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Hermes Investment Management

Dynamic Valuation by Relationships

Bringing Data Science to Finance

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For professional investors only

Context

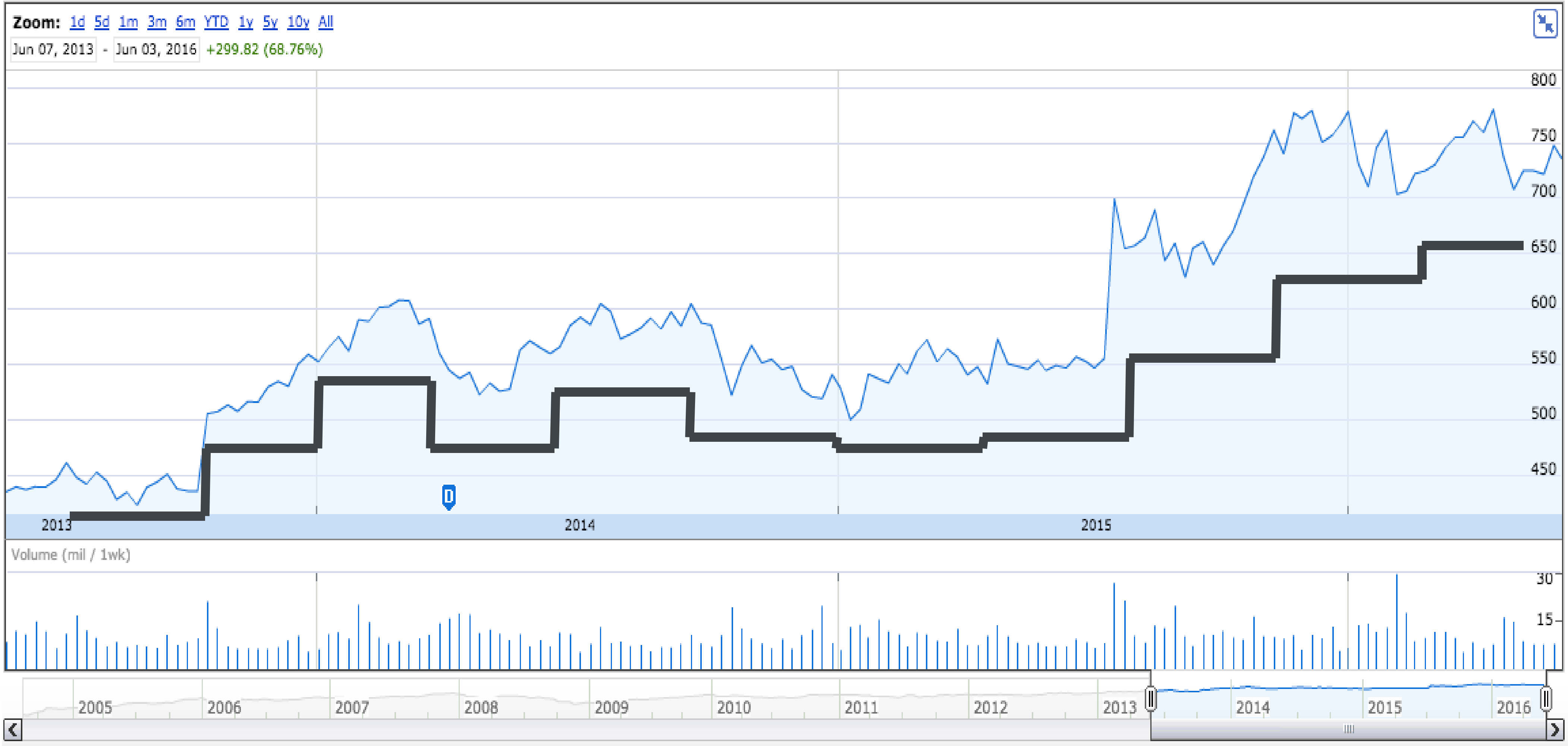
Institutional investors seem to be forced to invest in ways which damage economies, societies and environment

- We need to improve the stewardship of investments and the quality of relationships
- Companies and their shareholders are interdependent and have the opportunity to co-create a sustainable future
- We need to shift our focus from short-term transactions to long-term relationships

Challenges with current valuation approaches (e.g. DCF, CFROI)

