STOCK REPUTATION

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A key factor that explain share prices

By Julien Onillon

How do you explain a company's valuation on the stock market? What moves a share price? What are the reasons for a "fair" valuation, or on the contrary, for an undervaluation?

Technically, many valuation methodologies exist for a company and a stock. Valuation methodologies are mainly based on profit generation (EV/EBITA, P/E…), on future cash flow (DCF), on value creation (EVA-MVA®) and on asset value (P/BV, EV/IC…). As all investors more or less use the same methodologies and do the same calculations, the share prices of listed companies should stabilize around their true intrinsic value (at least in a theoretically perfect and efficient stock market). In reality, that is not always the case. Most of the time, share prices show a significant gap from the intrinsic value of the stock.

To understand these gaps, I believe that there are five factors which explain valuation multiples and share prices.

The company, its business model and the industry

This is of course the main valuation factor on which analysts and fund managers focus. It is the business model of a corporate which determines its capacity to generate future profit and cash flow. This business model has to be put into the context of the industry; an industry which is growing or not, cyclical or not... A well-established company, in a mature industry in a developed economy will not have the same valuation multiples as an emerging market growth company.

Size and listing

Even if it is a technical factor, the size of the company, its market capitalization, company free float, liquidity and where it is listed, all play a role in the valuation of the stock. A small capitalization, with limited free float, low liquidity and a listing on a minor stock exchange will have little chance to be valued fairly.

The economic environment

The economic environment is the main reason for short and medium term movement of share prices. For many companies, notably "cyclicals", the economic environment has a major impact on results and futures prospects. Not only does it impact the company's markets, potential growth and FOREX, but it also impacts interest rates and yields from which valuation calculations are derived. To a large extend, economic indicators and prospects are key reasons for the movement of valuation multiples.

Management and strategy

The CEO and management team play a major role in the development, strategic orientation and the general adaptation of the company to the economic environment. As such, they are critical to the results and therefore, the company's valuation and multiples. However, for an outsider, it is very difficult to have a clear, objective and quantifiable view on management. It is for this reason that financial analysts rarely give a view on CEOs. That being said, , it does not mean this factor is not taking into account in share prices. Investors meet regularly with management and judge them through their actions (strategy, investments, M&A…).

Stock reputation

Stock reputation that corresponds to the company's reputation on the stock market is generally not taken into consideration. This is a concept that is typically not formally followed. This is also difficult to reconcile, as it is non-material and not easily quantifiable. Yet, the share's reputation is essential for listed company valuation. Investment decisions are based on prospects and expectations, but also on the aggregate of past experiences (historic results, share price performance…). A good reputation will be positively valued in the share price because it lowers investment risk, brings trust and gives confidence to the future behavior of the company and its share price. To the contrary, a bad reputation with investors will lead to a valuation discount. In most cases, this is in fact the main reason for under valuation.

"How to spot an issue with stock reputation"

As we have seen, a company's reputation on the stock market is critical to investors and shareholders as it its plays a major role in valuation and share price movements. Despite this, stock reputation is not really taken into consideration because it is not formally followed, not measured and mainly qualitative. Many listed companies do not even have a precise idea of their reputation with investors. Equally, financial analysts and fund managers can have distorted views on a company.

Traditionally, companies have an idea of their reputation through analyst reports and the feedback they got from their meetings with fund managers. When they want to know more about it, they can order a perception study to be performed by specialized agencies. These studies are generally professional and highlight key areas of concern, but they remain qualitative and highlight only one part of the true reality. Fund managers and analysts also listen to what it said on the market and typically form their own opinion of a company. Yet their view is not always the full story or can be misrepresentative of the truth.

Yet, there exist two ways to spot a real problem of stock reputation with certainty.

Historical analysis of valuation and share price performance together

The underperformance of a stock can be due to a reputation problem but this is not always the case. Equally, an undervaluation is not always proof of a bad reputation on the stock market. On the other hand, an intrinsic, historical and constant undervaluation together with stock underperformance is a strong signal that a problem exists related to stock reputation. Under normal conditions, undervalued companies have relatively good share price performance. Investors, in particular "value" investors, are interested in those types of stocks and support them. If this is not the case, it is most likely because the company has reputational issues.

Analysis of share price behavior around publications

The other way to spot a bad stock reputation is to look at the share price behavior of a company before and after making announcements or publishing results. To have a full understanding and avoid any misinterpretation, it is necessary to analyze these movements over a long enough period. A review of more than ten publications (quarterly results, specific announcements…) is needed to form a clear opinion. That being said, a share price decline following results or an announcement is not necessarily due to a reputational problem within the investor community. It might simply be because profits or prospects are poor, or alternatively because expectations were too high. It will impact reputation but it is more due to a mismanagement of the announcement. To the contrary, a poor or stable share price performance before and after good results publication or a positive announcement is a clear signal that something is wrong. It means that investors are ignoring the positive, that they are solely focused on the risks and that they do not trust the company. Similarly, when a share price falls before results publication that means that investors are worried, lack confidence in the announcement to come and expect to be disappointed. If that happens once, it is probably not a problem but if it is systematically every quarter, it is most likely due to a real problem of stock reputation.

