

- Valuation of AF Gruppen:
how wide is the moat? -

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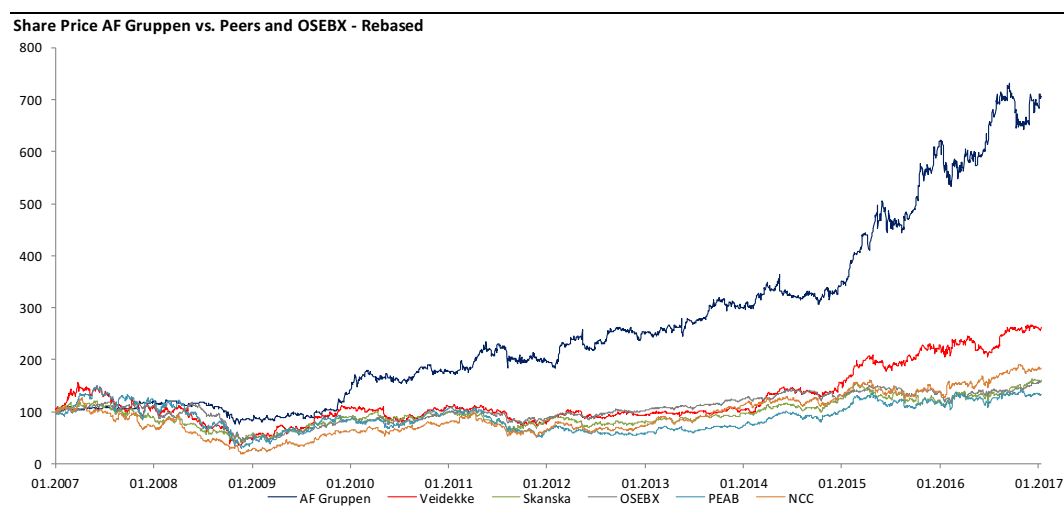
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1. Introduction and Motivation

AF Gruppen is a leading contracting and industrial group. The company was listed on the Oslo Stock Exchange in 1997 and has six business areas including civil engineering, building, property, energy, environment and offshore (Veidekke).

The AF-share experienced its best year ever in 2015 and rose 89 percent adjusted for dividends. Over the course of the past ten years, the AF-stock has been the share on the Oslo Stock Exchange that has delivered the highest return to its shareholders, with a return of 1 472 percent – an average annual return of 32 percent. The company has thus been able to consistently outperform both the market and its peers during this period.



The authors of this thesis are intrigued by the performance of AF Gruppen and its ability to generate superior shareholder returns whilst operating in relatively mature business areas. In competitive markets, capitalism plays its part and competitive advantages tend to diminish after some time. Be that whether a company's technological innovation loses its prowess or a shift in consumer demand reduce the need for certain products. In any way, competitive forces eventually drive returns toward the cost of capital. Some companies however, are able to maintain their competitive advantage year-after-year and are thus characterized by wide economic moats and consistently high shareholder returns. We suspect that AF Gruppen is one of these companies, and the thesis will attempt to emphasize this further.

Legendary investor Warren Buffett and CEO of Berkshire Hathaway says the following:

"The most important thing to me (when considering an investment) is figuring out how big a moat there is around the business. What I love, of course, is a big castle and a big moat with piranhas and crocodiles." – (Buffet, 1994)

Morningstar claim that firms in possession of a wide economic moat will generate superior shareholder value over the long-term (Larson, 2004). This assertion however, has not been extensively tested empirically and is neither the purpose of this thesis. What we aim to do however, is to add further substance to a classical valuation of a company, by determining the size- and value of the company's moat and figure out *why* AF Gruppen consistently deliver good results and returns to shareholders. As such, we aim to mimic what Warren Buffett and other successful value investors have managed to do; identify and value economic moats.

