intelligent OPTION INVESTOR

This 124-Year Old Looks Better Without Make-Up

General Electric (GE) is a much different firm now – bravo!

April 6, 2016

For information, please contact:

Erik Kobayashi-Solomon

+1 646 801.2464

Key Takeaways

- **We have updated our estimated fair value range for GE.** We continue to think the shares are moderately (20%-40%) undervalued with limited downside.
- **"Bad Finance" is gone – "Good Finance" remains.** Less than 10% of GE's revenues are generated from GE Capital (GECC) and these are good businesses to keep.
- **Portfolio realignment and share buybacks continue to make GE's fair value difficult to pin down.** We are less excited about GE at $30 than we were at $26, and we have already de-levered our position.

Overview

Our analysis of GE's recently-released 2015 Annual Report allowed us a glimpse at this grande dame's last three years of financial results unobstructed by the "make-up" from GE Capital Corp (GECC). We like what we see.

Most of the pieces of GECC that remain are essential to GE's long-term global business strategy (mainly from a tax avoidance / tax management perspective), so we anticipate that divestments are nearly at an end. The company is plowing money generated from the sale of its finance divisions into share buybacks and potentially into acquisitions. We think this is a sensible strategy.

While sensible, the shuffling of its business portfolio and the uncertainty regarding the timing of sharecount reductions give us a Schrödinger's cat-style valuation range. Our present estimated valuation range is essentially unchanged from that which we published in early 2015 – worst-case in the upper $20 range, best-case in the lower $40 range, and most likely, somewhere in the upper $30 range.

We reduced the leverage in our GE position in early January 2016, before option expiration (in favor of a levered position in Oracle ORCL) since we are getting closer to what we perceive as the company's likely fair value range. For new investors, a short put "Bond Replacement" investment may be attractive.

Information provided by IOI Investment Services, LLC, should not be used as investment advice. IOI Investment Services, LLC does not act in the capacity of a Registered Investment Advisor. For investment advice geared towards your specific needs, we encourage you to contact your financial planner or advisor.

Fair Value Range

Our valuation range in January, 2015, overlain with the option market's price range, looked like this:

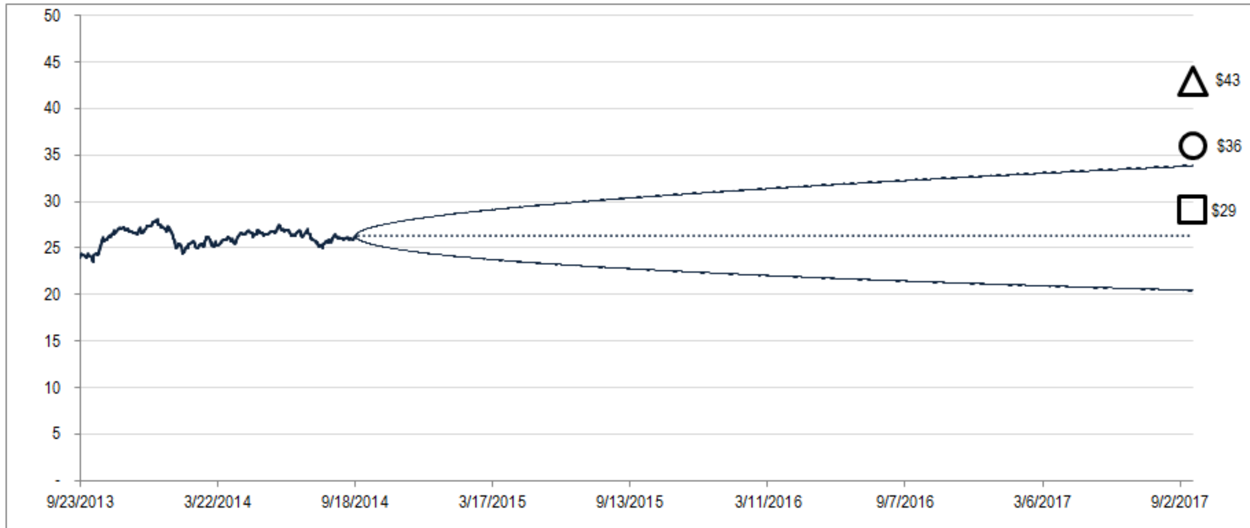

Figure 1. Source: CBOE, YCharts, IOI Analysis. The cone-shaped region represents the option market's best idea for the future price of the stock. The geometric shapes to the right of the diagram represent IOI's estimated valuation range.

