

# Are some analysts more equal than others?

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- A study of All-America Analysts (chosen by Institutional Investor) found that
  - There is no evidence that analysts who are chosen for the All-America Analyst team were chosen because they were better forecasters of earnings. (Their median forecast error in the quarter prior to being chosen was 30%; the median forecast error of other analysts was 28%)
  - However, in the calendar year following being chosen as All-America analysts, these analysts become slightly better forecasters than their less fortunate brethren. (The median forecast error for All-America analysts is 2% lower than the median forecast error for other analysts)
  - Earnings revisions made by All-America analysts tend to have a much greater impact on the stock price than revisions from other analysts
  - The recommendations made by the All America analysts have a greater impact on stock prices (3% on buys; 4.7% on sells). For these recommendations the price changes are sustained, and they continue to rise in the following period (2.4% for buys; 13.8% for the sells).

# The Five Deadly Sins of an Analyst

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- Tunnel Vision: Becoming so focused on the sector and valuations within the sector that you lose sight of the bigger picture.
- Lemmingitis: Strong urge felt to change recommendations & revise earnings estimates when other analysts do the same.
- Stockholm Syndrome: Refers to analysts who start identifying with the managers of the firms that they are supposed to follow.
- Factophobia (generally is coupled with delusions of being a famous story teller): Tendency to base a recommendation on a “story” coupled with a refusal to face the facts.
- Dr. Jekyll/Mr. Hyde: Analyst who thinks his primary job is to bring in investment banking business to the firm.

# Propositions about Analyst Growth Rates

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- Proposition 1: There is far less private information and far more public information in most analyst forecasts than is generally claimed.
- Proposition 2: The biggest source of private information for analysts remains the company itself which might explain
  - why there are more buy recommendations than sell recommendations (information bias and the need to preserve sources)
  - why there is such a high correlation across analysts forecasts and revisions
  - why All-America analysts become better forecasters than other analysts after they are chosen to be part of the team.
- Proposition 3: There is value to knowing what analysts are forecasting as earnings growth for a firm. There is, however, danger when they agree too much (lemmingitis) and when they agree to little (in which case the information that they have is so noisy as to be useless).

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# Growth III

It's all in the fundamentals

# Fundamental Growth Rates

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$$\begin{array}{|c|} \hline \text{Investment} \\ \text{in Existing} \\ \text{Projects} \\ \hline \$ 1000 \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Current Return on} \\ \text{Investment on} \\ \text{Projects} \\ \hline 12\% \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Current} \\ \text{Earnings} \\ \hline \$120 \\ \hline \end{array}$$

$$\begin{array}{|c|} \hline \text{Investment} \\ \text{in Existing} \\ \text{Projects} \\ \hline \$1000 \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Next Period's} \\ \text{Return on} \\ \text{Investment} \\ \hline 12\% \\ \hline \end{array} + \begin{array}{|c|} \hline \text{Investment} \\ \text{in New} \\ \text{Projects} \\ \hline \$100 \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Return on} \\ \text{Investment on} \\ \text{New Projects} \\ \hline 12\% \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Next} \\ \text{Period's} \\ \text{Earnings} \\ \hline 132 \\ \hline \end{array}$$

$$\begin{array}{|c|} \hline \text{Investment} \\ \text{in Existing} \\ \text{Projects} \\ \hline \$1000 \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Change in} \\ \text{ROI from} \\ \text{current to next} \\ \text{period: } 0\% \\ \hline \end{array} + \begin{array}{|c|} \hline \text{Investment} \\ \text{in New} \\ \text{Projects} \\ \hline \$100 \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Return on} \\ \text{Investment on} \\ \text{New Projects} \\ \hline 12\% \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Change in Earnings} \\ \hline = \$ 12 \\ \hline \end{array}$$

# Growth Rate Derivations

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In the special case where ROI on existing projects remains unchanged and is equal to the ROI on new projects

$$\frac{\text{Investment in New Projects}}{\text{Current Earnings}} \times \text{Return on Investment} = \frac{\text{Change in Earnings}}{\text{Current Earnings}}$$

$$\frac{100}{120} \times 12\% = \frac{\$12}{\$120}$$

$$\text{Reinvestment Rate} \times \text{Return on Investment} = \text{Growth Rate in Earnings}$$

$$83.33\% \times 12\% = 10\%$$

in the more general case where ROI can change from period to period, this can be expanded as follows:

$$\frac{\text{Investment in Existing Projects} * (\text{Change in ROI}) + \text{New Projects (ROI)}}{\text{Investment in Existing Projects} * \text{Current ROI}} = \frac{\text{Change in Earnings}}{\text{Current Earnings}}$$

