 2016 | | | | |
|--------------------------------------|----------------------------|--------|-----------------|--------------|--|
| Industry Name | Number of Firms | ROC | Cost of Capital | (ROC - WACC) | |
| Oil/Gas (Production and Exploration) | 964 | -4.02% | 10.26% | -14.27% | |
| Oil/Gas (Integrated) | 49 | 1.66% | 9.56% | -7.90% | |
| Precious Metals | 961 | 3.24% | 9.44% | -6.20% | |
| Metals & Mining | 1517 | 3.01% | 8.76% | -5.75% | |
| Coal & Related Energy | 278 | 2.80% | 7.89% | -5.09% | |
| Steel | 737 | 2.79% | 7.32% | -4.53% | |
| Shipbuilding & Marine | 326 | 2.94% | 7.14% | -4.20% | |
| Oilfield Svcs/Equip. | 544 | 5.65% | 9.07% | -3.41% | |
| Utility (Water) | 96 | 5.23% | 7.55% | -2.31% | |
| Real Estate (General/Diversified) | 420 | 4.77% | 6.80% | -2.04% | |

Across Industries: Good Businesses

| | "Best" Businesses in 2016 | | | | |
|------------------------------|---------------------------|--------|-----------------|--------------|--|
| Industry Name | Number of Firms | ROC | Cost of Capital | (ROC - WACC) | |
| | | | | | |
| Aerospace/Defense | 222 | 19.70% | 8.91% | 10.79% | |
| Computer Services | 929 | 22.62% | 8.26% | 14.36% | |
| Business & Consumer Services | 772 | 22.66% | 7.77% | 14.88% | |
| Beverage (Soft) | 103 | 22.02% | 6.79% | 15.23% | |
| Entertainment | 353 | 23.92% | 8.38% | 15.54% | |
| Household Products | 494 | 25.16% | 7.91% | 17.25% | |
| Healthcare Support Services | 334 | 30.86% | 7.93% | 22.93% | |
| Advertising | 251 | 33.48% | 8.25% | 25.23% | |
| Information Services | 186 | 33.98% | 8.67% | 25.30% | |
| Tobacco | 59 | 38.92% | 6.83% | 32.09% | |

Closing Thoughts

- There are more "bad" businesses in the world than most people realize. In fact, it is the "good" business that is unusual, not the "bad" one.
- Many of these bad businesses seem to operate as if they were in good businesses, either because they are ignorant (of how much capital they have at play and what they need to make), in denial or just don't care.
- That, in a nutshell, is why you need oversight over management and the willingness to change management.