This paper will attempt to elaborate on all parts important for a valuation of AF Gruppen by thoroughly presenting necessary frameworks, models and assumptions in order to properly value the company. Thus, we will undertake a sum-of-parts per share valuation of the equity of AF Gruppen and attempt figure out whether the company is currently under- or overvalued, both with- and excluding the value of the economic moat.

Thus, our problem statement is: "What is the value per share of the equity of AF Gruppen?"

2. Literature Review

"A cynic is someone who knows the price of everything and the value of nothing" – a common saying amongst value investors coined by professor at NYU, Aswath Damodaran. However, how does one define value? The goal of a value investor is to purchase companies at a large discount to their intrinsic value, what the business is actually worth. Although no universal term for value exists, one common way to define value is *the present value of all future cash flows*.

Commonly regarded as the father of fundamental analysis and author of *The Intelligent Investor*, Benjamin Graham, focused extensively on the underlying business in order to value companies and invest in those with a low price relative to its value. In recent time, investors, with one of the world's richest men Warren Buffett has seen great success following this philosophy (Forbes).

Although practitioners seemingly have made good profits following Benjamin Graham and the principles in *The Intelligent Investor*, the famous Efficient Market Hypothesis presented by Eugene Fama states that "security prices at any time "fully" reflect all available information". In practice this means that there is no place for value investors, simply because the value of a company always equals its price, and the possibility of

making abnormal returns based on fundamental analyses should be zero. According to the Efficient Market Hypothesis we expect to find a value per share equal to the price at the information cut-off date, expected to be the release date of the 2016 annual report.

Conducting a valuation of a company is however a widespread concept, it's a profession. It's taught in business schools around the world and the literature on the subject is plentiful. The methodology is thoroughly tested by scholars and professionals and hence, the authors feel confident that there is sufficient empirical research and similar papers to obtain the proper inspiration. Valuation: Measuring and Managing the Value of Companies by Koller, T., Goedhart, M., Wessels, D. & McKinsey & Company is commonly regarded as one of the best literature on valuation, and the authors will depend on the framework presented here extensively. We will also supplement with theory and framework from Stephen Penman: Financial Statement analysis and Security Valuation.

By time of writing (06.01.2017) - 12-month analyst Bloomberg consensus target price on AF Gruppen is NOK 145,29 per share with 1 buy rating, 5 hold ratings and 1 sell rating. The professional analysts deploy several valuation models, such as discounted cash flows (DCF) and relative peer valuation. These, and others, are models the authors intend to use as well, nevertheless this will be elaborated later on.

Whether an economic moat is cause of excess returns is however less extensively researched. Although, as previously mentioned, this is neither the purpose of the thesis. The valuation and identification of economic moats are not common part of valuations, simply because few companies possess wide lasting moats (Boyd & Quinn, 2006). However, similar quality-student theses exist and frameworks for the process have been developed e.g. by Mauboussing & Callahand for the the Swiss investment bank Credit Suisse; Measuring the Moat: Assessing the Magnitude and Sustainability of Value Creation (Credit Suisse, 2013)

3. Theory

Theories presented is based upon numerous assumptions, some more realistic than others. However, this section has its aim to present theories relevant for this master thesis without digging into its assumptions, which will be more elaborated upon in the main paper.

3.1 Agency Theory

Jensen and Meckling (1976) claims that the agency relationship occurs if one party (the principal) engages another party (the agent) to perform some services on their behalf, which involves delegating some decision-making authority to the agent. However, if both the agent (manager) and the principal (owner) are utility maximizers, there is a great possibility of the occurrence of a conflict interest. A way for the principal to maintain its control is to implement incentive schemes and monitoring costs for the agent, which would in turn align both parties' interests. (Jensen & Meckling, 1976)