For instance, if the ROI increases from 12% to 13%, the expected growth rate can be written as follows:

$$\frac{\$1,000 * (.13 - .12) + 100 (13\%)}{\$1000 * .12} = \frac{\$23}{\$120} = 19.17\%$$

# Estimating Fundamental Growth from new investments: Three variations

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Earnings Measure	Reinvestment Measure	Return Measure
Earnings per share	Retention Ratio = % of net income retained by the company = 1 – Payout ratio	Return on Equity = Net Income/ Book Value of Equity
Net Income from non-cash assets	Equity reinvestment Rate = (Net Cap Ex + Change in non-cash WC – Change in Debt)/ (Net Income)	Non-cash ROE = Net Income from non-cash assets/ (Book value of equity – Cash)
Operating Income	Reinvestment Rate = (Net Cap Ex + Change in non-cash WC)/ After-tax Operating Income	Return on Capital or ROIC = After-tax Operating Income/ (Book value of equity + Book value of debt – Cash)

# I. Expected Long Term Growth in EPS

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- When looking at growth in earnings per share, these inputs can be cast as follows:
  - Reinvestment Rate = Retained Earnings/ Current Earnings = Retention Ratio
  - Return on Investment = ROE = Net Income/Book Value of Equity
- In the special case where the current ROE is expected to remain unchanged

$$\begin{aligned}g_{\text{EPS}} &= \text{Retained Earnings}_{t-1} / \text{NI}_{t-1} * \text{ROE} \\ &= \text{Retention Ratio} * \text{ROE} \\ &= b * \text{ROE}\end{aligned}$$

- Proposition 1: The expected growth rate in earnings for a company cannot exceed its return on equity in the long term.



# Estimating Expected Growth in EPS: Wells Fargo in 2008

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- Return on equity (based on 2008 earnings)= 17.56%
- Retention Ratio (based on 2008 earnings and dividends) = 45.37%
- Expected growth rate in earnings per share for Wells Fargo, if it can maintain these numbers.

$$\text{Expected Growth Rate} = 0.4537 (17.56\%) = 7.97\%$$

# Regulatory Effects on Expected EPS growth

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- Assume now that the banking crisis of 2008 will have an impact on the capital ratios and profitability of banks. In particular, you can expect that the book capital (equity) needed by banks to do business will increase 30%, starting now.
- Assuming that Wells continues with its existing businesses, estimate the expected growth rate in earnings per share for the future.

New Return on Equity =

Expected growth rate =

# One way to pump up ROE: Use more debt

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$$\text{ROE} = \text{ROC} + \text{D/E} (\text{ROC} - i (1-t))$$

where,

$$\text{ROC} = \text{EBIT}_t (1 - \text{tax rate}) / \text{Book value of Capital}_{t-1}$$

$$\text{D/E} = \text{BV of Debt} / \text{BV of Equity}$$

$$i = \text{Interest Expense on Debt} / \text{BV of Debt}$$

$$t = \text{Tax rate on ordinary income}$$

- Note that Book value of capital = Book Value of Debt + Book value of Equity- Cash.

# Decomposing ROE: Brahma in 1998

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- Brahma (now Ambev) had an extremely high return on equity, partly because it borrowed money at a rate well below its return on capital
  - ▣ Return on Capital = 19.91%
  - ▣ Debt/Equity Ratio = 77%
  - ▣ After-tax Cost of Debt = 5.61%
  - ▣ Return on Equity =  $ROC + D/E (ROC - i(1-t))$   
 $= 19.91\% + 0.77 (19.91\% - 5.61\%) = 30.92\%$
- This seems like an easy way to deliver higher growth in earnings per share. What (if any) is the downside?

# Decomposing ROE: Titan Watches (India) in 2000

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- Return on Capital = 9.54%
- Debt/Equity Ratio = 191% (book value terms)
- After-tax Cost of Debt = 10.125%
- Return on Equity =  $ROC + D/E (ROC - i(1-t))$   
=  $9.54\% + 1.91 (9.54\% - 10.125\%) = 8.42\%$