After review of GE's most recent annual report, and updating the stock price, our valuation range presently looks like this:

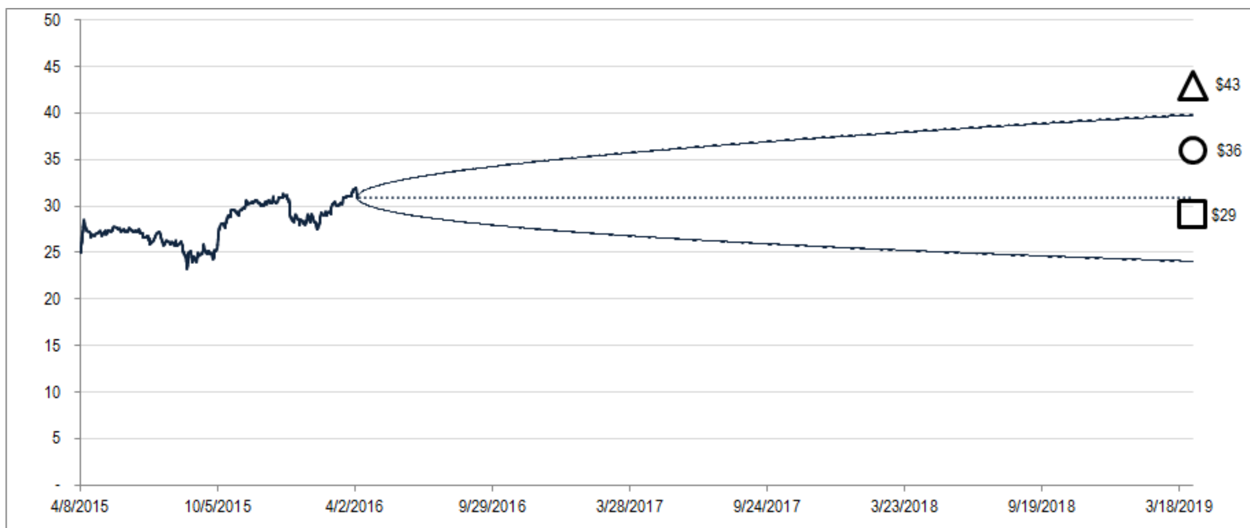

Figure 2. Source: CBOE, YCharts (data), IOI Analysis

Valuation Details

IOI's valuation methodology focuses in on the only three drivers that can affect the cash flows of a firm: revenue growth, profitability, and investment level and efficacy (the latter of which expresses itself in medium-term cash flow growth). Our analysis below looks at each one of these valuation drivers and our projections for them.

A tabular summary of the values we are using as best- and worst case assumptions for each of the three valuation drivers are as follows:

Case	Near-Term Revenue Growth	Near-Term Profitability (OCP Margin)	Medium-Term CF Growth
BEST	6%	16%	7%
WORST	2%	12%	5%

Revenues

As GE announced various major divestments of its finance business during 2015, we built into our model a steep revenue decline coupled with a large share buy-back. At the time, we believed the divestment would take several years to carry out, and we've been surprised at the alacrity with which GE has shed its finance business worldwide.

Reshuffling of GE's business portfolio is still underway. The acquisition of France's Alstom will add in the neighborhood of $13 billion in top-line growth this year, partially offset by the sale of the Appliances business to Haier.

GE revenue growth will continue to be affected by acquisitions and divestitures as well as foreign exchange fluctuations.

Best-case revenue growth is influenced by the Alstom acquisition. In essence, we are projecting best case revenue growth to be 5% per year – 25% faster than the 4% organic growth rate management believes is a best-case value.

Our standard assumption for worst-case revenue growth is a 2% organic growth rate that management believes to be its worst-case organic growth rate. We do not believe the firm will grow only through organic revenues over the next five years, but we know that revenues is likely to be affected by divestitures, foreign exchange fluctuations, and continuing weakness / uncertainty in Europe and Asia.

In graphic format, our revenue assumptions look like this:

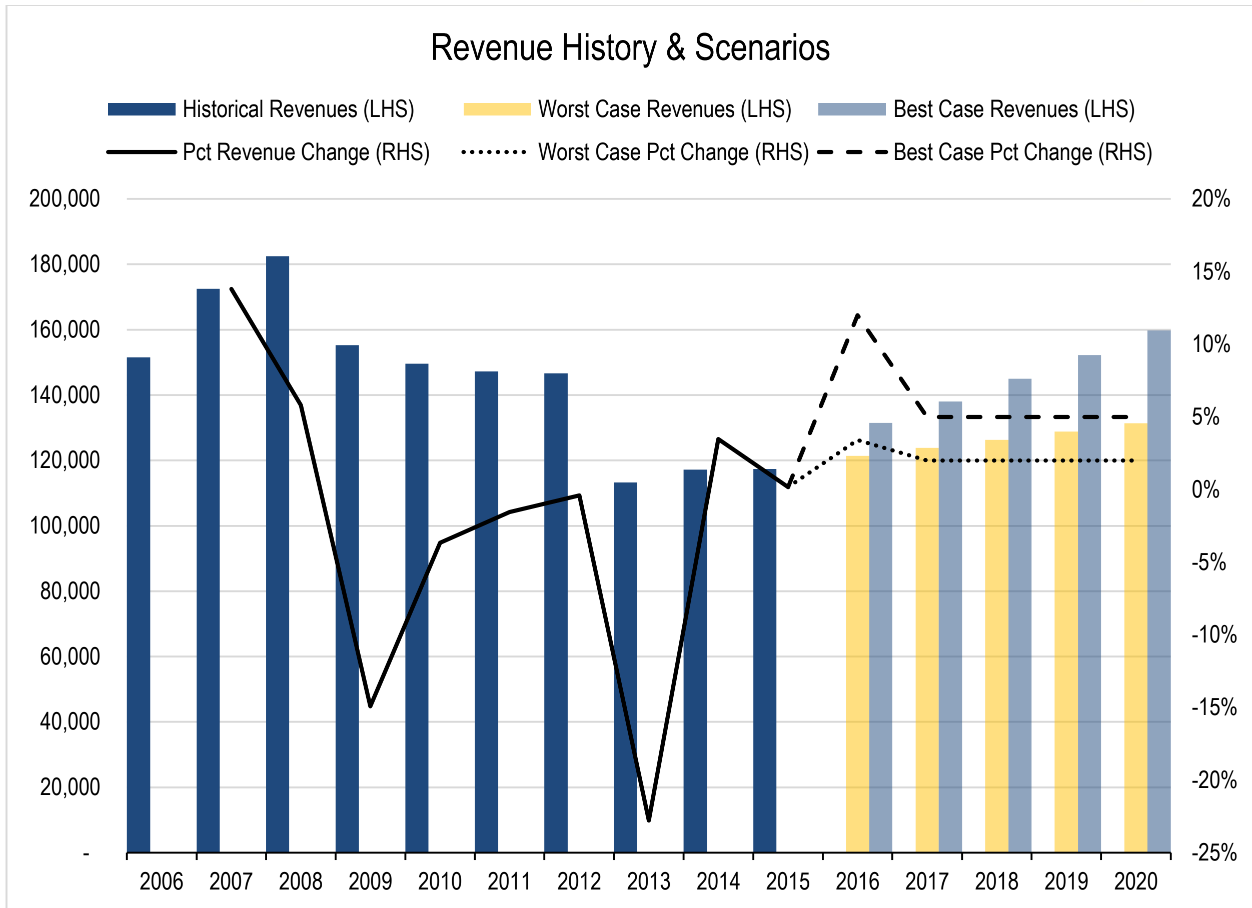

Figure 3. Source: Company Statements, IOI Analysis and Projections. Data prior to 2013 includes divested units of GECC.

Profits

Trying to sort out GE's baseline profitability using IOI's preferred metric of Owners' Cash Profits has been tricky. GE has published Statements of Cash Flows separating out the Industrial businesses from GECC, but it was hard to understand what effect a divestment of some parts of GECC would have on the remaining combined entity. In addition, the past several years have seen material but what looked like one-off increases and decreases in current liability and asset accounts, which also serves to depress the OCP measure. This year, GE's OCP margin was at 13% – better than our worst-case scenario, but the previous two years – adjusted for divested GECC units – was lower. We are sticking with our best- and worst-case profitability estimates of 16% and 12%, respectively, but will be watching this measure closely.

Our best-case profitability assumptions may be too high.

The shift of GE into industrial businesses increases its capital intensity. This capital intensity is an important driver of maintenance capital expenditures, which serves to lower profitability in the IOI framework. We believe that thanks to the businesses it is in and its competitive positions in those businesses, it can still retain higher profitability than other industrial conglomerates, but our 16% best-case OCP margin may be unreasonable.

Here is a graphic display of our profit assumptions:

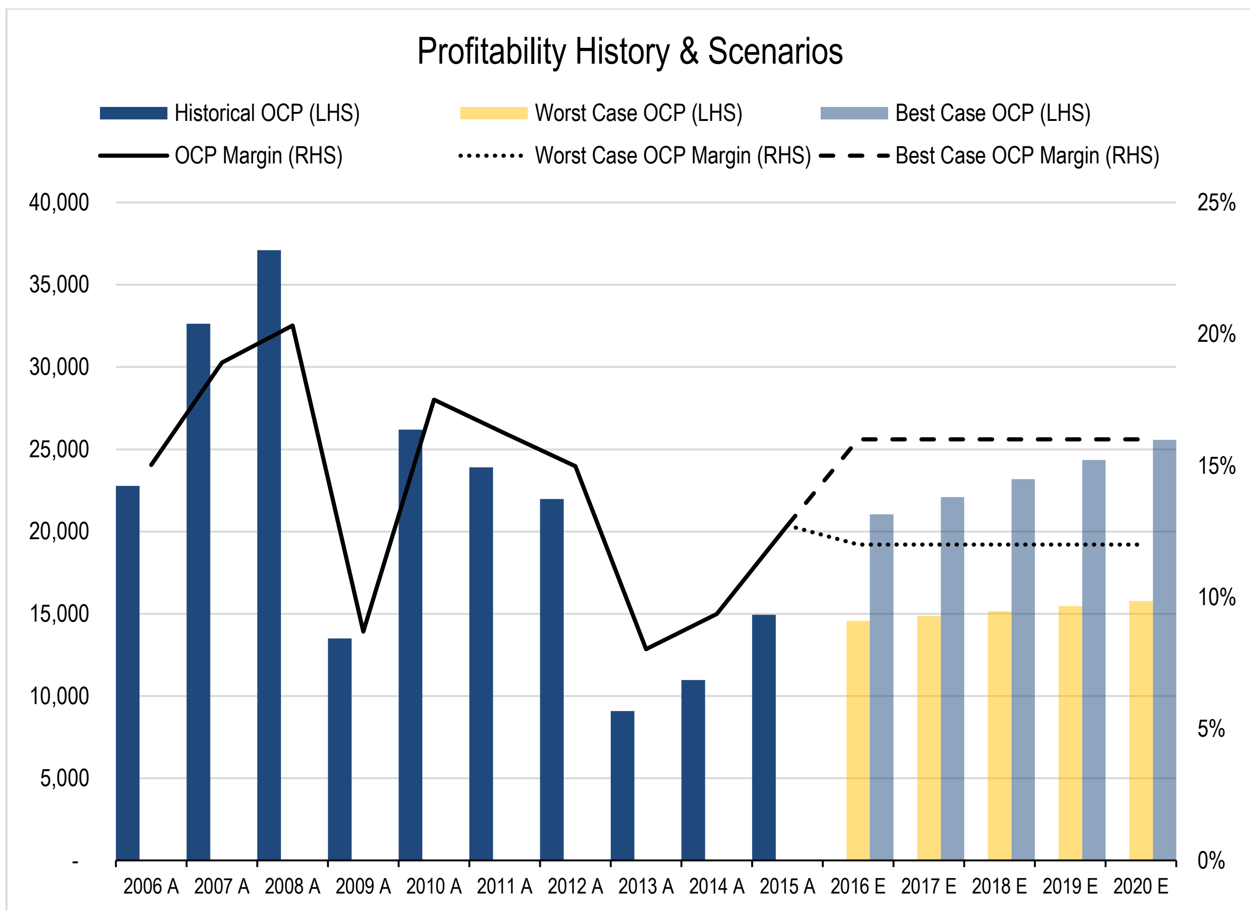

Figure 4. Source: Company Statements, IOI Analysis and Projections. Data before 2013 includes divested GECC units

Medium-Term Cash Flow Growth

The significant divestments of the past decade have made GE's investment efficacy appear weak. However, the firm has been "selling off profits" to "buy cash flows" and has used the cash flows to decrease the sharecount. In essence, management has decided to shrink both the business and the ownership pie.

Despite what appears to be low efficacy (e.g., in figure 5 below), a closer look at the areas in which the company is investing – Power, Infrastructure, and Technology – makes us think that the firm's potential for medium-term growth is good. We wrote more about what we call GE's "PIT Strategy" in a report several years ago, and believe it makes a great deal of sense as long as you assume 1) that human civilization will continue, 2) developed markets will become older, and 3) developing markets will become wealthier, start demanding better infrastructure, and buying more electronic gadgets.

We use a best-case medium-term cash flow growth factor of 7% – slightly faster than our assumptions for growth of the economy at large. Our worst case value is 5% – the same rate as we assume long-term economic growth to be.