3.2 CAPM

The capital asset pricing model is building on the early work of Markovitz' research on diversification and modern portfolio theory and was introduced by Treynor (1962), Lintner (1965) and Mossin (1966), independently. Its purpose is to describe the relationship between systematic risk and expected return of an asset. The model requires three inputs, namely a risk-free rate, a market risk premium and a beta. The risk-free rate captures the return if you investing within a period without taking any risk, therefore such assets will have zero default risk and no reinvesting risk. The risk premium is an estimate of the historical return of the market over the risk-free rate, which represents an investor's required rate of return to be in possession of the market portfolio. The beta represents the systematic risk, also known as the "undiversifiable risk". This input is considered as the most important variable in the CAPM, as this captures the price volatility of securities on the overall market. By undiversifiable risk means risk the investors cannot eliminate, therefore CAPM suggests that any deviations from the market should be compensated. (Perold, 2004, ss. 9, 14, 17)

$\beta > 1$, stock more volatile than the overall market.

$\beta < 1$, stock less volatile than the overall market.

3.3. Efficient Market Hypothesis

Expected future cash flows as well as the associated risk are incorporated in the stock price of a company. Investors are always looking for stocks that are undervalued, in order to make a profit from its expected price-increase in the future. Because of the vast existence of analysts, Eugene Fama argues that detection of undervalued stocks is almost impossible. He states that the best choice of an investor is to invest in index funds instead of investing in individual stocks, because the stock price reflects all relevant information. (Bergen) Thus, attempts to outperform the market are essentially

a game of chance rather than one of skill, because new information is reflected in the price before an investor can trade on and make a profit from it (Morningstar)

3.4 Market Segmentation Theory

This theory asserts that interest rates should be viewed separately, meaning that there exists no inherent relationship between short-term and long-term interest rates. For each independent market, yield curves are determined by the supply and demand, therefore the yields for one market cannot be used to predict the yields for securities in another maturity market (Investopedia). Construction companies, such as AF Gruppen which has complex, long-lasting projects may desire to sell ten-year bonds and then repay them as the project is finished when there is sufficient liquidity to meet the demands of the creditor.

3.5 Dividend Decision – Walter Model

James E. Walter (1963) argues that the dividend decision of a company almost always will affect its valuation, and that companies that paying higher dividends will obtain a higher value compared to companies that have a lower (or none) payout of dividends. In his research, he uses the internal rate of return (r) and its cost of capital (k) to illustrate his view, and uses the following examples:

If $r > k$, also known as *growth firms*, dividend payout ratio and enterprise value is negatively correlated. Such companies should retain their earnings, because it will gain more for their shareholders through investment opportunities, compared to what the shareholder would earn if they reinvested the dividends. Therefore, for growth firms the optimum dividend payout ratio is equal to zero.

If $r < k$, which is categorized as a *declining firm* are not able to gain more from investments than what the shareholders can make on their investments. Therefore, such companies should not retain their earnings, but instead distribute all its earnings to their shareholders. Thus, optimum payout ratio is equal to 100%.

If $r = k$ the payout ratio will have no effect on firm-value, because the company and its shareholders will have equal return. Ergo, this kind of companies cannot affect its market price with its dividend policy, and any dividend payout ratio is optimum (Borad)

3.6 Modigliani-Miller, Dividend Irrelevance

Merton Miller and Franco Modigliani (1961) assert the irrelevance between a company's dividend policy and its cost of capital and share value. Rather, the only thing that will affect the firm value and the investors' investment decision is the company's earnings,

which in turn is affected by the company's investment policy and future prospects (Hill, 2012). The underlying idea behind this claim is that investors are always capable to make their own cash flows from an investment, depending on their need for cash. If a company are not capable to give the investor sufficient money in terms of dividend, he can always sell some of his stocks to fill his needs. Thus, the dividend policy is not important for an investor when deciding whether to invest or not. (Borad)

3.7 Miller & Modigliani, Capital Structure irrelevance

Before Miller and Modigliani stated the irrelevance between an investors investment decision and dividend policy of company, they also presented an idea regarding company's capital structure. They hypothesized that it is no difference whether a company finances its operations through debt or equity, and that the market value of a company does not depend on the structure between these two combinations. Instead, it is the company's earnings power and risk of its underlying assets that decides the market value of the company. Hence, a company with high future growth prospects will have a high value, and consequently have a high stock price regardless of whether that growth is financed through debt or equity (Investopedia).

