



Monthly Newsletter – November 2015

A SIMPLE INTRODUCTION TO INTRINSIC VALUE

Its official, the most expensive stock on the market is a **supplement company**. Who would have thought a company selling vitamins, herbal and nutritional supplements would be the first (that I can remember) \$200 stock on the ASX. I surely didn't expect it, my pick was CSL Limited. Nonetheless its a reminder that despite a company not offering a significant yield (1.65% fully franked), in a low interest rate environment there are still plenty of people willing to pay a premium for a company that offers a unique growth opportunity, especially when its a company moving into the lucrative Chinese market. Makes sense, but how much of a premium are people paying for a slice of the fortunes Blackmores are **expected** to make from such a move? Is Blackmores a good buy at \$200 per share and trading at a P/E of 74 times earnings? If you wouldn't buy it at this price what price would you consider a reasonable price per share? So how does one make a rational decision when we are surrounded by so much irrationality in the marketplace? **This is where the concept of Value Investing comes into play.**

Value Investing is a concept all investors need to be aware of. It helps you to make a **rational choice** by removing all the "noise" that influences the daily fluctuation in share prices, such as emotion and speculation. Market participants are often far too optimistic, too pessimistic or somewhere in between so determining a companys intrinsic value allows us to determine how far market participants have taken their irrationality. **Every company has an Intrinsic Value derived by factoring in a companys book value, its ability to generate profits and its inherent risk, company specific or otherwise.**

There are a number of models that can be used to calculate the intrinsic value of a company, all widely available on the internet. The method we use is a combination of the Warren Buffet and Richard Simmons models which simplifies the calculation in six steps.

- 1) ***Calculate Equity Per Share***
- 2) ***Calculate the Payout Ratio***
- 3) ***Calculate Return on Equity (ROE)***
- 4) ***Determine your Required Rate of Return (ROR)***
- 5) ***Determine the Bond and Growth Multiple and apply to Equity Per Share***
- 6) ***Calculate Intrinsic Value***

We have found this to be the easiest method of calculating a companies intrinsic value **so dont be alarmed!** You can use figures from a companies Annual Reports, or if you are looking to calculate a forecasted figure (as per below) there are a number of research providers you can source this information from. To calculate you will need the following;

Shareholders equity: \$151,060,000 (forecasted FY2016),
\$132,915,000 (FY2015, Annual Report)

Total shares on Issue: 17,225,000 (forecasted FY2016)

Net Profit After Tax: \$66,978,000 (forecasted FY2016)

Earnings Per Share: \$3.89 (forecasted FY2016)

Dividends Per Share: \$2.84 (forecasted FY2016)

(forecasted figures from Skaffold Research.)

We then calculate in order;

- 1) **The Equity Per Share** figure is the book value of a company on a per share basis. That is the minimum value of a company on a per share basis if we were to liquidate the company today.

$$\text{Equity Per Share: } \$151,060,000 \div 17,225,000 = \underline{\$8.77}$$

- 2) **The Payout Ratio** refers to the percentage of earnings paid out as a dividend.

$$\$2.84 \div \$3.89 = (0.73) \text{ or } \underline{73\%}$$

- 3) **Return on Equity** is a measure of a companys ability to generate profits on the funds invested by shareholders. A higher return on equity means surplus funds i.e. retained earnings can be used to improve the business without having to go back to the market for capital i.e. capital raisings. We use an average equity figure because profit is generated form the equity at the start (and during) the year.

$$\begin{aligned} \text{Average Equity } & ((\$151,060,000 + \$132,915,000)/2) \\ & = \underline{\$141,987,500} \\ & = (D)/\$141,987,500 = \underline{47\%} \end{aligned}$$

- 4) **The Required Rate of Return** will differ between investors because we all have different levels of risk tolerance, one company can be riskier than the next and so on. For a good quality company with a sound historical track record, Warren Buffet is known to demand no less than a 10% after tax return. In this example given the low interest rate environment we reside in, the high level of ROE projected and the volatility in the market we will demand a slightly higher ROR of 11%.

$$\text{Required Rate of Return} = \underline{11\%}$$

Income Multiple and Payout Ratio

The income multiple is an extension of the work developed by “The Father of Value Investing” Benjamin Graham and further work by Warren Buffett. The income multiple determines the maximum premium one should pay to achieve their required rate of return for a company that pays out all profits as dividends.

