



# StockVal informer

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**"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." - Warren Buffett**



**StockVal: REVIEWED**

## How Not to Value Southcorp!

In June the headlines said it all; *"Foster's Group Ltd Chief Executive Officer Trevor O'Hoy quit as Australia's biggest beer and winemaker cut earnings forecast and said it will write off as much as A\$770 million at its wine unit"* (Robert Fenner, Bloomberg, June 10, 2008).

Another overpriced acquisition, another write down and small shareholders lose another three quarters of a billion dollars.

It's easy to get caught up in the hype of takeovers, mergers and acquisition and when momentum is behind this activity it's a real challenge for investors to stand aside and not play the game. Sometimes sloth and inactivity can be far more rewarding. Combine patience with the ability to value businesses and you have almost everything you need to mitigate the prospects of losses from the hype and confusion surrounding takeovers.

Value and price are two different things. Price is what you pay and value is what you get. As you will discover, most investors, boards of directors and commentators, figuring it is just too hard to value a business, take their cues from price.

In recent seminars, Roger Montgomery has queried the price Wesfarmers paid for Coles. Roger very publicly warned investors in 2006 that the market price of \$8.00 for ABC Learning Centres was full of hype and nowhere near value and similarly warned investors away from Centro at \$9.80.

Warren Buffett said that the first rule of investing is to avoid losing money. Let's find out how **StockVal** could have provided investors (and perhaps the board of Foster's

Group Ltd) with a better understanding of the merits of the Southcorp acquisition.

Lets begin with some of the commentary from early 2005.

*"We are the natural owners in terms of financial and strategic factors"* - ABC PM Program, Monday, 17 January 2005

*"Today the Southcorp board rejected that [\$4.17] offer, saying it was inadequate and opportunistic"* - ABC PM Program, Monday, 17 January 2005

*"The combination of Foster's and Southcorp is Strategically and Financially Compelling...The offer is financially attractive for Foster's shareholders on all key acquisition metrics"* - Foster's Group Press Release, Monday, 17 January 2005

*"The acquisition of Southcorp is an excellent strategic fit. It will enhance Foster's long-term global growth prospects and deliver significant benefits to shareholders of both companies"* - Foster's Group Press Release, Monday, 17 January 2005

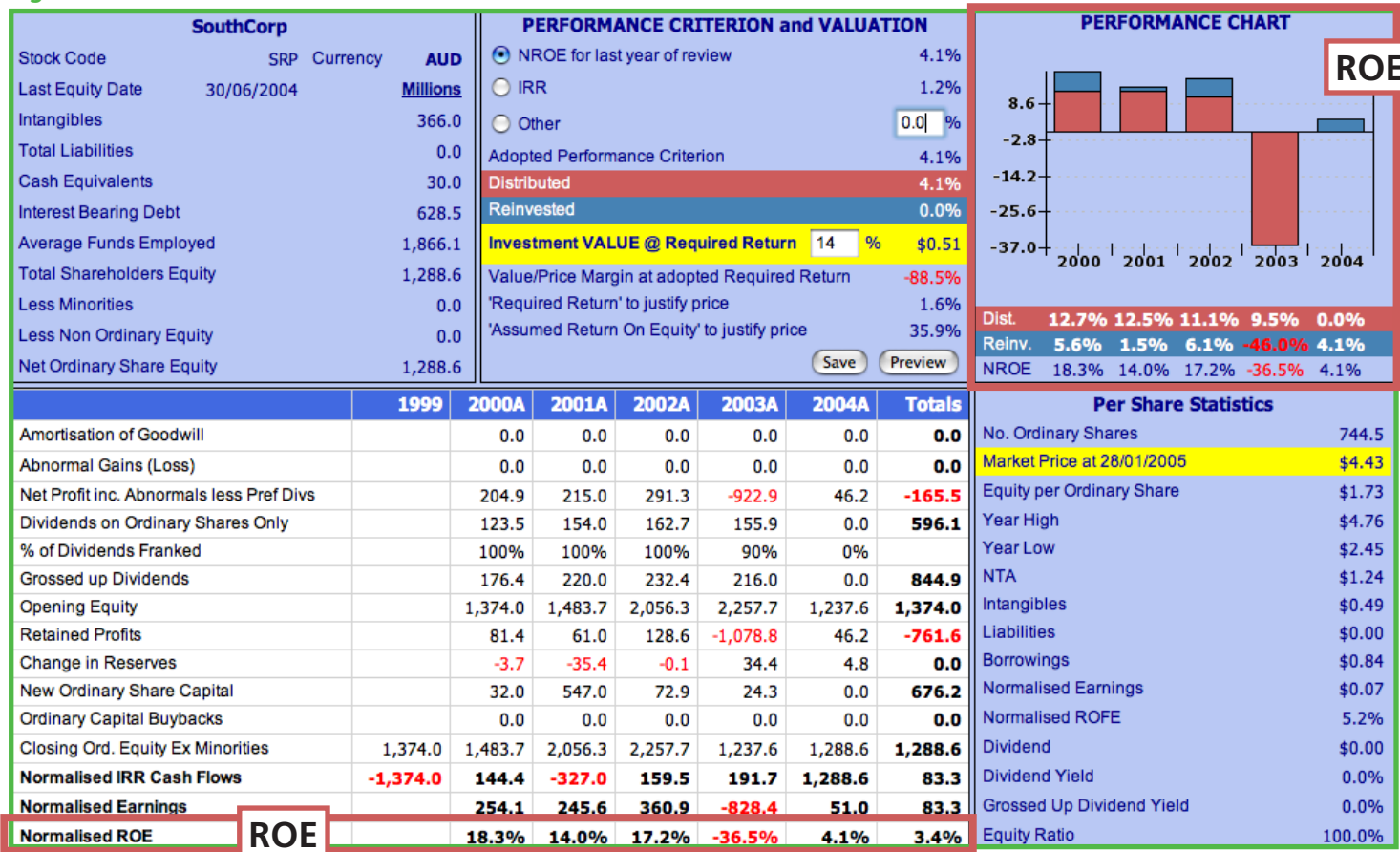
*"Southcorp chairman Brian Finn believes the winemaker's solid interim profit, an earlier-than-expected decision to resume dividends and modest earnings growth prove Foster's Group's hostile \$3.1 billion takeover bid is too low"* - Sydney Morning Herald, Buoyant Southcorp Damns Bid, James Chessell, February 10, 2005

