White Paper

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July 2013

Executive Summary

This paper details why Fenimore focuses on Owner Earnings when valuing a business, and not Reported Earnings, in order to protect and grow capital over the long term.

Topics include:

- **Valuing a Business** – the main sources of intrinsic value.
- **Reported Earnings** – applying a multiple to Reported Earnings that bears little resemblance to Cash Earnings can result in an inaccurate assessment of value.
- **Owner Earnings** – are often different from Reported Earnings and help indicate true economic worth.
- **Cash Balances** – are also important when valuing a business.

The assertions in this white paper are based on Fenimore Asset Management's opinion.

GAAP Earnings can Lead to Investment Gaps

Fenimore Asset Management's investment philosophy is deceivingly simple – buy stakes in great businesses, run by great managers when they are priced below what we believe they are worth. Hold them until they become overpriced, we find a better opportunity, or our assessment has changed. The lynchpin to this investment approach is having a strong sense of a company's value. After all, how do you know you are getting a bargain price unless you know what something is worth? Valuing a business is part art, part science. It is a complicated process that requires an abundance of clear thinking, due diligence, humility, and patience. Fenimore's valuation approach is thoughtful, unique, and laborious. It helps us to both reduce errors and uncover opportunities in our pursuit of capital preservation and growth. Comparatively, the industry convention of relying on simple multiples of reported earnings is a shortcut – and taking shortcuts endangers capital.

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Valuing a Business

The main sources of intrinsic value for most businesses are its cash flow and assets. If a company is a profitable, going concern, it is worth the present value of the stream of **cash the business will produce for its owners +** the net value of any non-operating assets on the balance sheet. For companies with no, or rapidly dwindling, cash earnings power the enterprise's worth might be the liquidation or secondary market value of its assets. We focus on the former so much of our appraisal effort is determining how much cash the business produces and how that amount will likely change over time.

Forecasting future cash flow is obviously a challenge. However, calculating current year cash generation – the starting point of any reliable appraisal – is also complicated. Despite the fact that a corporation files hundreds of pages of financials with the Securities and Exchange Commission every year, there is no single line for "Cash Earnings available to Owners."

Reported Earnings

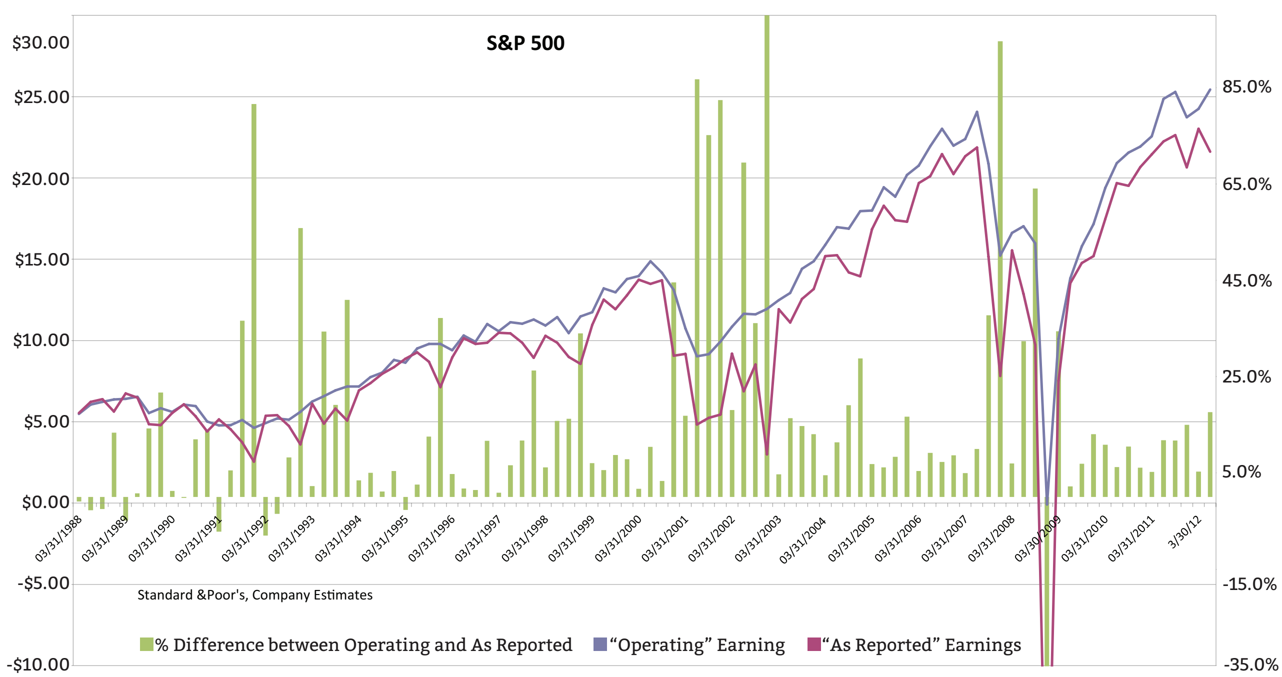
Pick up any business periodical or listen to the financial media for any length of time and there will be a reference to a company's reported earnings per share (EPS) and stock price expressed as a multiple of its earnings (Price-Earnings Ratio P/E). You see, Wall Street uses reported earnings as an approximation for cash earnings and, as a corollary, P/E multiples become shorthand for a company's value. That these metrics have become industry standards is understandable. Earnings per share are widely available and using them allows for quick, effortless, and relative assessments. The problem, though, is that reported earnings are often a poor proxy for cash earnings – and getting worse.