3.8 Net Income Theory

David Durand has a research which is based upon the theory that the capital structure decision is relevant to the value of the firm. He claimed that if a company changes its financial leverage this will lead to a change in both its cost of capital and the value of the firm. He stated that an increase in financial leverage is inversely related to the cost of capital, meaning that the value of a company can be increased by lower its cost of capital through higher proportions of debt. (Borad)

3.9 Net Operating Income Theory

This approach was also suggested by David Durand, which is the opposite view of the Net Income Approach, namely that capital structure decision of a company is irrelevant. Ergo, he claimed that any change in the leverage of debt will not affect the stock price or the value of the company. As Net Income Approach states that capital structure decision is a way to influence the cost of capital, this theory argues that the overall cost of capital is independent of the financial leverage-ratio. (Borad)

3.10 The Trade-Off Theory

When a company wants to decide how to finance its business, they must choose how much debt finance and how much of the business should be equity financed. The former provides the advantage of the interest tax shield, which is beneficial for the value of a

company. As Miller and Modigliani argued that the value of a company is irrelevant with respect to its capital structure, Litzenger and Kraus (1973) disagreed with this statement. Instead, they claimed that if a company has too much debt this may destroy value, as the marginal benefit of increased debt is decreasing as debt increases in terms of interest expense. Hence, this theory is related to the trade-off between costs and benefits of leverage when a company searches for an optimal capital structure. (Shahdila et. al, 2015). Leverage contains two different costs, namely financial distress, which is, i.e. related to the cost of insolvency of a company, and agency costs. The latter cost concerns the dispute of interests among the management of a company, debt holders and shareholders (see agency theory). It is first addressed as a problem, that in turn give rises to costs, and it may affect the capital structure of the company. The agency cost is a common argument to explain why companies are not 100% debt financed

3.11 The Pecking Order Theory

The pecking order theory is related to the research of Myers and Majluf (1984). Their research was influenced by the book of Donaldson (1961) and builds upon the phenomenon of asymmetric information. Myers and Majluf proclaimed that managers possess more information than investors, resulting in actions taken by managers provides a signal to investors regarding the prospects of the firm. Hence, if a company announces a stock issuing, the signal effect will cause the value of the stock to decrease as investors believe managers consider the stock to be overvalued. As a consequence of this adverse signal effect, firms prefer to issue debt in order to raise funds instead of issuing equity. (Murray & Vidhhan, 2005, s. 19) Thus, the theory argues that there exists no fixed target of debt to equity ratio, and firms follows a well-thought hierarchy when deciding how to finance its operations, per the law of least effort or least resistance.

“An old-fashioned pecking order framework, in which the firm prefers internal to external financing, and debt to equity if it issues securities. In the pure pecking order theory, the firm has no well-defined target debt-to-value ratio” (Myers, 1984)

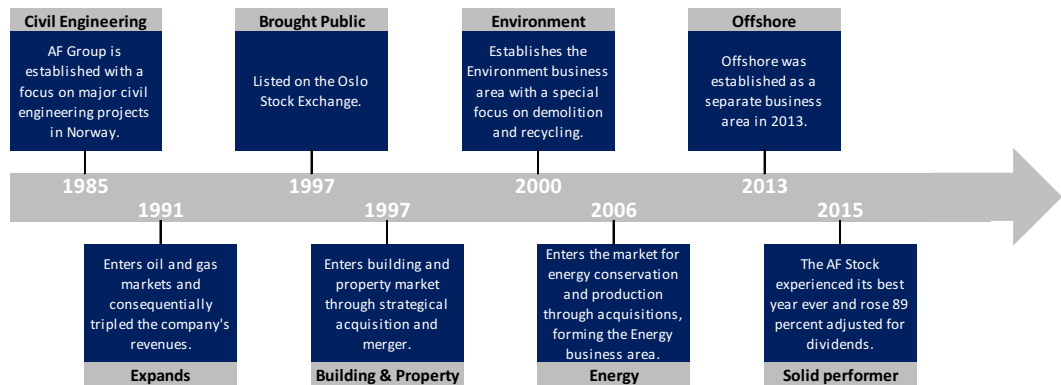
4. Setting the stage

4.1 AF Gruppen

When AF Gruppen was founded in 1985 it mainly started out as a construction company, eager to cover big construction projects all over Norway. From there, AF Gruppen has