*"We estimate Foster's could still pay up to \$5 a share and achieve earnings per share accretion"* - Broker quoted in SMH, Buoyant Southcorp Damns Bid, James Chessell, February 10, 2005

*"The acquisition is expected to be earnings per share accretive in year two"* - Foster's Group Press Release, Monday, 17 January 2005



Figure 1



"The market continues to trade Southcorp shares well above the Foster's bid price of \$4.17 – the stock closed 1c higher at \$4.41 – on expectations the company will attract a higher offer." - SMH, Buoyant Southcorp Damns Bid, James Chessell, February 10, 2005

"Mr. Ballard [Southcorp Chief Executive] said he agreed Southcorp and Foster's would be "an excellent strategic fit" as industry trends are "increasingly favourable." But he added, "I do not see those factors adequately reflected in their offer price." - FoodandDrinkEurope.com 25 April 2005

"In summary, these are our key ratios for the 2005 half-year. They show that we are moving in the right direction and that we have well and truly positioned the business for growth in the future." - Southcorp 2003/2004 HALF-YEAR RESULTS – SPEAKER'S NOTES Steve McClintock CFO Feb 9, 2005

With the great benefit of hindsight we can see how easy it is to succumb to the lure of potential dollars in the irrational and hyperactive world of mergers and acquisitions.

Prior to Foster's bid for Southcorp, Southcorp's shares traded well below the offer price of \$4.17. If you can buy a company's shares in the market for \$1.00, why would you entrust your money to the CEO of another company who will pay \$1.30 for the same business?



This question is rarely asked by investors and even less likely to be directed to the CEO by the shareholders of a company making the bid.

Based on the full year 2004 figures the valuation might look like Figure 1 (above) - a screen shot from **StockVal**.

Measured by Normalised Return on Equity (ROE), which can be seen in the bottom row of the main table and in the chart at top right of Figure 1, business performance had been deteriorating from over 18% in 2000 to just 4% in 2004. With equity per share of \$1.73, an investor expecting 4% returns to continue and desiring a 14% return from their share market investments would not expect to pay more than \$0.51 per share.

A sharp recovery in profits announced by the company for the half year to 31 December 2004, produced a substantially improved valuation, but still nowhere near the \$4.17 offered by Fosters.

Based on the numbers released by Southcorp for the half year ended 31 December 2004, a back-of-the-envelope valuation would go something like this: The company had \$1.3 billion of equity on the balance sheet [\$300 million of which was accounting goodwill and about the same amount in accumulated losses!]. With 744.5 million shares on issue, equity per share was \$1.80, earning an estimated return of approximately 9.5%. If you still want a 14% return on your money, then the right price to pay was

around \$0.68 for every dollar of equity. That's \$912 million for the whole business or about \$1.22 per share.

Fosters, in their obvious enthusiasm at enhancing their "long-term global growth prospects", paid way too much for Southcorp. The result was that they did not "deliver significant benefits to shareholders of both companies". They did succeed, however in delivering benefits to departing Southcorp shareholders.

