StockVal informer

Issue 10 - February 2008

"When prices decline you can buy more stocks for less money because people don't like them any more" - Warren Buffett

StockVal: REVIEWED

Understand our analysts thinking with a review of Blackmores Limited (BKL). This review was written by Clime Asset Management equities analyst Russell Muldoon on 23 October 2007 and published in Issue 16 of StockVal's fortnightly members' newsletter, *Fundamentally StockVal*.

"Buying great companies at reasonable prices can deliver solid returns for long-term investors. The challenge, of course, is identifying great companies and determining what constitutes a reasonable price."

Blackmores Limited (BKL)

In life, we surround ourselves with things that we are passionate about and those that give us enjoyment. The famous actor Mae West once said, "Too much of a good thing can be wonderful". Stamp collectors often have hundreds of individual postage collectables, fishermen - too much fishing tackle, sportsman – more sporting gear than they could ever use at once. If Mae West's statement holds true for most things in life, when seeking investments, this very principle should be also applied – accumulate large amounts of great businesses with which you have some form of interest.

While it is one thing to identify a company that could fit into your investment universe, what should you look for to weed out those great businesses over those that might burn a hole in your pocket?

Investors should look for companies that deliver **outstanding returns on capital**, have a **huge economic moat** to protect them from competitors, **bright prospects**, be **easy to understand** and can be **purchased for a decent price**. Businesses with these characteristics are worthy of a place for your surplus cash flow. Be wary of imitators.

Table 1

	2002	2003A	2004A	2005A	2006A	2007A	Totals
Amortisation of Goodwill		0.0	0.0	0.0	0.0	0.0	**0.0**
Abnormal Gains (Loss)		2.7	0.0	-0.5	1.2	0.8	**4.2**
Net Profit inc. Abnormals less Pref Divs		6.2	9.3	11.7	14.5	16.7	**58.4**
Dividends on Ordinary Shares Only		5.0	8.3	8.2	9.5	12.3	**43.3**
% of Dividends Franked		100%	100%	100%	100%	100%	
Grossed up Dividends		7.1	11.9	11.7	13.6	17.6	**61.9**
Opening Equity		18.8	22.7	27.6	30.6	36.8	**18.8**
Retained Profits		1.2	1.0	3.5	5.0	4.4	**15.1**
Change in Reserves		2.0	0.0	-0.5	1.2	0.8	**3.5**
New Ordinary Share Capital		0.7	3.9	0.0	0.0	1.5	**6.1**
Ordinary Capital Buybacks		0.0	0.0	0.0	0.0	0.0	**0.0**
Closing Ord. Equity Ex Minorities	18.8	22.7	27.6	30.6	36.8	43.5	**43.5**
Normalised IRR Cash Flows	**-18.8**	**6.4**	**8.0**	**11.7**	**13.6**	**55.4**	**76.3**
Normalised Earnings		**7.6**	**12.9**	**15.2**	**18.6**	**22.0**	**76.3**
Normalised ROE		**39.9%**	**52.2%**	**55.1%**	**60.7%**	**58.5%**	**53.3%**

Does the business make Outstanding Returns on Capital?

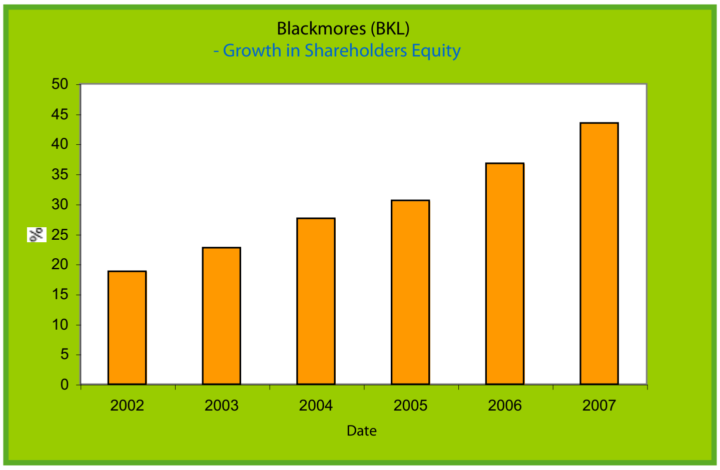
In order to determine if a particular business meets this criterion, the first variable to focus on is management's and the business' ability to retain and compound capital. We will use Blackmores Limited (BKL) as our case study. Table 1 reveals Blackmores underlying fundamentals.

