



# StockVal informer

Issue 11 - March 2008

**"I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years" - Warren Buffett**



## StockVal: INFORMED

### ABC Learning Centres – What Went Wrong?

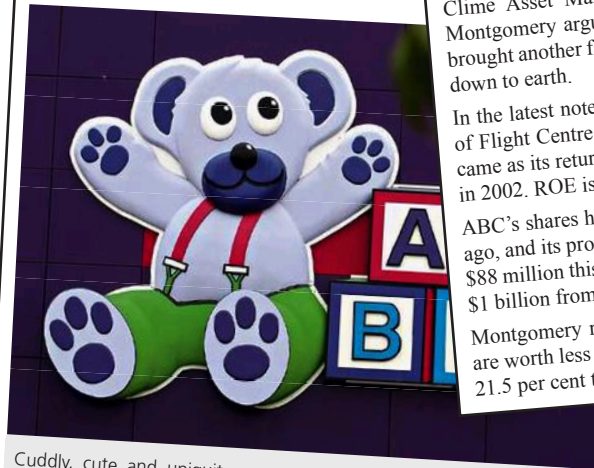
Investors will always have a few stocks in their portfolio that fail to live up to expectations. Many investors can attest to this. Some we become clouded by, but others show clear signs of poor business practice that a smart investor would never buy in a pink fit!

ABC Learning Centres hit the headlines recently. When the ABC Lateline Business Program, Channel Ten and SBS news called Clime Asset Management Managing Director Roger Montgomery over the last few weeks, they wanted to know why the share price had fallen so much and so quickly. Many analysts might have pointed to the disappointing profit result, the margin calls that saw management lose their stake in the company, or the mounting debt.

The reality, however, is that the stage for the most recent decline was being constructed in 2004, 2005 and 2006. In seminars around the country over the last two years, and in The Sydney Morning Herald,

### C for ABC

The Sydney Morning Herald  
4 April 2006



Cuddly, cute and unquitous... and overpriced to billyo, says Clime Capital  
Photo: Robert Rough

It would appear a brave call to rate a stock trading at about \$8 as worth \$3 but that's what Clime Capital thinks of ABC Learning.

With most brokers calling the childcare company between \$7 and \$8, and after a strong share price rise in recent years, Clime says ABC's share price would have to fall about 65 per cent to be of any interest.

Clime's chief criticism involves ABC's diminishing return on equity from 48 per cent in 2002 to below 11 per cent in 2006, during which time equity raised grew from \$10 million a year to \$330 million.

"If the return on equity remains at 11 per cent and we adopt a 15 per cent required return, the only sensible price to pay for the business is a discount to the equity in the business," Clime writes, adding its estimate of value is "less than \$3".

### Learning the ABC of rapid growth and return on equity

The Australian Financial Reivew  
3 April 2006

ABC Learning Centres boss Eddy Groves has been attracting his fair share of knockers since it became clear ABC is by far the dominant company in the politically sensitive arena of child care. But Groves is not just getting a hard time from opponents of the corporatisation of child care.

Some observers are also taking issue with the company's ability to handle its astonishing growth.

Clime Asset Management boss and Warren Buffett acolyte Roger Montgomery argues ABC is showing the same strains that eventually brought another fast-growing Queensland company, Flight Centre, back down to earth.

In the latest note to his investors, Montgomery argues that the decline of Flight Centre shares from almost \$29 in 2002 to \$9.06 in February came as its return on equity fell from 64 per cent in 1998 to 49 per cent in 2002. ROE is forecast at 24 per cent this year.

ABC's shares have surged more than 20-fold since it floated five years ago, and its profits have jumped from \$3.3 million in 2001 to a forecast \$88 million this year. But its Achilles heel has been its raising of almost \$1 billion from shareholders over the same period.

Montgomery reckons ABC shares, which rose 3? on Friday to \$8.33, are worth less than \$3 and the return on equity would have to double to 21.5 per cent to justify the current price.

The Age and The Financial Review over the same period, Roger has been warning investors about ABC Learning Centres.

In April 2006, with ABC Learning's shares trading around \$8.00, **StockVal** provided enough information and confidence to make the above statements publicly.



By 2006, ABC Learning Centres had been growing profits each year, and rapidly too. In the four years between and including 2001 and 2006, profits grew from \$3.3 million to \$81.5 million. CEO Eddy Groves recently challenged anyone to match that record, in the process indicating to wise investors that even he does not understand what drives business value.