become one of Norway's leading contracting and industrial groups with over 3 000 employees. In 2015 they received 12,3 billion NOK in revenue (9,9 billion NOK in 2014), with an EBITDA margin of 9,2% (6,3%, 2014). Chief Executive Officer is Morten Grongstad, and the company headquarter is located in Norway, Oslo.

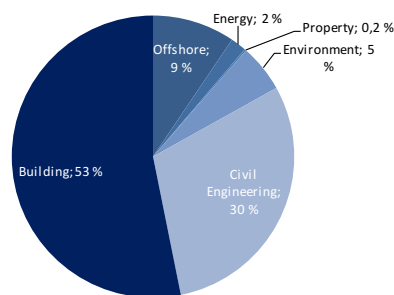
History of AF Gruppen



Source: AF Gruppen

AF Gruppen operates within six different business areas, mainly in Norway and Sweden: Civil Engineering, Building, Environment, Property, Energy and Offshore.

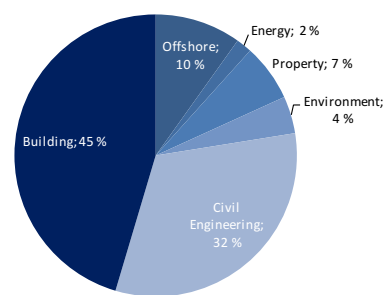
Segment share of Revenue - 2015



■ Offshore ■ Energy ■ Property ■ Environment ■ Civil Engineering ■ Building

Source: AF Gruppen

Segment share of EBIT - 2015



■ Offshore ■ Energy ■ Property ■ Environment ■ Civil Engineering ■ Building

Source: AF Gruppen

4.2 Ownership and Dividend Policy

AF Gruppen's three biggest shareholders today is OBOS BBL with a 16,71% stake in the company, ØMF Holding AS (15,62%), Constructio AS (14,61%), with a total of 93.610.000 shares outstanding. One of AF Gruppen's main goals is to maximize shareholders return, which they today thrive to have a 50% dividend payout ratio relative to its profit of the year. In 2015, earnings per share (EPS) equaled 5 NOK with a payout ratio of 65,4% (AF Gruppen, 2015). When it comes to their competitors, most of their competitors also pay dividends, and the payout ratio ranging from 40 to 70% of net operating profit. Due to capital structure theories presented, there are contradictory

opinions in what way dividend policy of companies can affect firm value, this will be looked further into in the main paper.

Since AF Gruppen was founded they have focused on the importance that employees should be engaged in their jobs through stock options. Today, employees in AF Gruppen are in possession of shares equal to 1 billion NOK (15 % of the company), and AF Gruppen is the only company within the industry operating with employee stock option (Veidekke).

4.2 The Construction Industry and Peers

Due to a strong housing demand and high activity within public infrastructure, the construction market has shown a positive trend throughout 2016. Furthermore, AF Gruppen is competing in a market with strong competitors with thick order book, which has shown solid performance the last years. However, because of a growing share of local competitors in the construction market, construction companies have almost consistently lost market shares the last few years (Vesola, 2016).