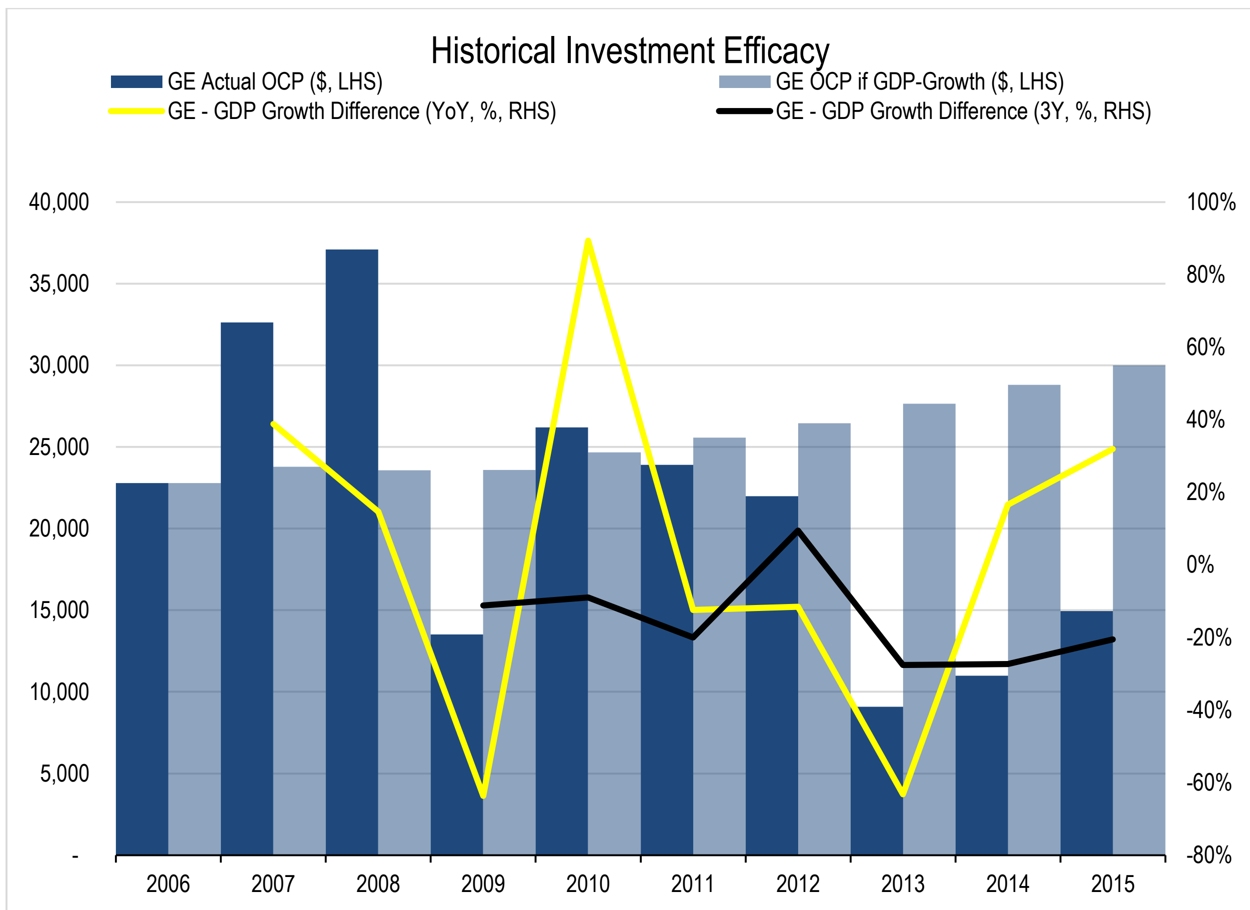

Figure 5. Source: YCharts, Company Statements, IOI Analysis. Shorter dark blue columns in comparison to light blue ones indicate the firm's profits have grown more slowly than the economy at large. This is reasonable for a company making major divestitures.

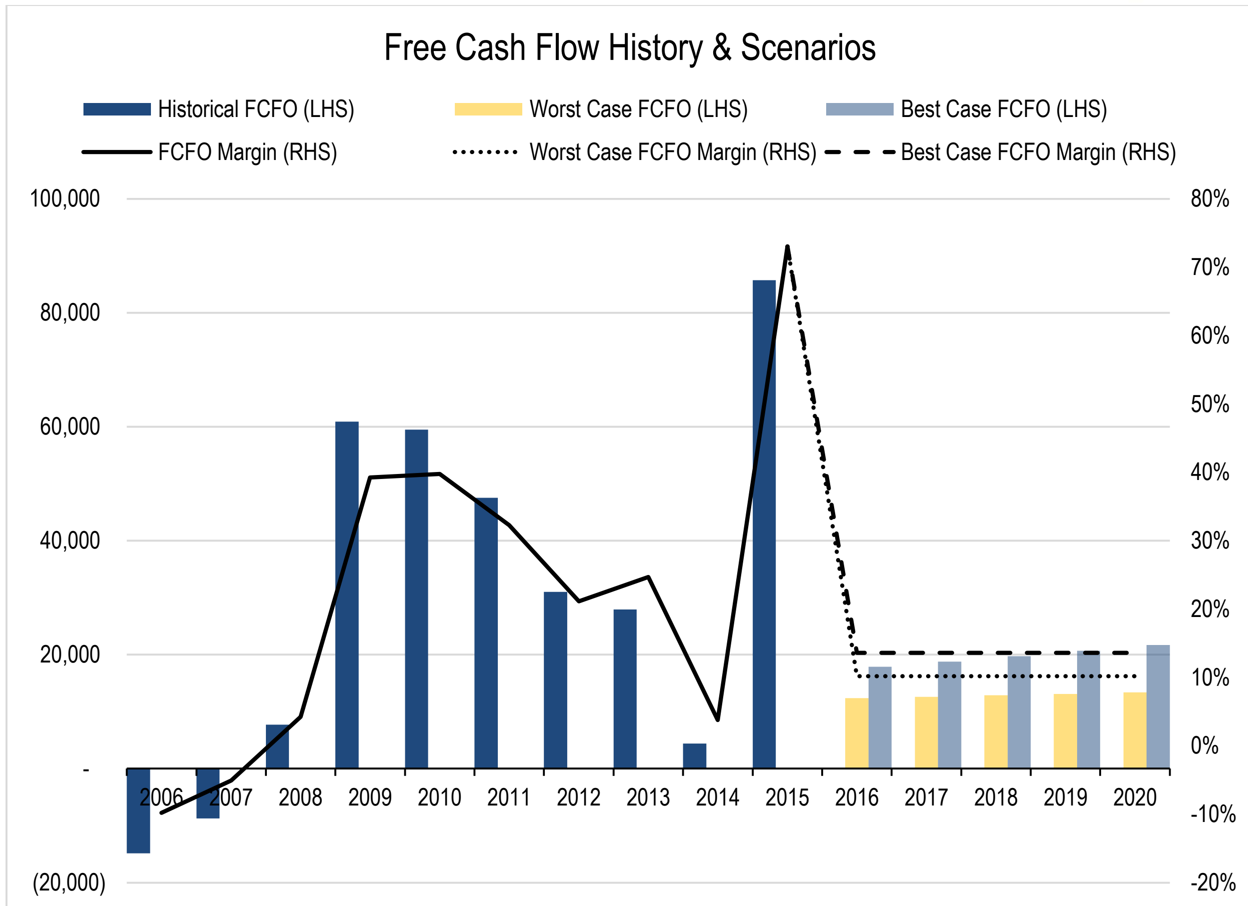

Figure 6. Source: Company Statements, IOI Analysis and Projections

"Selling profits" is clearly seen in figure 5 – where GE profits far undershoot where they might be, were the firm to be growing lock-step with the economy.