The last total column, Totals, is important for this step. In the past five years Blackmores has retained $15.1m in after tax profits and generated an additional $6.1m in new ordinary share capital. Coupled with a small gain from changes in reserves $3.5m (i.e. foreign currency translations gains – the transferring of international profits back into Australian Dollars from overseas operations), shareholders equity has grown from $18.8m in 2002 to $43.5m at the end of the 30 June 2007 financial year – equity has increased 131% in a very short period of time (Table 2).

The reason why we focus on this variable when analysing businesses is because equity is the real driver behind share prices over long periods of time (remember Benjamin Graham's Mr Market analogy). Market prices will follow a business' growth in net assets (resources employed) should the company have the ability to generate a sufficient (preferably consistent / increasing) return on that incremental capital. A truly outstanding business requires no additional capital to generate higher levels of future profitability. However these businesses are very rare, and if found, a gem.

"There's a huge difference between the business that grows and requires lots of capital to do so and the business that grows and doesn't require any additional capital" - Warren Buffett, Berkshire AGM, 1994

Table 2



Blackmores is now a much bigger business in terms of resources employed compared to five years ago. Over 400 staff in various occupations (i.e. research and development, sales), a greater variety of vitamins, minerals, herbs and nutrients are now in production, and operations have expanded into New Zealand, Malaysia, Thailand, Taiwan, Singapore, Hong Kong and the United Kingdom.

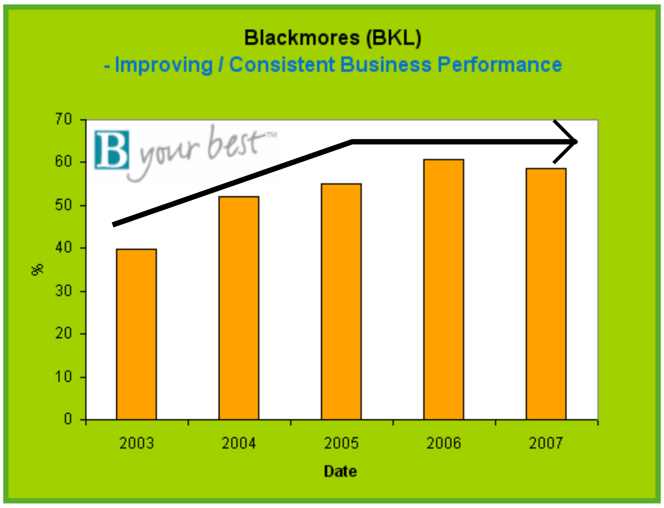
Significant investment has also been made in a 25,000sqm site at Warriewood. The property, located on Sydney's northern beaches, encompasses office space, distribution, storage, production and staff facilities. Its an all-in-one facility boosting efficiencies and manufacturing/distribution capabilities. As is the case with most businesses, additional investment is required should the business wish to increase capacity and market reach. Remember, those businesses that require the least amount of incremental equity to increase profits are the gems.

Equity in BKL is growing. But how profitably is the new equity being employed? Whilst our rocking chair principle comes into play here, (i.e. if you give a business more capital, profits should/would simply go up if management simply retained the capital in an interest bearing bank account earning interest revenue), what we require is justification for retained capital. Is the business generating consistent returns or improving returns on incremental capital? The best fundamental investors look for businesses which are able to compound retained capital at the highest return possible. The greater the sustainable compounding rate and amount retained, the greater the return to shareholders.

