Financial Strategy and Capital Allocation

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What Really Moves a Company’s Stock Price?

“What people say, what people do, and what they say they do are entirely different things.”

Go by what investors do, not what they say.

Margaret Meade
Famous Anthropologist
Holistic Capital Deployment Framework

Most companies apply different analytics to capital deployment alternatives making comparisons impossible. Fortuna Advisors’ consistent shareholder value framework makes tradeoffs clear and fact based.

Sources of Capital
- Cash from Operations
- Cash from Financing
- Cash from Investing

Attractive Growth?
- Yes
- No

Future Reinvestment Opportunity?
- No
- Yes

Value Creation
- Organic Growth
- Collaborative Growth
- Acquisitive Growth

Value Distribution
- Share Repurchase
- Dividends

Financial Flexibility
- Debt Repayment
- Hold Cash
Who Says M&A Doesn’t Create Value?

**TSR vs Acquisition Intensity**
- Small: 10.8%
- Medium: 4.7%
- Large: 10.5%

**TSR vs Acquisition Frequency**
- Rare: 7.9%
- Occasional: 7.0%
- Serial: 11.5%

**Median 2-Year Relative TSR**
- Significant Acquirers:
  - Year 1: 77%
  - Year 2: 50%
  - Year 3: 43%
  - Year 4: 40%
  - Year 5: 46%

**Acquirer TSR Hinges on Results**
- Year 1: 20%
- Year 2: 21%
- Year 3: 20%
- Year 4: 15%
- Year 5: -7%

“Who Says M&A Doesn’t Create Value”, February 26, 2010
(based on Industrial Machinery Industry)

“Acquirer TSR Hinges on Results”, June 14, 2011
(based on all industries)
Fortuna Advisors developed Buyback ROI in order to measure the return and timing of repurchases, for comparison to other uses of capital like acquisitions and capital expenditures. This tool can help companies better determine when buybacks are likely to help the remaining shareholders.

### Buyback ROI

**2-5 Years of Buybacks**

IRR Based on Dividends Avoided and Value of Shares Now

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company Name</th>
<th>Ticker</th>
<th>% Total Buyback / Market Cap</th>
<th>Buyback ROI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>NVIDIA Corporation</td>
<td>NVDA</td>
<td>5.5%</td>
<td>80.5%</td>
</tr>
<tr>
<td>2</td>
<td>Electronic Arts Inc.</td>
<td>EA</td>
<td>9.8%</td>
<td>43.4%</td>
</tr>
<tr>
<td>3</td>
<td>E*TRADE Financial Corporation</td>
<td>EFTC</td>
<td>5.3%</td>
<td>42.0%</td>
</tr>
<tr>
<td>4</td>
<td>Northrop Grumman Corporation</td>
<td>NOC</td>
<td>27.0%</td>
<td>35.5%</td>
</tr>
<tr>
<td>5</td>
<td>Martin Marietta Materials, Inc.</td>
<td>MLM</td>
<td>5.5%</td>
<td>35.2%</td>
</tr>
<tr>
<td>6</td>
<td>Southwest Airlines Co.</td>
<td>LUV</td>
<td>15.7%</td>
<td>35.1%</td>
</tr>
<tr>
<td>7</td>
<td>Global Payments Inc.</td>
<td>GPN</td>
<td>12.9%</td>
<td>34.1%</td>
</tr>
<tr>
<td>8</td>
<td>Applied Materials, Inc.</td>
<td>AMAT</td>
<td>13.8%</td>
<td>34.0%</td>
</tr>
<tr>
<td>9</td>
<td>Activision Blizzard, Inc.</td>
<td>ATVI</td>
<td>23.6%</td>
<td>33.2%</td>
</tr>
<tr>
<td>10</td>
<td>Boston Scientific Corporation</td>
<td>BSX</td>
<td>4.2%</td>
<td>33.0%</td>
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</tbody>
</table>
Immediate Share Price Reactions are Often Different from TSR Over Time
Moneyball: Business is Like Baseball

Make decisions based on facts, not opinions.
Introducing **Residual Cash Earnings (RCE)**

*Improving the Growth vs Return Tradeoff*

**Gross Cash Earnings**
- Adjusted After Tax Operating Cash Flow

**Residual Cash Earnings**

**Capital Charge**
- Gross Operating Assets × Required Return %

Note: Predicted value based on gross operating assets plus the present value of RCE which in the graph is estimated simply as RCE capitalized as if it were expected to stay flat forever.
RCE holds management accountable for this bad investment

<table>
<thead>
<tr>
<th></th>
<th>Existing</th>
<th>+</th>
<th>Invest</th>
<th>=</th>
<th>Combined</th>
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<tbody>
<tr>
<td>Sales</td>
<td>$3,200</td>
<td></td>
<td>$1,000</td>
<td></td>
<td>$4,200</td>
</tr>
<tr>
<td>Margin</td>
<td>5%</td>
<td></td>
<td>6%</td>
<td></td>
<td>5.2%</td>
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<tr>
<td>Gross Cash Earnings</td>
<td>$160</td>
<td></td>
<td>$60</td>
<td></td>
<td>$220</td>
</tr>
<tr>
<td>Gross Oper Assets</td>
<td>$4,000</td>
<td></td>
<td>$1,000</td>
<td></td>
<td>$5,000</td>
</tr>
<tr>
<td>ROIC %</td>
<td>4.0%</td>
<td></td>
<td>6.0%</td>
<td></td>
<td>4.4%</td>
</tr>
<tr>
<td>Required Return</td>
<td>10.0%</td>
<td></td>
<td>10.0%</td>
<td></td>
<td>10.0%</td>
</tr>
<tr>
<td>Capital Charge</td>
<td>$400</td>
<td></td>
<td>$100</td>
<td></td>
<td>$500</td>
</tr>
<tr>
<td>Residual Cash Earnings</td>
<td>($240)</td>
<td></td>
<td>($40)</td>
<td></td>
<td>($280)</td>
</tr>
</tbody>
</table>

Note: Analysis simplified for illustration.
Value Based Scorecard: 5 Tools
Goal Setting, Planning, Decisions and Performance Mgt

All 5 Tools Required
- Revenue Growth
- Gross Cash Margin
- Asset Intensity
- Reinvestment Rate
- Reinvestment Effectiveness

ΔRCE

RCE Margin

Value Creation/Share

Valuation Multiple
- Differentiation
- Profitable growth
- Sustainability
- Risk

Current Value

Future Value

CFO University, FEI Houston, May 18, 2017
Comprehensive RCE Management Framework

Moving from many different and seemingly unrelated measures used for different applications ... 

... to a single measure that links drivers of value in a meaningful way and is applicable to all decisions.
Q&A
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