Valuing a business is not very complicated and so investing is not a game where the person with the highest IQ wins. If you have \$1 of equity that will produce a 10% return for every \$1 and you are content with a 10% return, then the only price to pay for that business is \$1 for every dollar of equity. If you need a higher return than 10% because a) you can get a higher return elsewhere or b) the risk is such that you should demand a higher return, then you should pay some discount to the \$1 of equity per share.

Takeovers, mergers and acquisitions provide fodder for the front pages of the business press. Global domination, egos and salaries play some part in many of these corporate actions.

Warren Buffett, in his 1993 letter to Berkshire Hathaway shareholders wryly observed, "In the past, I've observed that many acquisition-hungry managers were apparently mesmerised by their childhood reading of the story about the frog-kissing princess. Remembering her success, they pay dearly for the right to kiss corporate toads, expecting wondrous transfigurations. Initially, disappointing results only deepen their desire to round up new toads... Ultimately, even the most optimistic manager must face reality. Standing knee-deep in unresponsive toads, he then announces an enormous 'restructuring' charge."

Buffett's observation is as true today in the case of Foster's Group as it was fifteen years ago.



in the NEWS

## Valuations and Bear Markets

*Ladies and Gentlemen,*

(To be read fast and with the voice of the Harvey Norman television advertisements)...

*Bear Market! Bear Market! Bear Market Sale! Welcome to the Bear Market. We haven't had a sale like this for a decade and we are overstocked. All of our best brands and names are on sale and they must be sold. Out they go! Come and bag a bargain! Have a look at some of these specials...*

**Perpetual Trustees 50% off**

**ASX Limited 50% off**

**Cochlear 45% off**

**Cabcharge 45% off**

**NAB 40% off**

**Woolworths 33% off**

**Tabcorp 45% off**

**Blackmores 30% off**

**Aristocrat 67% off**

**Seek 45% off**

**AMP 40% off**

**Reece 30% off**

**Qantas 50% off**

**Babcock and Brown 82% off**

*We're slashing prices.... because... there's no hope! The world's coming to an end! There will never be another bull market again! The sky is falling! The sun will not rise tomorrow!*

You get the drift don't you? For many companies, this is a crash. It would be nice to blame someone or something for it but in reality, prices gyrate over time between extreme bouts of optimism and fear. Right now, it's fear that has gripped investors. Fear of inflation, fear of a recession, fear of an oil crisis, fear of a food shortage. You name it, investors are running scared.

Benjamin Graham observed that in the short run the market is a voting machine but in the long run it is a weighing machine. **StockVal** allows investors to weigh up the value of companies for the long term.

If you are an investor and have recently entered the market, you are probably thinking the worse. The reality is however at some point in the future (we cannot know when), this will all be a distant and admittedly bad memory.

We cannot tell you how bad it will get or how long it will last, but as prices begin to approach intrinsic



values just make sure you are being realistic when estimating future business performance. Companies can downgrade their earnings guidance in this environment and when that occurs, prices fall substantially.

As a value investor, you need to think beyond this year and next and ask yourself what is a reasonable return on equity for the next ten, fifteen and twenty years. Remember Ben Graham, Weighing Machines and The Long Term.

If you believe that a company will be around in five ten and twenty years, will have grown its earnings materially, will be the dominant player in its space, still have a high rate of return on equity and you can buy them at below intrinsic value, then you have all the elements you need to build a wonderful portfolio of business whose market value will also rise over time.

Here's a final thought from a StockVal member:

*I first started using StockVal about 18 months ago. The "rational me" accepted that StockVal could help prevent me from making investment blunders. However, I must confess that the "irrational me" was often diverted by hype, tips, and the meanderings of market commentators.*

*I fell in love with overvalued stocks and bought without reference to StockVal. I also bought risky stocks on a tip, or simply because the price was going up!*

*Each time I would convince myself - it would be okay, momentum would keep me safe.... until the fallout from the current financial crisis occurred.*

*I had to learn this the hard way, but what StockVal has done for me is anchor me to something worth knowing about... VALUE!! On 22 January when my heart was in my mouth and the market was plummeting, I kept reminding myself of something Brian McNiven once said... "market crashes are a cause for celebration". Using my StockVal watch list, I bought heavily and almost doubled the portfolio focusing on good companies. Within weeks I had recouped a substantial part of our losses and it made me realise what an invaluable tool StockVal is.*

Jan D, StockVal member since 2006

We couldn't have said it better ourselves.