The key measure for this is Return on Equity (ROE).

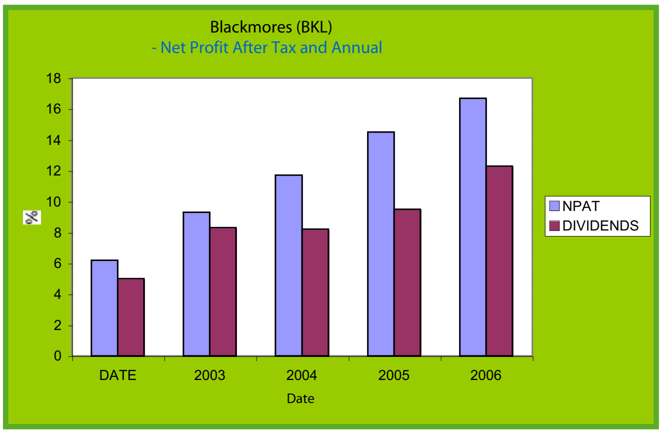
In 2002, Blackmores employed $18.8m in shareholders equity which returned $6.2m in after tax profits and paid $5.0m in fully franked dividends to shareholders. ROE from an owner's perspective was 39.9%. As new equity has been employed, return on incremental capital has improved and ROE from an owner's perspective has risen from 39.9% to 58.5% (average ROE 53.3%) - Table 3.

Table 3



Performance has been driven by an increase in after tax profits to $16.7m in 2007 from which $12.3m was paid out to shareholders (Table 4).

Table 4



A doubling in the level of net assets employed over the five year period from 2002 – 2006 from $18.8m to $36.8m has been met with a 169% increase in after tax profits. BKL management has retained additional equity wisely - exactly the fundamentals investors should look for.

Does the company have strong branding?

The best way to identify companies with economic moats is by looking for strong brands alongside consistent returns on capital.

BKL has excellent returns on incremental capital, but does it have an entrenched brand name to complement its performance? Yes.

From the beginning, Blackmores has been an industry leader – a history spanning more than 70 years and a huge barrier (moat) to protect them from competitors. Maurice Blackmore started the company in the 1930s and opened one of Australia's first health food stores in Brisbane in 1938. Over time, BKL has leveraged their first mover advantage and built a strong brand platform which remains a key differentiating factor in this sector, along with their 150 + product range.

Major competitors are tiered in two distinct markets; the pharmacy channel where Bullivants (part of the Mayne Group) is the major competitor, and the retail / grocery market where Nature's Way and Cenovis compete against Blackmores firm footing.

Nature's Own
PUT YOUR HEALTH FIRST®
CENOVIS®
Bullivants
Natural Health Products

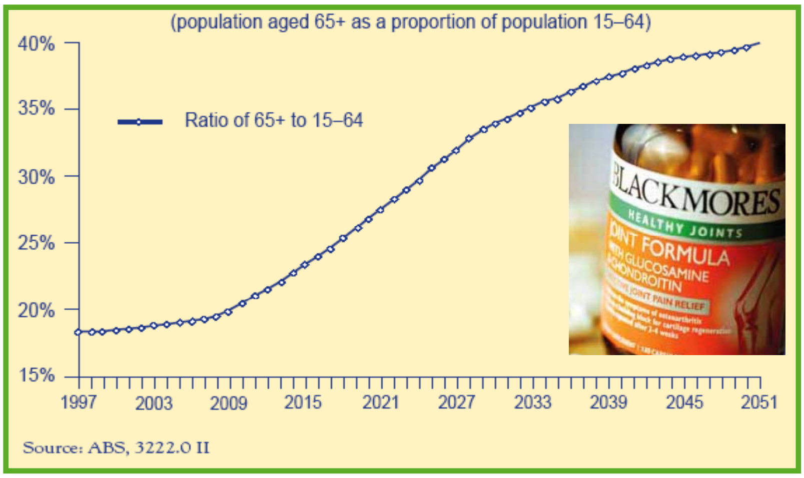
In 2003 BKL experienced significant market share gains after the Therapeutic Goods Administration (TGA) suspended the licence held by Pan Pharmaceuticals Limited to manufacture medicines.