"Buying cash flows" is clearly seen in figure 6 – where we see FCFO in years 2009-2011 and especially in 2015 hugely overshooting the "normalized" cash flow generation capacity of the company.

Other Considerations

If we look at the present sharecount, the valuation range in figure 2 is actually shifted down by a few dollars per share. And while we usually prefer to use the nominal sharecount in valuations, since the company is in the midst of a very large buy- back program, we are continuing to use our back-of-the-envelope projection for sharecount that we used in our notes late last year. Were we to use the present nominal sharecount, our valuation range would lie almost perfectly on the option market's price projection range.

Like Schrödinger's cat – which was simultaneously living and dead until observers could confirm its true state – our valuation is at once bullish and neutral. GE has done everything its management said it would do regarding the divestment of GECC, so we are giving it the benefit of the doubt that it will also do everything its management said it would do regarding share buybacks.

The New Face of GE

GE's revenue profile is completely changed from just a few years ago. In 2008, GECC revenues made up 42% of total. In 2015, this proportion had fallen to 9%.

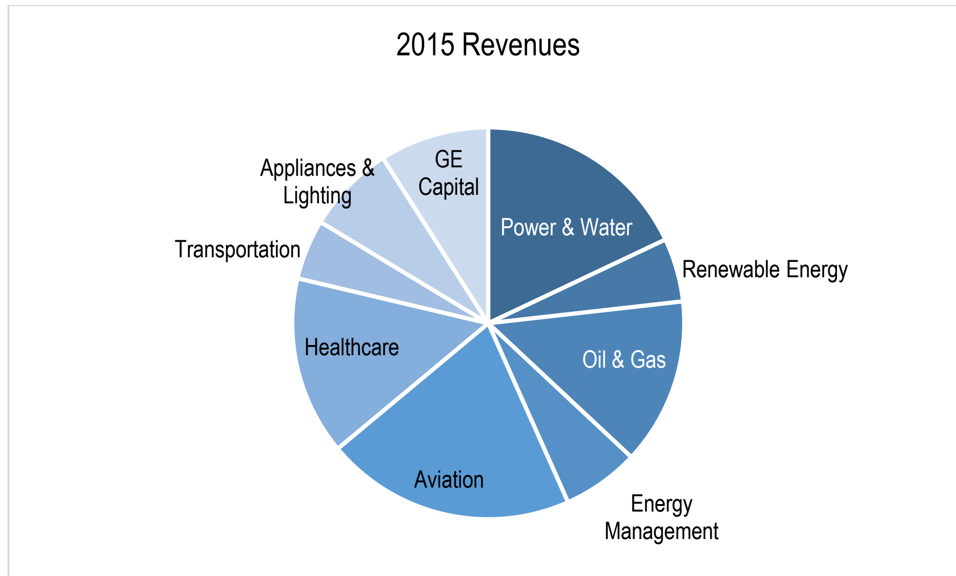

Figure 7. Source: Company Statements, IOI Analysis

GE's profitability profile has also shifted considerably with the divestiture of GECC. Energy Management's profits will expand in 2016 as GE digests the Alstom acquisition and Appliances & Lighting will become smaller with the successful sale of the Appliances division to Haier. Note that the profit shown below for GECC is adjusted. The division actually incurred a loss in 2015 related to divestitures. We have made a back-of-the-envelope adjustment and believe GECC probably made about $1 billion in pro-forma profits last year rather than incurring a $9 billion loss.

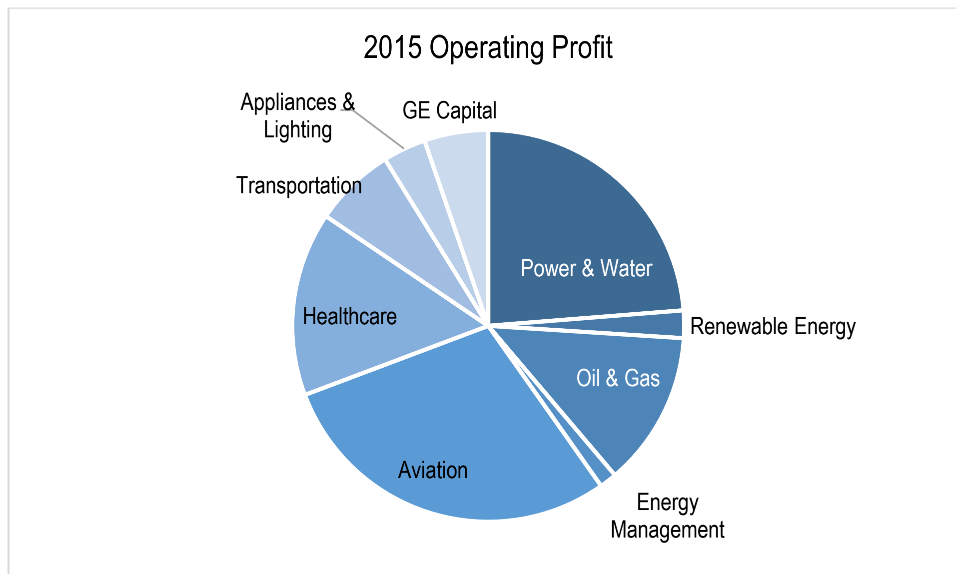

Figure 8. Source: Company Statements, IOI Analysis

The Future of GECC

GE has divested enormous portions of its finance-related business. The last divestment to be announced was the sale of GE Asset Management to State Street (yes, GE had an asset management arm like Fidelity or Blackrock!) for $485 million. The day after announcing this divestment, GE applied to the Financial Stability Oversight Council to remove its designation as a Systematically Important Financial Institution (SIFI).