1. **They provide one, theoretically correct, valuation for a listed firm while**
   - ► the actual market values constantly fluctuates and
   - ► investment returns represent the change in price not the price itself
2. **They are static until their next update, which is normally earliest in a quarter**
3. **They struggle to integrate non-monetary key performance indicators of business**

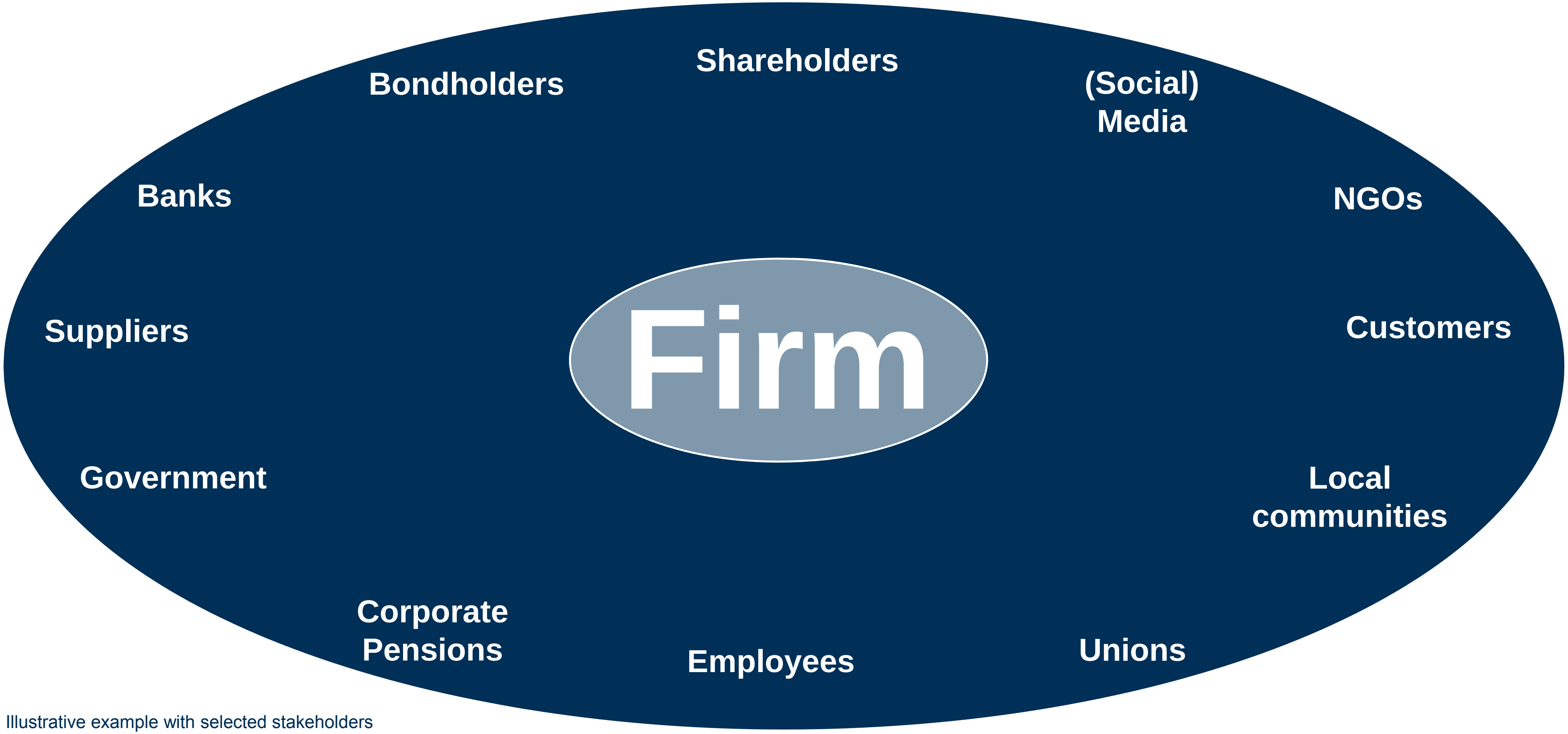
Can any quarterly updated DCF explain Apple's share price development?