Fours years after the event, the safety of health care products remain under question and the perception of quality continues to be an important issue. BKL management have always had a focus on quality products, ensuring market share gains are likely to be permanent. Undoubtedly, focus will be paid on maintaining and increasing their share through marketing and distinguishing Blackmores as a premium quality brand. Did anyone notice the major sponsor in this year's Sydney Marathon? 20,000 entrants no doubt did.

Does the company have bright prospects?

In BKL's 2007 annual report management stated, "we have reason to be optimistic about the coming year". Although this statement appears to be a little short sighted, a significant demographic change in our population is likely to see many optimistic years ahead.

The proportion of the population aged 65 or more is set to double over the next 40 years. The greatest single reason is that we're living longer. Over the past century, life expectancy at birth has increased from 57 to 80 years.



Source: ABS, 3222.0 II

Australia's ageing population is good news for those businesses that service this demographic. As an ageing population becomes more health conscious, greater demand for natural health products will be a logical progression.

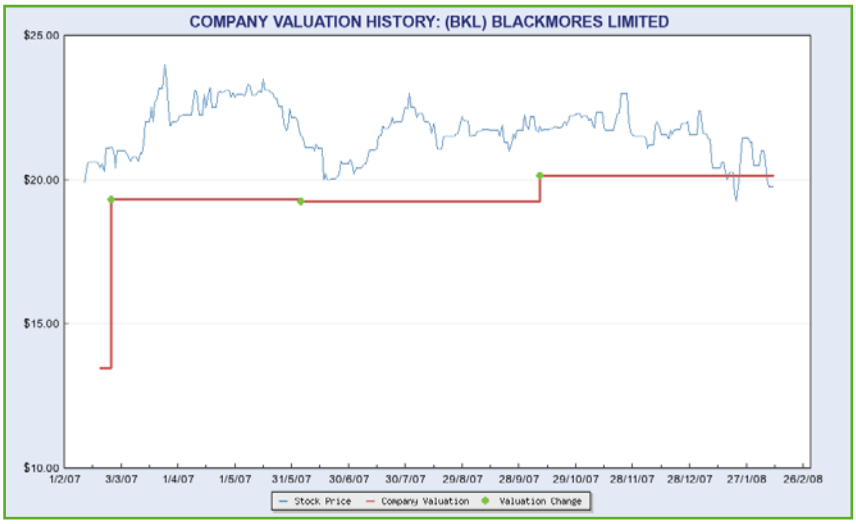
A more mature Australian market is expected to grow revenues by 10% per annum. This may be conservative given recent strong demand, market share gains from other major competitors and maintenance of a market leading position.

Outside of Australia, BKL's operations continue to expand, particularly in Asia where consumer trends are similar to ours. New Zealand, Malaysia, Thailand, Taiwan, Singapore, Hong Kong and the United Kingdom now contribute around 15-16% of total Revenue. Asian markets are expected to see revenue growth of around 22% per annum. It is not improbable that the business will see international revenue outstripping earnings in Australia in the foreseeable future as brand awareness continues to grow over time. An issue will be a continued strengthening of the $AUD against most currencies. As the AUD strengthens, it will take more overseas earnings to buy the same quantity of Aussie dollars.

Can the company be purchased for a decent price?

Buying great companies at reasonable prices can deliver solid returns for long-term investors. The challenge, of course, is identifying great companies and determining what constitutes a reasonable price.