To calculate the multiple we simply use the formula ROE/RR or $47\%/11\% = 4.273$ meaning an investor should pay no more than 4.273 times Equity Per Share to achieve their required rate of return. We then multiple this by Equity Per Share to determine the maximum price to pay for share.

$$= \$8.77 \times \text{Income Multiple of } 4.273 = \$37.47$$

Then we adjust the figure to reflect the amount paid out to the investor as a dividend:

$$= \$37.47 \times \text{Payout Ratio of } 73\% = \underline{\$27.36(A)}$$

Growth Multiple and Payout ratio

We then have to determine the value of the earnings retained by the company. The growth multiple we use was developed by Richard Simmons, an Oxford scholar for companies that retained all its profits. A company that retains all its profits and generates a high return on equity will be far more valuable to us due to the power of compounding. The formula is;

$$= (\text{ROE/RR})^2 \text{ or } (47\%/11\%)^2 = 18.256$$

$$= \$8.77 \times \text{Growth Multiple of } 18.256 = \$160.10$$

Then we adjust the figure to reflect the amount retained as shareholders equity:

$$= \$160.10 \times (1 - \text{Payout Ratio of } 73\%) = \underline{\$116.89(B)}$$

Calculate Intrinsic Value

Simply add the two together;

$$\underline{\underline{A+B = INTRINSIC VALUE OF \$144.24 PER SHARE}}$$

If we compare the current market price per share of \$172.40 against the Intrinsic Value of \$144.24 per share we can conclude, at this point in time the market price is overvalued given our required rate of return. We would have to accept a lower rate of return if we were to purchase the stock at the current price of \$172.40, but by doing so puts us at greater risk of price correction e.g. if the company reported an event that would impact their earnings profile. Ideally we would wait for the stock to return to \$144.24 or lower before we would consider buying this company.

Performance of Key Indices

<i>Equities</i>	<i>Close</i>	<i>Change (M)</i>	<i>Change % (M)</i>
All Ordinaries	5288.56	+229.96	+4.55%
S&P/ASX200	5239.44	+217.81	+4.34%
Dow Jones (US)	17663.54	+1378.84	+8.47%
NASDAQ	5053.75	+433.59	+9.38%
S&P500	2079.36	+159.33	+ 8.3%
FTSE 100 Index	6361.09	+299.48	+4.94%
Nikkei 225 (Japan)	19083.10	+1694.95	+9.75%
10-year bond rate (US)	2.2144%	+0.001748	+8.57%

Upcoming RBA Events

Reserve Bank Board Meeting – 3rd November
Minutes of the RBA meeting – 17th November

ABS releases March

Building Approvals (September) – 2nd November
Retail Trade (September) – 4th November
International Trade in Goods and Services (September) – 4th November
Housing Finance (September) – 10th November
Labour Force (October) – 12th November
Lending Finance (September) – 13th November
Wage Price Index (September) – 18th November
Labour Force (October) – 19th November

Upcoming US Economic Releases

PMI Manufacturing Index – 2nd November
ISM Manufacturing Index – 2nd November
International Trade – 4th November
US Employment Situation – 6th November
Producer Price Index – 13th November
Retail Sales – 13th November
Consumer Price Index – 17th November
Industrial Production – 17th November
Housing Starts – 18th November
FOMC Minutes - 18th November
Existing Home Sales – 23rd November
GDP – 24th November
Durable Goods Orders – 25th November
New Home Sales – 25th November
Jobless Claims – Weekly Basis

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