We believe that the application to remove its SIFI status marks a milestone in its re-structuring process and doubt there is much left in the way of finance business divestment in the works for GE.

GECC is a crucial tool in GE's corporate tax management strategy. Don't expect many more finance divestments.

GE is (in)famous for leaning forward as far as possible regarding tax management schemes and structures. Many of these structures result from sale-leaseback transactions that are managed through the remaining GECC businesses. Without these tax dodges, GE would be stuck paying a higher tax rate than it does at present. Needless to say, it's unlikely that, barring a revolutionary rewrite of the U.S. tax code, GE will voluntarily divest itself of these valuable tax avoidance profit centers.

We believe that, similar to Ford, GECC also pulls some demand forward by offering financing for some of its products, but there is still enough divestment noise in the financial statements to make an accurate assessment of the extent of this effect difficult to judge. This issue is one that we will be watching in quarters to come. At present, we do not believe the firm is "buying its revenues" by lending money to its customers.

Many long-term (read "suffering") holders of GE's stock look back to the halcyon days of Neutron Jack Welch with great fondness, and look on Jeff Immelt as incompetent. In our opinion, these observers have it backwards. Welch is ultimately responsible for sowing the seeds of GE's near destruction during the mortgage crisis with his tunnel-vision emphasis on the finance business. Immelt continued down his mentor's path, but to his credit, also realized that the sword of leverage cuts both ways and had the brains to start divesting GE of that business post-Crisis. In our opinion, Immelt has done a credible job of re-structuring the firm and laying the foundations for its future success.

At 124 years old, GE is looking pretty spry.

Investment Strategy

We are clearly less excited about GE as a bullish investment at the present stock price than we were 20 percentage points ago. Early in January, when we were rolling our LEAPS option positions in GE, we took the opportunity to de-lever our position in this firm. At the same time, we increased both our concentration and leverage in Oracle – a decision that has proven profitable.

We retain a very modestly levered position in GE today, but especially with our Schrödinger's cat valuation, we will be looking for opportunities to further reduce our exposure.

Complex Valuation Range

The degree to which GE is beginning to approach a fair valuation to us is evident through a glance at our "complex" valuation range for the company.[1]

