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# ValueLine: Why I still don't like Wesfarmers

By Roger Montgomery

PORTFOLIO POINT: The profits don't justify the share price, which I calculate are trading at more than twice their intrinsic value.

Reading the headlines lauding Richard Goyder's "audacious" and now "successful" bid for Coles and the almost lyrical waxing of the turnaround, you'd be forgiven for thinking you should buy shares in Wesfarmers immediately. But rarely is impatience rewarded, so before you rush in consider the following.

The enthusiasm surrounding Wesfarmers' results last Thursday can only be justified if your sole focus is growth. Coles outpaced Woolworths' sales growth in the half-year to December for the first time since the early 1990s and volume growth of food and liquor has risen in each of the past five quarters to now exceed 7%. Kmart's turnaround has been impressive, with returns on invested capital more than doubling, and the liquor business – which includes Liquorland and Vintage Cellars – has delivered the targeted increase in market share and won share from arch-rival Dan Murphy.

But all is not as it seems, and in investing it is always best to be sceptical. Let's start with the liquor strategy.

The company's liquor strategy is to win market share by discounting and then improve margins later. Improving margins may involve raising prices, which could lead to a loss of market share. Improving margins can also mean cutting costs.

But keeping overheads low for a retailer should be like breathing is to you and me: automatic. Implementing a cost cutting "strategy" at a later date is akin to deferring breathing – not wise. And while Kmart's improvement in return on invested capital is impressive, one does wonder how arbitrary the allocation of the invested capital to Kmart is.

More importantly, buying shares in Wesfarmers, buys you a lot more than Coles, Liquorland and Kmart (or a lot less, depending on your perspective). One share of Wesfarmers buys you a (now much smaller) piece of a conglomerate that includes coal, insurance, chemicals and a hardware business.

When all businesses are included it's difficult to share the market's enthusiasm. Net profits rose from $871 million to $879 million – less than 1% – and on a per share basis the earnings actually fell 26% from 103.3¢ per share to just 76¢. This is because capital was raised to pay down debt.

Debt reduction via equity issues rarely produce desirable results for shareholders. On the one hand there's the fact that shareholders are investing capital in a business at a return equal to the interest rate on the debt. This dilutes overall returns on equity and presents shareholders with a very low return for their risk.

On the other hand, the number of shares on issue rises, and for Wesfarmers the number was significant because much of the raising was done at prices less than the equity per share. Using the same share price,

**The ValueLine portfolio, as at February 23, 2010**

| Company | Buy price | Price today | Est value | Margin of safety | Shares purchased | Invested | Capital value | Divs rec | Total return | Total return |
|---|---|---|---|---|---|---|---|---|---|---|
| JB Hi Fi | 14.8 | 20.05 | 25.76 | 22.2% | 845 | $12,500 | $16,934 | 0.62 | $4,958 | 39.66% |
| Cochlear | 56.36 | 64.12 | 56.3 | -13.9% | 102 | $5,744 | $6,535 | 1.97 | $992 | 17.26% |
| CSL | 31.81 | 34.75 | 32.87 | -5.7% | 163 | $5,197 | $5,678 | 0.4 | $546 | 10.50% |
| Woolworths | 26.16 | 25.77 | 26.85 | 4.0% | 206 | $5,377 | $5,297 | 0.56 | $35 | 0.65% |
| Reece | 17.8 | 26 | 14.83 | -75.3% | 236 | $4,209 | $6,149 | 0.33 | $2,017 | 47.92% |
| Platinum Asset Mgt | 4.06 | 5.52 | 3.95 | -39.7% | 854 | $3,467 | $4,714 | 0.12 | $1,349 | 38.92% |
| CommBank | 46.51 | 54.31 | 52.81 | -2.8% | 215 | $10,000 | $11,677 | 1.2 | $1,935 | 19.35% |

**Since July 1, 2009**

| | |
|---|---|
| Security Value | $56,983 |
| Cash Value | $57,268 |
| Total Value | $114,251 |
| Total Return ($) | $14,250.56 |
| Return Invested (%) | 29.54% |
| Total Return (%) | 14.25% |
| XAO Change | 18.30% |
| Outperformance (I) | 11.24% |
| Outperformance (T) | -4.05% |

**Negative Watch**

| Company | July 1 price | Price today | Est value | Margin of safety* | Divs rec | Total return |
|---|---|---|---|---|---|---|
| ISOFT | 0.635 | 0.565 | 0.19 | -197.4% | | 11.02% |
| Amcor | 4.79 | 6.01 | 3.63 | -65.6% | | -25.47% |

buying $10,000 of Wesfarmers' half-year earnings in 2009 would have cost you about $293,000, for 9680 shares. In 2010, the same share of earnings now costs almost $400,000, for just over 13,100 shares.

Dilution aside, growth is always a component of my calculation of intrinsic value. Sometimes it's a variable that has an enormous impact and sometimes it has none. More surprisingly, perhaps, is the fact that growth can be both a positive and a negative contributor to the estimate of intrinsic value.

When return on equity is low, growth hurts the investor because profits have to be retained to fund the growth. These profits, however, are being employed at low rates of return that represent an opportunity cost and fail to reflect the risk associated with the investment.

Using the company's own data, combining Coles, Officeworks, Target and Kmart's $1.6 billion EBIT and comparing it to the capital invested of $20.4 billion, produces a return of 7.7%, about the same as a five-year term deposit. And while I know the reasons for using EBIT, in reality someone has to pay the interest and the tax and so an owner's return should look at NPAT. Taking the enthusiastic analysts' optimistic forecasts for earnings, Wesfarmers returns on equity are forecast to improve from a rather miserly 6.5% this year to just under 9.5% in 2012.

As a result, Wesfarmers' per share intrinsic value is nowhere near the current price. This year intrinsic value is about $12 per share, rising to about $16.50 next year. With the shares trading today at $30, you may be wondering how the market could be so wrong? Or more likely, how could Roger be so wrong?

When Telstra traded at $9 and my valuation came out at less than $3, or when investors bought Myer at $4.10 and my valuation was under $3, I thought the same thing. In the short term the market is a voting machine – a popularity contest – and for time immemorial it votes with growth. Think ABC Learning, Babcock and Brown, Allco.

Wesfarmers should not be compared to these examples; over the long term it is a weighing machine and price follows valuations. Intrinsic value is based on profitability – how many dollars are required to be invested to get that dollar of profit out – rather than profits alone and Wesfarmers' profitability simply doesn't justify today's price. ◆

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