Alphabet Inc. (NASDAQ:GOOGL)

Source: Google Finance. For illustrative purposes only

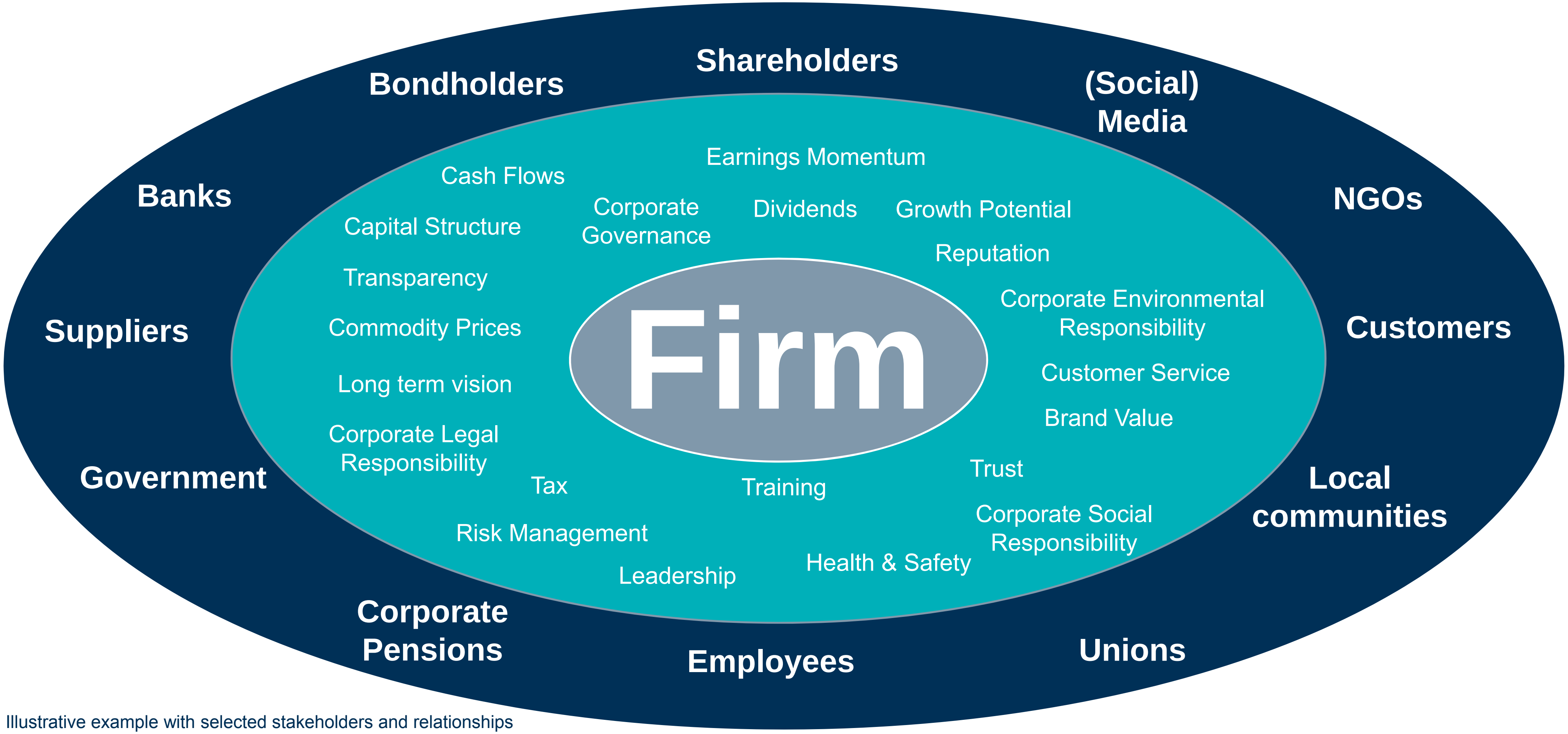
The Corporation and its stakeholders



Illustrative example with selected stakeholders

The Corporation and aspects of its relationships

Stakeholders relationships aspects



Illustrative example with selected stakeholders and relationships

Valuation of the equity of a firm

Currently dominant valuation approach

- ► Value of Firm = Assumed Cash Flows / (Empirical Discount Factor * Assumed Adjustments)

Dynamic Valuation by Relationship Aspects

- ► Change in Market Value of Firm = Change in National Market Environment + Change in industrial market environment + change in global market environment + Change in Relationship Aspects

Questions and conclusion

1. How can we measure good relationships and how do they relate to value creation?
2. Do we need to quantify relationships in the non-financial areas?
3. How do externalities arise out of poor relationships?
4. How do fund managers respond to this proposal?

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