Valuation is the key

by Malcolm Howard

There are two key elements in buying shares – risk and valuation. As discussed several times before, I do not regard volatility as a measure of risk, but rather that the main risk is the company's ability to generate cash and service its debts. I break companies down into three categories:

- Banks and Insurance companies
- Property companies
- All other companies

Property companies usually have a high amount of debt, but obviously the market value of their properties will be much greater. Now, the risk here is that the property market is cyclical; if companies take on too much debt by overinvesting then they can be in trouble in a downturn. This is what had happened to Land Securities plc in the past which led to the appointment of the current Chief Executive, Robert Noel. His strategy to de-risk the company was to reduce the debt percentage to around 25%. What we mean by this is that debt as a percentage of net assets before debt should be around 25%. This figures below show how this strategy has been achieved.

Land Securities – Debt % ratio at year ended March 31:

2010 - 37.3
2011 - 35.2
2012 - 36.9
2013 - 31.9
2014 - 27.2

So, I value property companies as follows, using Land Securities plc as an example:

Calculation based on year end 31 March 2015 (all figures in pence per share)	
Net asset value per share	1,332.8
Less valuation risk (10% of net asset value)	(133.3)
Less debt risk 500.3x0.25x1.0223	(127.9)
Discounted value of earnings (80p, no growth)	632.0
	1,703.6

At the date of writing this piece these shares were valued at 1,255 pence and as my valuation is significantly higher than this, there has to be a flaw.

The answer is that earnings in 2015 were boosted by a profit on the sale of assets (note: changes in unrealised property valuations are ignored) which are unlikely to be repeated. This was pointed out by Mr Noel at the annual UKSA meeting with his company. So, taking this into account the current price seems about right. Now, if we assume the earnings will fall next year the key will be to reassess the valuation. The point is that markets tend to overreact when companies show a decline in earnings, so such valuation could provide a buying opportunity.

Talking about buying opportunities, these occur when the market is in a stress as it is now. The reality is that markets go up and down, as demonstrated by the history of the FTSE 100 indices, at the year end, as below:

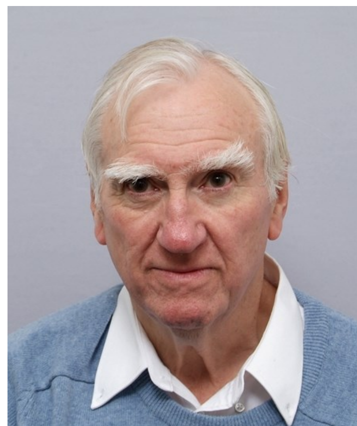
2000	2001	2002	2003	2004
6,222.5	5,217.4	3,940.4	4,476.9	4,814.3
2005	2006	2007	2008	2009
5,618.8	6,220.8	6,456.9	4,434.2	5,412.9
2010	2011	2012	2013	2014
5,899.9	5,572.3	5,897.8	6,749.1	6.566.1

In 2015, the market held relatively steady until the end of May, but the alleged crisis in China caused the market to panic. From May's close of 6,984.4, as I write it is 6,093.1, a decline of 12.8%.

I don't touch banks or insurance companies because I don't understand their accounts, but for all other companies, I have a simple strategy. First, I am only interested in companies where the net inflow from operating activities (from the Cash Flow Statement) exceeds the net income (from the Income Statement). As a general rule for these companies cash generated should be at least 120% of net income and when it isn't it can be because inventories and/or receivables are too high or there is a problem with the pension scheme. If companies pass this test, then they can be valued by comparing the potential growth with the growth built into the share price. If the potential is greater than the actual built in there is a buying opportunity. Of course, it can go wrong when companies fall short of both previous actual growth and potential growth, with Rolls Royce being an example. However, the most important reason for calculating a valuation is to understand when the market has significantly overvalued the company, often because it has been tipped in a newspaper.

I give two examples to demonstrate the point:

At an UKSA meeting in April 2015, a member suggested investing in SDL plc, as it was an innovative company. He said that he had bought into the company at a significantly lower price than 464p, but had seen the share price steadily rise. For Croydon members I analysed the company and wrote: "The current share price assumes over 20% growth, but this does not seem likely. Debtor days are a major worry, as is the worsening cash position". The current price is 370p, down 20%.



Malcolm Howard - former Finance Director

In the January 2015 issue of the Private Investor, I looked at ten companies, with a view to assessing whether or not investing in AIM companies carried a fair amount of risk. There were swings and roundabouts, as shown:

Price at (p)	11/11/13	14/1/15	4/9/15
Dart Group	223	285	502
Blinkx plc	207	26	23

Of the ten companies, I analysed three and rejected them all, two on the ground of risk and the other, shown in bold, on the ground of valuation.

Fairpoint Grp (debtors?)	134	114	175
Northbridge IS (over-valued)	**469**	**392**	**158**
Statpro Grp (accounts doubt)	93	74	70

Reading the above, it can be seen that of the two factors, risk and valuation, the latter is by far the most important. Warren Buffett frequently writes that he likes a falling market because it provides buying opportunities, but we can only take advantage if we can assess what a reasonable price would be.

Malcolm Howard