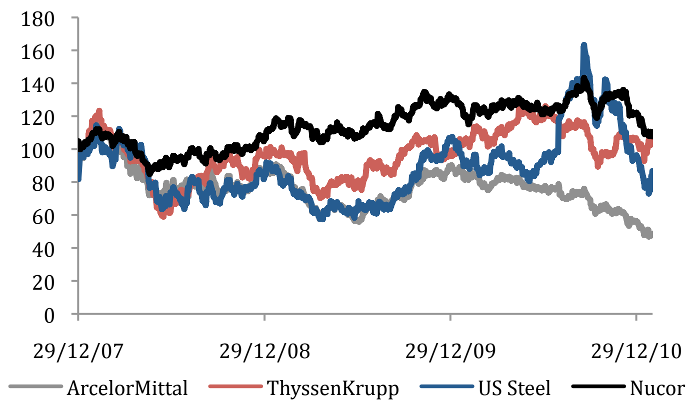
"Case study: A quick look at the reputation of 4 steelmakers on the stock market"

As we have seen it is not too complicated to do spot an issue with stock reputation. So let's have look at a concrete case. Considering that I was a former steel analyst and the former Head of IR at ArcelorMittal five years ago, some reader of my blog have asked me to look the reputation on the stock market of the steelmakers Nucor, ThyssenKrupp, US Steel and of course, ArcelorMittal.

Share price performance and valuation

In order to form an opinion on stock reputation, the first thing to do is to analyze a share price's performance together with its valuation over a long enough period of time. In this specific case, I looked at the last 3 years.

Steel stock price performance over the last 3 years (base 100 in USD)



EV/EBITDA 4 year average*

EV/EBITDA	03/01/12	30/01/15	Change
Nucor	9.5	7.5	=
ArcelorMittal	7.0	4.6	-
ThyssenKrupp	5.4	7.3	+
US Steel	N/A	4.6	N/A

* EBITDA is a mid-cycle EBITDA calculated on the average of 4 years including 2 prospective years (consensus).

Historically, Nucor has always benefited from an excellent image with investors. Its recent share price performance and its valuation multiples tell us that the American company has mostly retained this excellent image. Nucor has not only performed relatively well compared to its peers on the stock market but it has also maintained its valuation premium.

On the contrary, ArcelorMittal appears to have a new issue with stock reputation. The industry leader has underperformed the industry over the last 3 years but also faces a deterioration of its underlying valuation multiples. This means that its share price decline is not just the result of its financial performance.

The case of ThyssenKrupp is also interesting. Historically disliked by investors, the German group has faced a deterioration in its financial results over the last 3 years. Despite this, its share has resisted well and this has allowed an improvement of its valuation multiples.

Finally, US Steel, which sustained heavy losses 3 years ago, has succeeded to recover its profitability. Nevertheless, its share remains very volatile and its valuation multiples remain low. This suggests that investors are still discounting its recovery and continue not to trust the company.

Share price behavior around publications

In order to provide a more precise analysis, the share price behavior of these companies needs to be looked at both before and after publications. Once again, to form a solid opinion and avoid misinterpretation, I have looked at these movements over 3 years, which equates to 12 quarterly results. For each company, I have counted how many times its share underperformed, outperformed or moved in-line with the stock market, before and after publications.

Share price behavior versus the index before and after publications

	Before publication*				After publication		
	Proportion of underperforming behavior	Proportion of "in-line" behavior	Proportion of outperforming behavior		Proportion of underperforming behavior	Proportion of "in-line" behavior	Proportion of outperforming behavior
Nucor	17%	58%	25%	Nucor	25%	50%	25%
ArcelorMittal	17%	50%	33%	ArcelorMittal	33%	17%	50%
ThyssenKrupp	25%	33%	42%	ThyssenKrupp	33%	25%	42%
US Steel	42%	42%	17%	US Steel	33%	33%	34%

* Over 3 days

Once again, Nucor's stock shows excellent behavior. Investors show no specific fears or expectations ahead of results publications and they are generally not surprised by announcements. Results are largely non-events.

ArcelorMittal's publications also appear to have not generated any specific fears. Ahead of results, its share price has declined only one time out of five. On the contrary, results publications have been followed by a significant share price change four times out of five. Those changes are not positive for stock reputation as they create uncertainty for investors.

ThyssenKrupp is the steelmaker, which has generated the highest expectations from investors. Fortunately, its share price behavior after publication shows that the company has largely met expectations. This has meant an improving stock reputation.

On the other hand, US Steel's results publications seem to be anticipated with fear. Over the last three years, US Steel's share price went down five times out of 12 ahead of publications. That confirms that despite its results recovery, investors have little confidence in the company and its share.

Conclusion

As expected, this small analysis has revealed a lot about these companies' stock reputations. Even more so, it has demonstrated 4 key insights:

- A good stock reputation brings a valuation premium (e.g. Nucor).
- An outperformance on the stock market may not be sustainable without a good stock reputation (e.g. US Steel).
- A stock reputation can deteriorate (e.g. ArcelorMittal).
- On the contrary, even with mediocre financial performance, it is possible to improve a stock reputation (e.g. ThyssenKrupp).

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