Table 2

| ABC LEARNING CENTRES LTD  |            | PERFORMANCE CRITERIA and VALUATION |          | PERFORMANCE CHART                |              |
|---------------------------|------------|------------------------------------|----------|----------------------------------|--------------|
| Stock Code                | ABS        | Currency                           | \$AUS    | NROE for last year of review     | 11.6%        |
| Last Equity Date          | 30/06/2006 |                                    | Millions | IRR                              | 24.7%        |
| Intangibles               | 167.9      |                                    |          | Other                            | %            |
| Total Liabilities         | 287.0      |                                    |          | Adopted Performance Criteria APC | 11.6%        |
| Cash Equivalents          | 107.3      |                                    |          | Distributed                      | 5.0%         |
| Interest Bearing Debt     | 143.5      |                                    |          | Reinvested                       | 6.5%         |
| Average Funds Employed    | 1,108.3    |                                    |          | Investment VALUE @ RR            | 14.0% \$2.95 |
| Total Shareholders Equity | 1,191.2    |                                    |          | Annual Return at Value           | 13.3%        |
| Less Minorities           |            |                                    |          | Value/Price Margin at adopted RR | -62.6%       |
| Less Non Ordinary Equity  |            |                                    |          | Required RR to justify price     | 7.5%         |
| Net Ordinary Share Equity | 1,191.2    |                                    |          | Required APC to justify price    | 21.5%        |

|                                       | 2001  | 2002  | 2003  | 2004  | 2005   | 2006    | Totals  |
|---------------------------------------|-------|-------|-------|-------|--------|---------|---------|
| Amortisation of Goodwill              |       |       |       |       | 4.8    |         | 4.8     |
| Abnormal Gains (Negatives)            |       | 1.8   | 2.5   | -2.2  | 94.5   | -6.0    | 90.6    |
| Profit inc Abnormals less Pref. Divs. |       | 6.9   | 12.1  | 19.4  | 50.3   | 97.1    | 185.8   |
| Dividends on Ordinary shares only     |       | 4.2   | 4.0   | 6.4   | 18.9   | 33.5    | 67.0    |
| % Franked Dividends                   |       | 100%  | 100%  | 100%  | 100%   | 100%    |         |
| Grossed up Dividends                  |       | 6.0   | 5.7   | 9.1   | 27.0   | 47.9    | 95.7    |
| Opening Equity                        | 13.0  | 27.5  | 89.1  | 152.0 | 795.9  | 13.0    |         |
| Retained Profits                      |       | 2.7   | 8.1   | 13.0  | 31.4   | 63.6    | 118.8   |
| Change in Reserves                    |       | 1.8   | 2.5   | -2.2  | 94.5   | -6.0    | 90.6    |
| New Ordinary share Capital            |       | 10.0  | 51.0  | 52.1  | 518.0  | 337.7   | 968.8   |
| Ordinary Capital Buybacks             |       |       |       |       |        |         |         |
| Closing Ord Equity ex Minorities      | 13.0  | 27.5  | 89.1  | 152.0 | 795.9  | 1,191.2 | 1,191.2 |
| Normalized IRR                        | -13.0 | -4.0  | -45.3 | -43.0 | -491.0 | 815.6   | 219.3   |
| Normalized Earnings                   |       | 8.7   | 13.8  | 22.1  | 63.2   | 111.5   | 219.3   |
| Normalized ROE                        |       | 48.3% | 26.1% | 19.2% | 15.4%  | 11.6%   | 24.1%   |

| PERFORMANCE CHART |       |
|-------------------|-------|
| 2002              | 33.3% |
| 2003              | 10.8% |
| 2004              | 7.9%  |
| 2005              | 6.6%  |
| 2006              | 5.0%  |
| Dist              | 33.3% |
| Reinv.            | 15.0% |
| NROE              | 48.3% |

| Per Share Statistics       |        |
|----------------------------|--------|
| No. Ordinary Shares        | 308.2  |
| Market Price at 06/04/2006 | \$7.90 |
| Equity per Ordinary Share  | \$3.97 |
| Year High                  | \$8.55 |
| Year Low                   | \$4.81 |
| NTA                        | \$3.41 |
| Intangibles                | \$0.56 |
| Liabilities                | \$0.96 |
| Borrowings                 | \$0.48 |
| Normalized Earnings        | \$0.37 |
| PER                        | 24.4   |
| Normalized PER             | 21.3   |
| Normalized ROFE            | 11.0%  |
| Dividend                   | \$0.11 |
| Dividend Yield             | 1.4%   |
| Equity Ratio               | 80.6%  |

An explanation of what was wrong with ABC Learning is offered in the following excerpt from Clime Capital Limited's annual letter to shareholders in April 2006.