Reported earnings are calculated in accordance with Generally Accepted Accounting Principles (GAAP), a set of guidelines which allows plenty of room for estimation and interpretation. This alone should lead one to be wary of reported earnings. Add to that the strong incentive for executives to potentially manipulate earnings, either up or down, and one should be downright skeptical. The faculty from Emory and Duke Universities conducted a recent study[1] and found that 20% of publicly-traded firms alter earnings. The bottom line is applying one set of accounting rules that satisfies multiple objectives for multiple constituencies to all global, public companies leads to results that are, at best, suspect.

Distortions between reported earnings and any notion of cash earnings have become material over time. One indication of this is Standard and Poor's, a leader in equity market fundamentals, which publishes two types of earnings on its indices – reported earnings and "operating earnings" – removing some of the non-economic effects of GAAP.

The chart below details the disparity over a 25-year period. The blue line depicts "operating" earnings, the red line reported earnings. These are scaled on the left axis. The green bars represent the difference between the two. For a number of reasons beyond the scope of this paper, the frequency and extent of differences is increasing. Bear in mind, this chart is an aggregation of the 500 largest U.S. public companies – at the company level the divergence can be even more pronounced.

Some sources of the distortion include: asset write-offs, one-time charges, one-time earnings, amortization of intangibles, accelerated depreciation, and changing effective tax rates. That is not to say these items are not important when assessing a business. For instance, a pattern of asset write-offs could signal a management team that makes poor judgments or deteriorating industry economics. However, despite their potential for information value, they are not often relevant to the determination of cash earnings power. A valuation approach of applying a multiple to reported earnings that bears little resemblance to cash earnings leads to a number that does not accurately represent the company's value.



[1] Dichev, I., Graham, J., Rajgopal, S., Earnings Quality: Evidence from the Field. Research Paper, Emory University and Duke University.

Owner Earnings

Sit through one of our many analyst meetings at Fenimore and you will rarely hear us mention earnings per share when discussing the value of a business. Instead, we focus on a term Warren Buffett coined – Owner Earnings (O/E). Though our calculation of O/E varies a bit from Mr. Buffett's, we borrowed the label because it effectively focuses us on what, at the end of the day, is the key source of value – the amount of cash generated by a business that could be distributed to owners without harming long-term operations.

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The basic equation for O/E is:

Net income **+** depreciation **+** amortization **+** non-cash charges and expenses **–** non-recurring items **+** non-cash tax effects **–** maintenance capital.

Not all of the figures are available; some have to be deduced, imputed or estimated. Calculating O/E requires an analyst to spend as much time with the Cash Flow Statement as the Income Statement or Balance Sheet. Each line item and accompanying note must be scrutinized for its potential to be manipulated and its impact on the company's sustainable cash generation. Occasionally, at the end of the exercise, our owner earnings are similar to reported earnings. More often than not, however, the two differ materially.

In many instances, reported earnings understate owner earnings causing P/E multiples to understate the value of the business. Consequently, our holdings (or portfolios) might register higher P/Es than one might expect from a value manager even though we are paying a relatively conservative multiple of owner earnings (see Table 1). The opposite can also be true (see Table 2).

Table 1

Reported Earnings < Owner Earnings (O/E)	
Brown & Brown (BRO)	
• 2012 Reported Earnings Per Share:	$ 1.26
• 2012 Owner Earnings Per Share:	$ 1.93
• 2012 Year-End Price:	$25.46
• 2012 Year-End P/E Multiple:	20.2x
• 2012 Year-End O/E Multiple:	13.2x

Table 2

Reported Earnings > Owner Earnings (O/E)	
Interpublic Group (IPG)	
• 2012 Reported Earnings Per Share:	$ .94
• 2012 Owner Earnings Per Share:	$ .86
• 2012 Year-End Price:	$11.02
• 2012 Year-End P/E Multiple	11.7x
• 2012 Year-End O/E Multiple	12.8x

Cash Balances

Also missing from a focus on EPS and P/E is the value of non-operating assets. These can come in many forms such as a former HQ building that is being sold, or an outside investment that has value but does not produce cash earnings. More frequently ignored is a company's excess cash. When you invest in Zebra Technologies, for instance, you are buying a cash flow stream arising from the sales of thermal printers, RFID equipment, and related consumables. You are also investing in a pro-rata share of a cash account and investment portfolio worth up to $7 per share (almost 20% of the current price). To be sure, you do not receive the $7 when you buy the stock and there is no guarantee that the business will not squander your $7 on a bad investment. However, it is worth something and that value is not explicitly captured in an EPS/PE approach.

At Fenimore, we haircut the cash balance based on where the cash is held (U.S. versus international), the company's history of profitable redeployment, faith in management, and more. Next, we add the adjusted number to our owner earnings valuation to get a cash-adjusted intrinsic value.

Unconventional Investing

Rote reliance on EPS and P/E ratios can result in investing errors – of both omission and commission – that jeopardize capital and squander opportunities.

Through a careful study of the data and rigorous due diligence, we strive to thoroughly understand how the companies we research operate and the true drivers of their intrinsic value. With this strong sense of economic worth and our commitment to in-depth research, we gain unique insights that put us in a better position to protect and grow capital.

Fenimore Asset Management is an independent investment advisory firm located in Cobleskill, NY since 1974. Fenimore's affiliates are the Fenimore Private Client Group & FAM Funds – offering separately managed accounts and mutual funds. In-depth research. Insightful investing.