### Conventional Wisdom and Interest Rates

Brian McNiven

*//Truth is the gem that is found at great depth; while on the surface of the world all things are weighed by the false scale of custom." Lord Byron 1788 – 1824.*

The renowned economist John Kenneth Galbraith attributed the tendency to cling to conventional thinking and customary practices to what he termed 'conventional wisdom'. He said; *"It's easy to see why the conventional wisdom resists so stoutly such change. It is far, far better and much safer to have a firm anchor in nonsense than to put out on the troubled seas of thought."*

Notwithstanding that a dollar of interest paid is a dollar of interest received; conventional wisdom suggests that the best way to fight inflation is to dampen demand by reducing disposable income and demand for credit by increasing interest rates. The theory sounds reasonable and is endorsed everyday by the media, so why bother giving it any further thought?

Before exploring the theory it should be recognised that because assets are more frequently acquired with the help of debt, increased interest rates undoubtedly curb or reduce asset prices.

Because the CPI is measured by reference to retail prices rather than supply costs, the added cost of higher interest rates is considered inconsequential in determining prices. The absurdity of this notion is the implication that the difference between cost and retail prices will be absorbed by suppliers and retailers through reduced profit margins. Suppliers must be able to recover costs, including the cost of capital, in order to supply. While margins might be temporarily determined by surges in demand, in the medium to long-term they are governed by competition, not government intervention.

In the relatively free global market system we now enjoy, domestic prices are governed not by domestic supply and demand, but world prices as determined by world supply and demand. In the absence of legislating against the right to export, our farmers and resource companies are entitled to sell their commodities at the best prices. Hence, what the Reserve Bank does in attempting to reduce domestic demand, will have nil or negligible effect on prices of consumables. If farmers can't get a good price here, they'll sell it to someone else.



Conventional wisdom suggests that a long-held economic theory should carry more weight than any other theory. Yet, why do we need theories when factual evidence abounds. We only have to look at the world's second largest economy, Japan, for evidence of the impact of interest rates on the CPI.

It is hardly a well kept secret that for the past two decades or more, Japan has had the world's lowest interest rates coupled with the lowest rate of inflation. With interest rates of less than 1%, the CPI fell to 0.9% in 2003, minus 0.3% in 2004, minus 0.1% in 2005, minus 0.3% in 2006 and plus 0.9% in 2007. The increase in 2007 was due to the increased price of imported oil. Japan's low and negative rates of inflation are logically due to lower interest rates as a component of cost.

The above should not be seen as an endorsement for low interest rates. I believe that low interest rates, while curbing inflation as measured by consumption, have not helped the Japanese economy, which has been in or close to recession for two decades – a factor, which coupled with declining stock prices since 1987 and continuing low ROEs, quite surprisingly has not deterred foreign investment in Japanese stocks.

While beneficial for consumer prices, low interest rates are a disincentive to save and therefore divert funds from savings to consumption. As Charlie Munger noted: "It's ludicrous when the health of a country's economy is measured by the level of foolish spending." Less consumption provides more money for semi-permanent assets and infrastructure that enhance our real standard of living. Yet for some strange reason we applaud the opposite. The real impact of less than desirable interest rates has not been CPI increases, but increases in asset prices and the consequences of their subsequent correction.

The real impact and damage to the economy occurs when interest rates change significantly over the short to medium-term. The feasibility of debt tends to be based on the expectation that current interest rates are permanent, so rate rises have a detrimental impact on asset values that lead to a chain of undesirable consequences.

The interest rate policy of the Reserve Bank should be to maintain prime mortgage rates of between 7.5% and 8.25% and only to intervene at times of dire economic circumstances. Like everything in life, economies run best on a reasonable degree of certainty.

While a consequence of much lower interest rate volatility in Australia than that of the US has been a much lower disruption of our economy, how much better would things have been with no volatility?



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- Powerful search and sort capability
- Exclusive StockVal Forum
- Fortnightly newsletter
- Portfolio Manager
- Unlimited watchlists
- Access to live, online webinars

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2 years membership	\$2395
Renewal type (following initial membership)	Investment
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2 years	\$1895





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**Where's the Value?** covers everything you need to know to become a more certain and more successful value investor. **You will learn how to:**

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- **Identify quality stocks** – invest in wonderful businesses with great economics
- **Reduce your risk** – avoid overpaying for shares

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DATE	CITY	
Thursday 28 August	<b>Bowral</b>	Bowral Golf Club
Tuesday 21 October	<b>Caloundra</b>	Caloundra RSL Services Club
Wednesday 22 October	<b>Tweed Heads</b>	Twin Towns Clubs and Resorts
Thursday 23 October	<b>Ballina</b>	Ballina Beach Resort
<b>DATE CHANGE</b> Monday 10 November (previously Thursday 21 August)	<b>Perth</b>	Somerst St Georges Terrace
Thursday 20 November	<b>Orange</b>	Orange Ex-Services' Club



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