*But why the history lesson? Well, there is another company whose shares have risen in price almost as dramatically... , whose earnings have grown just as quickly... over the same period but whose equity has risen even more dramatically than the earnings and thus witnessed a similarly dramatic decline in ROE... Indeed the similarities between the two are uncanny and if history has any say in the matter, the outcome will be just as disappointing for those who are currently buying shares on the back of the bullish broker reports, international expansion and demographic support.*

*That company is ABC Learning Centres and a quick profile on the balance sheet tells the story (Table 1):*

| Table 1          | 2001 | 2002   | 2003   | 2004   | 2005   | 2006   | CAGR    |
|------------------|------|--------|--------|--------|--------|--------|---------|
| EARNINGS*        |      | 8.7    | 13.8   | 22.1   | 63.2   | 105    | 86.39%  |
| EQUITY RAISED    |      | 10     | 51     | 52.1   | 518    | 329.6  |         |
| ENDING EQUITY    | 13   | 27.5   | 89.1   | 152    | 794    | 1172   | 146.03% |
| RETURN ON EQUITY |      | 48.03% | 26.10% | 19.20% | 15.40% | 10.90% | -31.90% |

\* proprietary calculations

*ABC Learning centres (ASX: ABS) is Australia's largest provider of childcare centres. Most recently, the company announced the acquisition of up to 106 centres through a takeover of Kids Campus, taking the targeted number of centres ABC owns to 1,263 by the end of the 2006 financial year.*

*Analysts at stock brokers around Australia have been enamoured by ABC Learning Centres. Research notes*



*are saying everything short of reciting the lyrics from the Jackson 5's hit I Want You Back. Entitled "Centre Growth Well Ahead of Expectations" and "Acquisition Frenzy Continues in Australia" and with published price targets ranging from \$7.73 to \$8.59 not a single report suggests investors are at risk of a substantial decline if the company's return on equity does not improve.*

*Perhaps not surprisingly, our 'valuation' (we don't use price targets) is substantially lower. Indeed, ABS shares would need to fall by 64% before becoming interesting to us and even then, for reasons we'll explain in a moment, not very interesting at all.*

*Take a look at the table and screen shot from StockVal. While the proprietary calculation of earnings has grown at an average annual rate of 86% in the four years since 2002 – a significant reason for the share price*

*appreciation from \$2.39 to over \$8.35 –*

*equity has grown at an even more staggering 146% per year. This is due to the company raising just shy of \$1 billion from shareholders [1] (see Table 2) in the*

*four years to 2006. Our rocking chair principle comes into effect here; one would certainly expect earnings to rise if you inject an additional \$1 billion into a business – why, even a person sitting in a rocking chair would be likely to earn more interest by injecting an extra billion into their account!*

*... the end result is that the company is producing*

a return on equity now of just 11% - down from 48% in 2002 [2] and a rate of return that is lower than our required return of 14%. If the return on equity remains at 11% [3] & [4] and we adopt a 15% required return, the only sensible price to pay for the business is a discount to the equity in the business [5]. Indeed by our estimates, the company has \$4.68 of equity per share and our estimate of value is less than \$3.00 [6]. If ground level represents value, the share price is hovering somewhere in the stratosphere.

So in 2006, with the share price of ABC Learning Centres at \$8.00 and the broking community issuing "Strong Buy" recommendations, **StockVal** members were quietly avoiding it like the plague. **StockVal** simply indicated a declining return on equity chart and a valuation significantly below the price.

If your job as an investor is to purchase at an attractive price, a part share of a wonderful business, then ABC offered neither an attractive price nor a wonderful business.

Benjamin Graham said that in the short run the market is a voting machine, but in the long run, the market is a weighing machine. While the most recent sell off – that which has triggered margin calls and seen management lose their stake in the company – is the reason the company has hit the headlines, it is the factors described above that is the real reason price has finally reflected the true value of the business.

### What Is StockVal Warning Investors About Today?

Today, **StockVal** is sounding a warning about another company that has overpaid for an asset. As a result, this company's return on equity will plunge over the next two to three years. And its valuation in 2009 is 40% lower than today's share price. The shares remain stubbornly "overpriced to billyo". To find out which company displays a similar profile in the next two years to that which ABC displayed in the last two, join **StockVal**.



## StockVal: NEWS

### Berkshire Hathaway

For those interested, copy and paste the following link into your web browser to download Warren Buffett's latest annual report:

<http://www.berkshirehathaway.com/reports.html>

### New book

Even the most seasoned value investor can learn something new from Brian McNiven's new book, *Concise Guide to Value Investing: How to buy wonderful companies at a fair price*.

To purchase this book for just \$35.00, including GST & postage, call the **StockVal Team** on 1300 136 225.