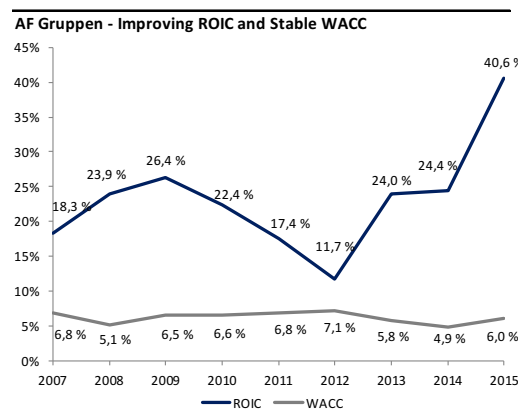
Some of AF Gruppen's main peers are Nordic Construction Company (NCC), PEAB, Skanska and Veidekke. These are all mature- and more or less solid companies. Veidekke has for instance been able to deliver a surplus every year since its inception in 1936 and has been a solid performer for its shareholders (Veidekke)

After a company surpasses its growth period and matures, theory states that ROIC should converge towards WACC (Koller, Goedhart, & Wessels, 2015)

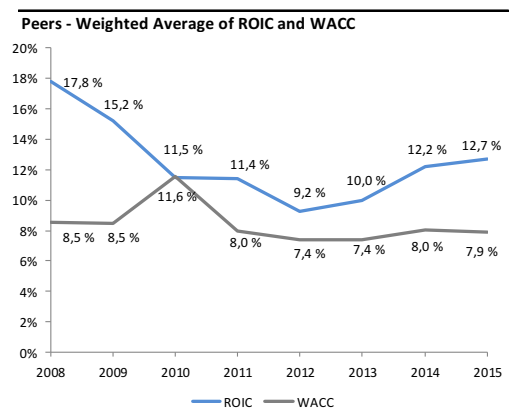
Peers - ROIC and WACC								
NCC	2008	2009	2010	2011	2012	2013	2014	2015
ROIC	18,40 %	16,57 %	13,57 %	10,83 %	13,51 %	12,18 %	11,62 %	13,14 %
WACC	5,84 %	8,27 %	13,97 %	8,15 %	7,35 %	7,50 %	7,18 %	6,83 %
PEAB	2008	2009	2010	2011	2012	2013	2014	2015
ROIC	n.a.	8,83 %	7,25 %	7,36 %	5,48 %	2,86 %	9,50 %	10,64 %
WACC	n.a.	7,22 %	11,09 %	6,05 %	6,39 %	6,71 %	7,72 %	7,86 %
SKANSKA	2008	2009	2010	2011	2012	2013	2014	2015
ROIC	11,32 %	18,37 %	13,57 %	13,15 %	9,95 %	12,56 %	12,25 %	12,85 %
WACC	9,06 %	8,71 %	13,10 %	9,77 %	9,12 %	8,41 %	9,17 %	8,79 %
Veidekke	2008	2009	2010	2011	2012	2013	2014	2015
ROIC	23,74 %	16,96 %	11,45 %	14,42 %	8,04 %	12,44 %	15,57 %	14,18 %
WACC	10,65 %	9,65 %	8,06 %	8,00 %	6,78 %	6,95 %	7,97 %	8,08 %

Source: Bloomberg

The underlying idea of value creation is that companies create value by investing capital raised from investors to generate future cash flows at rates of return exceeding cost of capital. Hence, the combination of growth and return on invested capital relative to its cost of capital is what drives value. From the above tables, AF Gruppen's peers have a somewhat stable ROIC relative to its cost of capital, which indicates that they are creating stable value to its shareholders. Koller et. al states that, if all companies within the same industry earned the same ROIC, then the only metric that would differentiate participants in the market is earnings growth (Koller, Goedhart, & Wessels, 2015). However, what the authors deem as interesting, is that despite being a mature company operating in mature areas, AF Gruppen has been able to maintain- and even increase the difference between return on invested capital and its cost of capital (Bloomberg), which in turn is significantly higher than their peers (see graphs below). This further increases the authors' suspicion that AF Gruppen is in possession of a strong competitive advantage(s).



Source: Bloomberg



Source: Bloomberg and Authors' calculations

Note that the authors are aware of the fact that these ratios are dependent on many factors, including debt-to-equity ratio, cost of debt etc. Uncovering these factors will be done in the main part of this thesis.