In the context of great businesses, strong performance and expectation that this is likely to continue in both Australia and overseas highlights the strength of the Blackmores brand and its market leading position. Coupled with high returns on capital and significant cash flow generation to fund organic growth, BKL has a recipe for success.



As at 11 February 2008, **StockVal** values Blackmores at $20.14. **The valuation has not changed since this review was first published for StockVal members on 23 October 2007.**

As a result of recent market volatility, BKL is currently trading at a price below value.

Should the business continue to increase shareholders equity as they have done over the past five years, and retain current levels of profitability, today's price in 10 years could well prove to be a bargain.

StockVal: COACH

Reasons to buy in a market full of opportunities

by Brian Mciven

One has to go back at least twenty years to find the opportunities that are so abundant today.

It is during times of major declines in stock prices, such as those we are currently experiencing, that we see a huge transference of wealth from sellers to buyers.

Some, having borrowed too much in the expectation that prices will continue their upward spiral, are forced to sell. Others, who bought without reference to value have reason to panic and are now selling without reference to value.

As Warren Buffett noted, "when prices decline you can buy more stocks for less money because don't like them any more". The only reason that stocks are more popular when they are expensive and less popular when they are cheap, is that in the absence of value assessment people see only a bottomless pit and panic.

There are of course two factors that inhibit buying in a downturn. If already fully invested one can only salivate at the bargains. The other is the knowledge that a bargain today might be an even greater bargain tomorrow or next week. Picking the bottom is an impossible task, and when confidence is restored, prices tend to escalate quite quickly. It is at such times that we reminisce and say: "I could have bought XYZ at such and such a price, and look at what it is now selling for."

If a stock is bought because it was selling at a discount to its value and its business performance is unchanged, then in the absence of selling nothing has been lost. The price will eventually head back in the direction of the value. That's the way it has always been and always will be.

The current downturn in prices has not been caused by a weakening in the Australian economy. Quite the contrary. Unlike the US economy that has required a succession of interest rate cuts for stimulus, ours is so strong that the Reserve bank is likely to increase interest rates.

The perception that when the US sneezes the rest of the world catches a cold is not as valid as it once was (even less so for a resource rich country like Australia in a resource starved world). While China's huge trade surpluses give it the wherewithal to buy our resources, our economy will not falter. We are indeed, the lucky country.

StockVal: COMMENTARY

The Australian share market fell about 11% in January. This was consistent with falls in European and Asian markets, but much greater than USA markets. Thus, as the finger for economic gloom is pointed squarely at the USA, it is noteworthy that its market has been able to insulate it.

The reasons for this divergence can be explained by the substantial drop in interest rates by the US Central Bank, and a continued weakening in the US dollar. Relaxed monetary policy settings and an increase in money supply are supportive of a recapitalisation of US banks. A weakening US dollar is supportive of major US multi-national companies.

In Australia, market weakness exposed the high level of debt in the market. It is clearly an unsatisfactory situation that brokers and banks have lent significant amounts to investors at very high ratios of debt to security. Hedge funds have borrowed the shares, acquired from the brokers and hedge funds, to short the same shares. These two activities have caused extreme volatility in markets as borrowers are sold out due to hedge funds driving prices down.

The volatility presented opportunities for savvy value investors to acquire meaningful positions in good companies at significant discounts (margin of safety) to **StockVal** valuations.

Throughout 2007, **StockVal** indicated that prices in the market for most leading companies were excessive. The recent large correction in the market vindicates the quality of our investment methodology and accuracy of **StockVal** as a superior investment tool for value investors seeking to purchase shares in businesses for cheap prices.

StockVal: MEMBERSHIPS

What to become a member of StockVal?

Prices quoted include GST. Membership benefits include:

- Over 400 live valuations
- Fortnightly newsletter
- Phone and email access to a team of analysts

Membership type (initial)	Investment
12 months membership	$1795
2 years membership	$2395
Renewal type (following initial membership	**Investment**
12 months	$1249
2 years	$1895

INFORMER bulletin board

StockVal Website Upgrade

Our web development team were very busy over the Christmas/January break working on the upgrade of the **StockVal** program and members area. Grand changes are planned for **StockVal**, including an integrated search function, multiple watchlist option and portfolio management feature. The new and improved **StockVal** service is scheduled for release mid-late March.