## 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     |





The following article was written by Clime Investment Management (ASX: CIW) Managing Director, Mr John Abernethy.

**“As our case is new we must think anew and act anew”... - Abraham Lincoln**

As investors, our challenge is to make rational investment decisions.

We do so, however, in an irrational world. The starkest example of irrationality is the mispricing of risk. Why are investors prepared to accept seemingly low returns on their investment capital when a change in economic outlook, a change in interest rates, a change in market conditions or any number of exogenous events can cause total destruction of investment value?

I suspect investors are currently watching the dramatic fall in share prices, asking why it is happening and is this a buying opportunity?

The general share market correction is a function of the repricing of risk. We must always remember that equities are the riskiest of investment assets. Equity is not redeemable. Equity ranks behind secured and unsecured creditors. Interest is paid before dividends. Employee and Director entitlements are paid before shareholder returns. In a wind up, a shareholder is last in line.

Thus, what is the return that an investor should require before committing to an investment?

As a general rule, the lowest return should be the return of a government bond. As a true investment should be long term, then the “risk free” rate of return on a 10 year Government Bond should be our base. A risk margin for equity risk should be added. Individual companies should be rated and the risk premium adjusted for:

1. The quality of a company’s franchise, its brand and market share;
2. The quality of a company’s balance sheet;
3. The quality of a company’s economic performance, as measured by return on equity; and
4. The quality of a company’s management.

In recent weeks our analysts at **StockVal** have adjusted the “Required Returns” of all companies as an acknowledgement of higher interest rates. Our analysts have also critically analysed the Adopted

Performance Criteria (“APC”) of companies, taking into account the deteriorating economic outlook in the USA and the ramifications for Australia.

Required Returns are being increased due to the significant monetary tightening by the Reserve Bank. The tightening has been undertaken in response to capacity constraints being shown in the economy and the risk of inflation. Growth in Australia has been stimulated by the resources boom. The growth has directly benefited corporate Australia. Indeed, the growth has been aided by quite loose monetary policy settings and historically low interest rates. These economic conditions have helped companies produce outstanding returns, particularly those companies servicing the household sector. Full employment and a credit binge have artificially inflated shareholder returns.

Thus, our view is that the end of this high growth and high debt cycle will necessarily lead to a reduction in most companies economic performance. Thus, we are generally adopting a lower APC for companies which have generated unsustainably high returns over the last three years.

The combination of higher interest rates, tighter credit conditions, a slowing economy and inflation does lead us to require a much higher return from a share investment.

So what does this mean for investors?

The last six months have seen a dramatic change in the investment landscape. Indeed the changes and causes are so immense that I could not possibly cover them all in this article. However, it is amazing to think that the mispricing of risk in loans to sub-prime mortgages by USA Banks has now contributed to:

1. Massive write-offs and provisions by USA Investment Banks;
2. A liquidity crisis in debt markets;
3. A dramatic drop in USA interest rates by the USA Central Reserve;
4. A dramatic devaluation in the US dollar; and
5. The collapse in the USA housing market and the imminent declaration of recession.

For investors in Australia, these developments are not good news. Whilst it was hard, just six months ago, to see the direct connection of the USA credit problems to the Australian economy; it has now developed into a dramatic financing problem for Australian Banks and corporations.

Just last week (commencing 3 March 2008), we saw the announcement that Australia’s Current Account Deficit moved to 7% of GDP. Over half of this deficit is the effect of interest payments on foreign debt. A substantial part of this is interest on foreign debt raised



by Australian Banks and Corporations. Despite the fall in headline interest rates in the USA, the actual interest rates charged to Australian corporate borrowers are increasing and its availability being reduced. We have dramatically and quickly entered a "credit squeeze", and at a time when our Reserve Bank is adjusting interest rates up to slow the economy.

The Banks are the bell weather of the health of any economy and its outlook. The dramatic fall in Bank share prices of 30% in the last three months may be overdone. However, it is a clear warning sign of the difficulties that lay ahead.

Now is not the time to be aggressively buying equities. Why buy equities when the outlook is so uncertain and when the bell weather stocks are ringing alarm bells?

Is it simply not better to stay in the safety of cash and wait for the fear in share markets to really develop before investing again? Time is on the side of the true investor.