5. Methodology

5.1 Valuation Model

There are numerous methods of valuation, and these are not mutually exclusive. In fact, in order to attain the most reliable estimate of the value of the equity, different methods should be combined (Damodaran, 2012). However, the choice of method is contingent on the company and its stage in the life cycle, availability and quality of

information and the time available to the authors to thoroughly perform the analysis (Koller, Goedhart, & Wessels, 2015)

Listed companies at a mature stage in their life cycle are often characterized by stable cash flows and easy access to publicly available information such as annual reports. AF Gruppen is a listed company with stable cash flows and is required by law to present detailed annual reports with information about income statements, balance sheets and cash flows. Hence, based on this criterion, the authors argue that a fundamental analysis method should be used to value the company.

The authors plan to spend around 6 months on this paper, so there is plenty of time available. However, properly applying the different methods is time consuming and requires a lot of attention to detail. Additionally, we aim to identify the width- of and value the economic moat and will spend time on this process as well. Hence, we have decided to apply a fundamental analysis of the company using the enterprise valuation of a multibusiness company with discounted cash flow method (DCF) and will supplement this with comparable valuation using multiples. This will be done using framework presented by Koller et. al.

As for the case of the economic moat, choice of method is dependent on the type of moat that is identified. Should for instance unique relations with suppliers be identified as the key compartment of AF Gruppens economic moat, we can isolate the monetary benefit and value the company with- and without it accordingly using DCF. However, this will be elaborated later on in the thesis as the authors gain further in-depth knowledge.

5.1.2 Discounted Cash Flow

The discounted cash flow model is considered the most accurate and flexible method to value companies according to Koller et. al. They present two ways of using the model to arrive at the equity value; either by estimating the equity value directly or by estimating the enterprise value (EV) and subtract net debt. The authors have decided to use the latter. The estimation of the enterprise value depends on the free cash flow to the firm (FCFF) which will be forecasted in the main paper. The cash flows are then discounted using the firm weighted average cost of capital (WACC).

$$FCFF_t = NOPAT_t + Depreciation_t \pm \Delta Working Capital_t \pm CAPEX_t$$

Since forecasting of many different variables may lead to errors in the valuation due to increased exposure to forecasting mistakes, an alternative equation may be utilized:

$$FCFF_t = NOPAT_t \pm \Delta Invested\ Capital_t$$

The enterprise value can then be calculated accordingly:

$$EV_0 = \sum_{t=1}^n \frac{FCFF_t}{(1+WACC)^t} + \frac{FCFF_{n+1}}{WACC-g} * \frac{1}{(1+WACC)^n}$$

The equity value is then the enterprise value less net interest bearing debt (NIBD):

$$E_0 = EV_0 - NIBD_0$$

In order to use these equations, WACC and consequentially the required return for equity needs to be calculated. The assumptions and calculations necessary for this will of course be elaborated in the final paper. The respective equations are found below.

$$WACC = \frac{Debt}{Debt + Equity} * r_{debt} * (1 - T) + \frac{Equity}{Debt + Equity} * r_{equity}$$

$$CAPM = r_{equity} = r_{free} + \beta * (r_{market} - r_{free})$$

5.1.3 Comparable Valuation - Multiples

Comparable valuation aim to value a company by using comparable multiples obtained from similar companies in similar industries. According to a framework presented by Stephen Penman (2013), a comparable multiple valuations are done through 3 steps:

1. Identify comparable companies in similar industries
2. Identify multiples that represent appropriate characteristics such as EV/EBITDA, EV/Sales etc.
3. Deploy obtained data to estimate the equity value of the company in question

This method is easy to use and is often practiced to create ballpark numbers and valuations (Penman, 2013). It is however, less accurate due to the fact that a lot of assumptions and information is compressed into a single number and is very susceptible to underlying differences in the companies in question. Thus, we aim to use this model to supplement our DCF-valuation.