Where's the Value? seminars

Where's the Value? is a two hour evening seminar presented by Roger Montgomery and covers everything you need to know to become a more certain and more successful value investor.

Over two hours you will learn how to apply Clime's common sense, long-term approach to investing that aims to purchase part shares of wonderful businesses at rational prices. Using case studies as examples, you will discover the importance of return on equity in calculating a company's value and learn how to distinguish a wonderful company from a mediocre company.

- Learn what's causing the current market conditions;
- Find great value, particularly during corrections;
- Understand the difference between a wonderful company and a mediocre company; and
- Purchase shares of wonderful businesses at cheap prices.

Cost: $65 per seat ($99 for two) and includes Roger Montgomery's DVD on value investing that explains how to use StockVal to value businesses and invest in wonderful companies.

DATE	CITY	
Wednesday 20 February	**Gold Coast**	Courtyard by Marriott
Thursday 21 February	**Brisbane**	Brisbane Polo Club
Wednesday 27 February	**Manly**	Manly Golf Club
Thursday 13 March	**Penrith**	Penrith Panthers
Thursday 3 April	**Gosford**	Gosford Golf Club
Thursday 15 May	**Albury**	Sundownder Albury Paddlesteamer
Thursday 5 June	**North Sydney**	Vibe Hotel North Sydney
Thursday 12 June	**Sans Souci**	St George Motor Boat Yacht Club
Thursday 19 June	**Melbourne**	Telstra Conference Centre

Would you like to meet the StockVal Team in your town?

If you are involved in an investment group or know of investors in your area who would like to attend a **StockVal** Q&A or Where's the Value? seminar, please email Vanessa – vanessa@clime.com.au - with your preferred location.

Climb with Clime sessions

Do you have an experienced investment partner?

If you prefer to spend your spare time enjoying life rather than managing a share portfolio, an investment partnership with Clime may offer the perfect solution.

Attend a ***Climb with Clime*** Investor Presentation and you will gain an insight into how Clime employs a long-term value based investment philosophy to manage one quarter of a billion dollars for clients, shareholders and family interests and successfully navigate market turmoil.

You will also learn about Clime's range of managed investment services, including the Discrete Share Portfolio Service, Clime Value Growth Fund and Clime High Yield Underdogs Fund, discover how you can begin an investment relationship with Clime and receive a demonstration of StockVal.com.au.

Climb with Clime is presented by Investor Services Manager Matt Perreau and Clime Equities Analyst Daniel Sciberras. The sessions comprise a 75-minute presentation followed by a 15 minute Q&A.

DATE	CITY	VENUE
Tuesday 19 February	**Melbourne**	Telstra Conference Centre
Wednesday 12 March	**Ballina**	Best Western Ballina Island
Wednesday 12 March	**Gold Coast**	Crowne Plaza Resort
Thursday 13 March	**Toowoomba**	TBA
Thursday 13 March	**Brisbane**	Holiday Inn
Tuesday 15 April	**Sydney**	Clime Sydney Office
Tuesday 6 May	**Adelaide**	TBA
Wednesday 7 May	**Perth**	City West Function Centre
Wednesday 20 May	**Sydney**	Clime Sydney Office
Wednesday 28 May	**Brisbane**	TBA
Tuesday 17 June	**Albury**	TBA
Tuesday 24 June	**Sydney**	Clime Sydney office

Please note that seats are limited so bookings are essential - call Investor Services on 1300 788 568 to reserve your place today.

INFORMER feedback

We welcome any comments or feedback you may have about **StockVal Informer** to stockval@clime.com.au.

DISCLAIMER