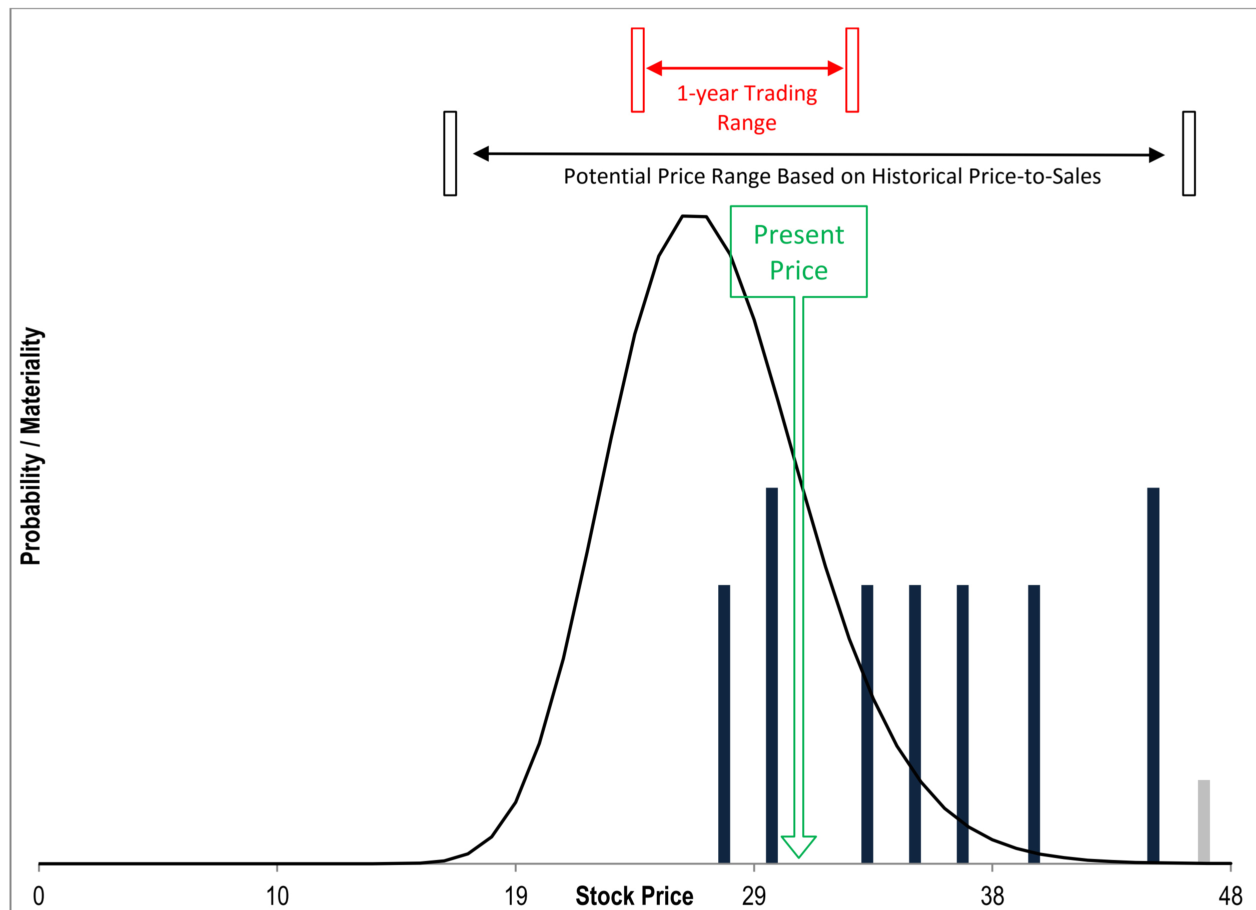

Figure 9. Source: CBOE, IOI Analysis

Market risk, as gauged by historical price-to-sales times our average revenue projections, is fairly large. We use the top and bottom deciles of historical PSR and find that, on this basis, the potential for the company's stock to trade below $20 per share cannot be counted out. On the upside, the price implied by the PSR measure contains our entire valuation range and is roughly the same as the Best | Best | Best[2] valuation scenario that we consider unlikely.

---

[1] Our complex valuation range is a combination of the 2^3=8 possible valuation scenarios given best- and worst-case possibilities for three valuation drivers.

[2] Best-case revenues, profitability, and medium-term growth, respectively.

New Investors

For new investors, implied volatility on GE's options are hovering at the 15.5%-16.0% range, so the potential for generating a high yield from selling downside protection (i.e., a "Bond Replacement" strategy effected by a short put or a covered call) is limited.

IOI's worst-case valuation is around $29 / share, so were the market to hit a downdraft – pushing GE's stock price down and its implied volatility up – a Bond Replacement investment would become more attractive.

A graphical representation of a short put strategy would look like this:

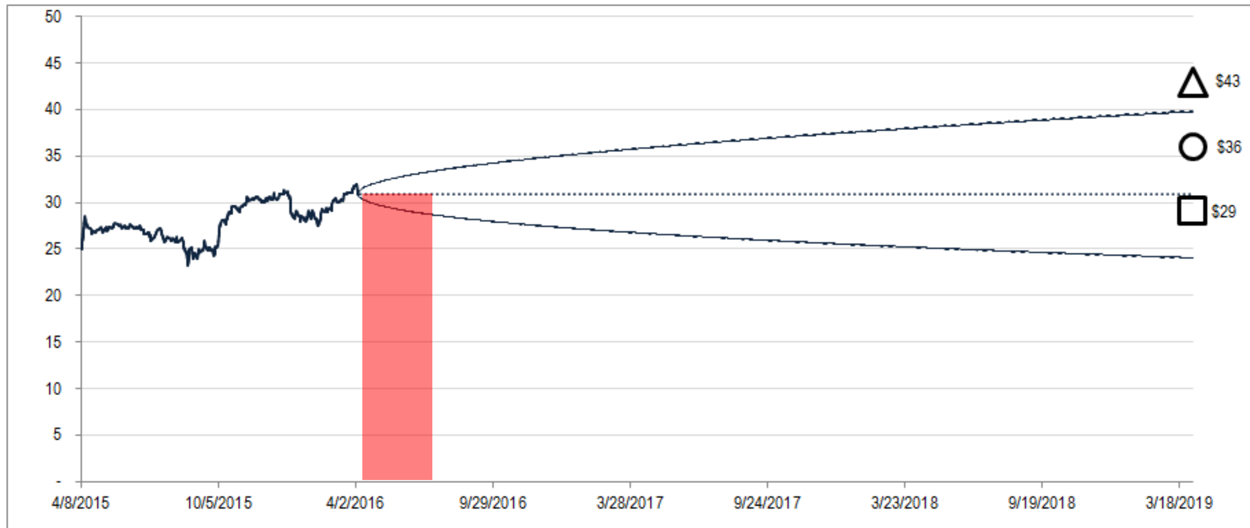

Figure 10. Source: YCharts, CBOE, IOI Analysis

Options involve risk and are not suitable for all investors. For more information, please read the Characteristics and Risks of Standardized Options.

Seminars and reports are provided to you for educational purposes only. No information presented constitutes a recommendation to buy, sell or hold any security, financial product or instrument discussed therein or to engage in any specific investment strategy. The content neither is, nor should be construed as, an offer, or a solicitation of an offer, to buy, sell, or hold any securities. IOI Investment Services, LLC does not offer or provide any opinion regarding the nature, potential, value, suitability or profitability of any particular investment or investment strategy, and you are fully responsible for any investment decisions you make. Such decisions should be based solely on your evaluation of your financial circumstances, investment objections, risk tolerance and liquidity needs.