



## The drivers of our full S&P 500 intrinsic value model

Most of our valuation model inputs are fairly straightforward and typical of any intrinsic value model; such as interest rates, risk premiums, retained earnings ratio, return on reinvestment, etc. But our normalized EPS input tends to require additional explanation.

### Understanding our normalized EPS estimates

We assess EPS normality or sustainability by evaluating the ability of current year EPS to grow at a healthy rate over the next several years. If EPS cannot grow at a healthy rate, which we approximate as the nominal cost of equity less the expected dividend yield, then current year EPS must be considered cyclically peaked. It is not enough for EPS to merely grow; in order to be considered normal or sustainable, EPS must grow at a rate that yields a return equal to the cost of equity on any additionally retained EPS.

Let us explain further using our S&P 500 EPS estimates. Although our 2015E S&P 500 EPS is \$119, we think \$122 better represents normalized S&P 500 EPS for 2015. Apart from Energy and Managed Health Care, we think 2015 earnings generally represent normal mid-cycle earnings for most sectors. We think Energy is under earnings in 2015 and parts of Health Care and some other industries over earnings. We think Managed Health Care (HMOs) profits could drift lower on higher industry taxes, limits to premium hikes and the mix of new enrollees weighted towards elderly or with pre-existing conditions. Our \$122 normalized EPS estimate for 2015 captures the outlook for improving profitability at Energy and weakness to come at HMOs. We consider our 2016E EPS of \$125 to be roughly \$2 shy of fully normalized mid-cycle earnings.

Comparing EPS growth expected over the next several years to a value neutral hurdle rate is how we capture the magnitude of current cyclical EPS distortions and the time it should take to return to healthy long-term growth in our normalized EPS estimates.

### Why an accounting quality adjustment to normalized EPS?

We deduct \$12 from our normalized S&P 500 EPS estimate for accounting quality. Pro forma or non-GAAP EPS tends to overstate and GAAP EPS tends to understate true EPS. A good measure of EPS should capture what FCF per share would be when no investments are made for growth. At steady-state  $EPS = FCF/sh = DPS$ .

### An EPS discount model versus a dividend discount model explained

In a dividend growth or free cash flow discount model, future flows can be discounted directly because earlier period flows should be reduced by investments that fed growth. However, earnings growth cannot be discounted directly because earnings growth fails to account for what portion of prior period earnings were retained to feed growth. Thus, an EPS discount model must separate EPS growth into two parts: 1) growth from reinvestment at returns equal to the cost of equity, 2) growth from returns in excess of the cost of equity or economic profit growth. Our EPS discount model calculates value by taking the present value of growth in economic profits (not ordinary profits) and adds this to the capitalized value of current normalized EPS.

DCF: Value = PV of all future free cash flows

DDM: Value = PV of all future dividends

Economic Profit Model: Value = book value plus all future economic profits

Incremental EP Model: Value = capitalized EPS plus all future economic profit growth

Once economic profit growth stops, equity value is simply EPS capitalized at the real cost of equity. This is because EPS growth only adds to steady-state value (EPS/real

### *Intrinsic value drivers:*

- 1) Normalized EPS*
  - 2) Accounting adjustments*
  - 3) Long-term real interest rate*
  - 4) Equity risk premium*
  - 5) Growth premium*
- Inflation affects EPS quality, and the risk premium.*

*We reduce our pro forma normalized EPS est. to ensure that it represents steady-state FCF per share and DPS.*

*Our normalized S&P 500 EPS estimate is the main driver of our intrinsic value model.*

*The mechanics of our model are equivalent to a DDM.*