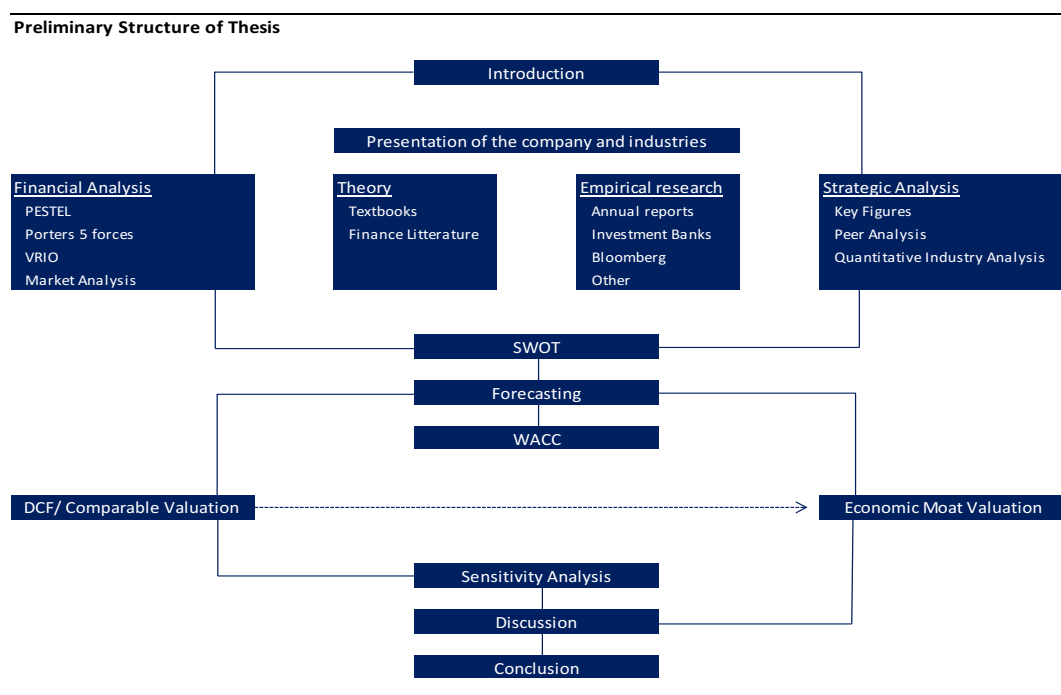
5.2 Data

In order to properly perform the valuation of AF Gruppen, the authors require access to financial information on the company for the previous fiscal years. Luckily, AF Gruppen has been listed on the Oslo Stock Exchange since 1997 and available information is plentiful. Available information on peers is also easily accessible. The authors expect to use information software such as Bloomberg in addition to company annual reports,

analyses from investment banks, news articles etc. and we see no obvious limitations or problems in accessing necessary information to perform the valuation.

5.3 Preliminary Schedule for the Valuation

With choice of valuation method falling on fundamental DCF valuation the authors has developed a tentative schedule for the rest of the thesis. Each section will be thoroughly analyzed and elaborated for the parts to sufficiently complement each other. At last, the sections and the process will culminate in a value-per-share of the equity of AF Gruppen, with- and without the economic moat.



Note that additional methods will be considered as we move further out into the paper. However we feel confident that for the main part of our valuation a DCF and a comparable valuation is a sufficient and suitable choice of model.

5.4 Preliminary Assumptions and Limitations

The authors expect AF Gruppen to release its annual report for 2016 february 14th 2017 (AF Gruppen). The date of release will then represent the date in which we no longer will take new information into consideration. This also applies to to AF Gruppens peers and the information used in the market analyses. Additionally, since AF Gruppen is a publicly listed company we will only use publicly available information.

Since AF Gruppen has divided its operations into 6 business areas we expect we have to put some restrictions on the industry analyses, however, this will be elaborated in the thesis in the appropriate section.

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