## INFORMER bulletin board

### 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 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    | VENUE             |
|-------------------|---------|-------------------|
| Thursday 13 March | Penrith | Penrith Panthers  |
| Thursday 3 April  | Gosford | Gosford Golf Club |



|                    |              |                                 |
|--------------------|--------------|---------------------------------|
| Thursday 15 May    | Albury       | Sundowner 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       |
| Thursday 31 July   | Perth        | The Chifley on the Terrace      |
| Thursday 14 August | Adelaide     | Mercure Grosvenor Hotel         |
| Thursday 28 August | Bowral       | Bowral Golf Club                |

### 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](mailto:vanessa@clime.com.au) - with your preferred location.



## CLIME investment options

Clime is unique. In every aspect of our business and relationships we tackle the challenges that face us as portfolio managers a little differently. Even though such an attitude is uncommon, we consider our clients as partners and treat them as such.

Clime is independent and 100% locally owned. Unlike other managers, we are clear about our fees and do not hide expense recovery clauses in our documents. We hope you are as excited about our low cost, fee for performance, focused investing services as we are proud to present them to you.

### Clime High Yield Underdogs Fund

**Minimum investment: \$10,000**

**Minimum additional investment: \$5,000**

- Nil management fee
- Nil entry fee
- Nil contribution fee
- 1% withdrawal fee within 1st year
- 10.25% performance fee
- 0.67% p.a. Recoverable Expenses

## Clime Value Growth Fund

**Minimum investment: \$20,000**

**Minimum additional investment: \$5,000**

- Nil entry fee
- Nil contribution fee
- Nil withdrawal fee
- 1.03% management fee calculated monthly
- 15.38% performance fee charged only when Clime outperforms the 12% per annum benchmark
- 0.52% p.a. Recoverable Expenses

## Discrete Share Portfolio Service

**Minimum investment: \$500,000**

**Minimum additional investment: \$25,000**

- Individually Managed Account Service
- Nil entry fee
- Nil exit fee after 5 years
- 1.1% annual management fee\*
- 20% performance fee charged only when Clime outperforms the ASX S&P 200

**If you would like to discuss an investment partnership with Clime further, please call 1300 788 568 or visit [clime.com.au](http://clime.com.au) to download a Product Disclosure Statement.**

## 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 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, and receive a demonstration of StockVal.com.au. You will also discover how you can begin an investment relationship with Clime.

**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 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](mailto:stockval@clime.com.au).

### DISCLAIMER

StockVal Informer and associated websites are published by Clime Investors Education Pty Ltd ACN 115 128 286 (Clime), Authorised Representative of Clime Asset Management Pty Limited ACN 089 420 770 AFS Licence 221146

The information provided in this newsletter is intended for general use only. The information presented does not take into account the investment objectives, financial situation and advisory needs of any particular person nor does the information provided constitute investment advice. Under no circumstances should investments be based solely on the information presented. StockVal Informer is intended to provide educational information only. The content of StockVal Informer does not forecast share prices nor does it provide recommendations of any type. StockVal Informer and its contents and [stockval.com.au](http://stockval.com.au) and its contents are not, and should not be construed as, an offer to sell or the solicitation of an offer to purchase or subscribe to any investment. We are not aware that any recipient intends to rely on the contents of [stockval.com.au](http://stockval.com.au) or StockVal Informer or of the manner in which the recipient intends to use it.

In issuing StockVal Informer, it is not possible to take into account the investment objectives, financial situations or particular needs of any individual recipient. Investors should obtain individual financial advice to determine whether the content is appropriate to their investment objectives, financial situation or particular needs before acting in any way on such information. However to the extent permitted by the relevant laws, Clime Asset Management Pty Limited, Clime Investors Education Pty Limited or any of their subsidiaries or employees gives no warranty of reliability or accuracy of any part of the content of StockVal Informer nor accepts any responsibility arising in any other way (including by reason of negligence) for any errors or omissions in the information published and included and will not accept responsibility for any consequences arising from action or inaction based on the published material and no claim for compensation will be entered. Please be aware that investing involves the risk of capital loss.

Clime Investors Education Pty Limited ("Clime") retains all rights (including copyrights, trademarks, patents as well as any other intellectual property right) in relation to all information provided in StockVal Informer. You may not copy, publish, distribute or reproduce any of the information contained in this newsletter in any form without the prior written consent of Clime or the appropriate consent of the owner. However, you may print out information contained in StockVal Informer for your own personal and non-commercial use.

The views and information presented in StockVal Informer are sourced from publicly available information and are believed to be reliable. [stockval.com.au](http://stockval.com.au) and StockVal Informer are committed to bringing our subscribers accurate, timely and informative company information. However, Clime Investors Education Pty Limited does not assume responsibility or accept liability whatsoever, whether arising from negligence, accident or otherwise, for any error contained in the information. If you have any queries please email StockVal at [stockval@clime.com.au](mailto:stockval@clime.com.au). © Clime Investors Education Pty Ltd 2007.

