ROGER MONTGOMERY

Value errors are key to market

PREDICTING share prices in the short term is almost impossible. They pitch and roll in reaction to all manner of influences, many of which have no real impact on the value of a business.

Even monitoring share prices over the short term can cause shareholders to lose both their appetite and hair.

In the long run, however, prices are more predictable. They follow intrinsic value, and over the years I have developed a formula to calculate this, which many ultimately achieve.

As an investor your job is to buy shares of extraordinary companies at prices lower than their appraised intrinsic value and whose intrinsic values are estimated to rise at a good clip.

Suppose I have a hypothetical bank account in the name of Roger's Valuations, in which $10 million has been deposited. This account earns an after-tax return of 20 per cent a year, fixed for 30 years. The interest cannot be reinvested. At current interest rates on bank accounts of 5 per cent (pre-tax), my $10m account looks very desirable. I suspect quite a few people would be willing to buy it.

Now suppose I offer the account for sale and I decide I am going to auction it.

What should you pay for it? Without any arithmetic, you know it is worth more than the $10m sitting in the account. If the money in the account represents my equity, or book value, the intrinsic value of this account is higher than that.

The world's greatest investor, Warren Buffett, said it took him a while to work that out, but his purchase of See's Candy at three times book value proves he did (Buffett is said to have made more than 2000 per cent on that investment).

How much more than the equity is the true value of the bank account? An auction would would be one way to discover what people are prepared to pay, but people can get carried away in an auction environment. If I marketed it really well I might be able to generate some excitement and extract a really dumb price from someone. But that price may not necessarily reflect what the account is worth, either.

So what would be a dumb price? As I mentioned, some banks are offering interest rates of about 5 per cent and they offer the benefit of reinvestment, thus compounding.

I would argue that someone would be paying a dumb price for the Roger's Valuations account if the interest from it amounted to less than 5 per cent.

> An auction would reveal what people are prepared to pay, but they can get carried away

That's not to say it wouldn't or couldn't happen, just that it would be irrational.

To calculate this dumb price, we simply divide the after-tax return being paid by the bank account (20 per cent) by the return the investor would be content with — the dumb return (5 per cent) adjusted for tax, say, about 3.5 per cent after tax.

We then multiply this amount by the equity, or the balance of the bank account. In the above example, this would look something like: 20 per cent of 3.5 per cent by $10m equals $57.1m.

If someone paid $57.1m for this bank account, that would be a very high and very dumb price, because the return they would receive would be a low, non-cumulative 3.5 per cent after tax.

You can check it: a $10m account at 20 per cent earns $2m. Earning $2m on the $57.1m paid for the account is equivalent to a 3.5 per cent return.

As an aside, because the 20 per cent in the formula represents the return on equity, which in turn equals profit divided by equity, the two equity items in the formula cancel out and you are left with: $2m at 3.5 per cent equals $57.1m

Using the same formula from which the dumb price is derived, we can also use it to arrive at the bargain (low) price.

If you were to pay $10m — the amount of equity actually in the bank account — that would be a bargain because you would end up receiving a 20 per cent annual return after tax (let's leave inflation out of the discussion).

Applying the formula produces: 20 per cent of 20 per cent by $10m equals $10m.

Therefore, paying anything lower than $10m would be an even greater bargain.

It occurs to me that you might be thinking you could never buy this Roger's Valuations account at auction for $10m, so forget about buying it for less.

In a rational trade sale environment, you would be correct. With the vendor and purchaser in a locked room with only their lawyers and accountants attending, it is less likely that a real bargain could be obtained. But thanks to the continuous auction environment of the stockmarket, with its enormous liquidity and everyone focused on what the price will do next, irrational reactions to events unrelated to the bank account's earning power frequently push prices to both dumb and bargain levels.

Our job now is simply to wait for the market to do something dumb. Thanks to our estimate of a company's intrinsic value, it is easy to see when that is occurring and to take advantage of it. What a relief to be able to see the ebb and flow of ever-changing sentiment for what it is. Soon you will be an investor and you can turn your back on spectating forever.

Roger Montgomery is the founder of Montgomery Investment Management and author of Value.able: How to Value the Best Stocks and Buy Them for Less Than They're Worth, available at www.rogermontgomery.com

When times are tough, turn to luxury

Europe may be teetering, but its high-end brands are thriving

JAMES FROST

EVER been tempted to invest in Louis Vuitton, Rolls-Royce and Dom Perignon?

Some experts are saying now is the time to add quality European companies after financial markets shrugged off some of the worst news since the crisis peaked in December last year.

Despite the flow of bad news — the disintegration of the Dutch parliament, confirmation of a double-dip recession in Britain and the prospect of a socialist ruling party in France — the message is that selective exposure could offer the prospect of outperformance that might be difficult to find in range-bound markets.

The main reason for pockets of renewed optimism are forecasts that one of the region's underlying problems, the depleted balance sheets of European banks, could soon be solved.

RBS Morgans Michael Knox said the European banking crisis could be dealt with before the end of the financial year.

"Over the next two months banks under the supervision of the European Banking Authority will complete a recapitalisation by raising the remaining balance of €115 billion," he said.

"This capital is intended to allow an orderly deleveraging of euro area banks with no reduction in bank lending. When this process is completed, the European banking crisis will have come to an end."

Readers buoyed by this assessment may want to consider investment bank CitiGroup's list of European World Champions, which contains the owners of the aforementioned luxury brands: LVMH, Rolls-Royce and Pernod Ricard.

Buying luxury brands such as these may appear counter-intuitive; however, the market for super-premium goods has proved remarkably resilient.

LVMH, for instance, revealed 25 per cent growth in revenue to €6.58bn when first-quarter earnings were released last week.

Citi's list of champion stocks has been selected on the basis of their strong balance sheets, exposure to emerging markets and brand equity.

During the past five years it has outperformed Europe's benchmark Stoxx 35 index by more than 155 per cent.

The 69 strong list of contenders includes sports brand Adidas, cosmetics group L'Oreal, luxury watch manufacturer Swatch, owner of the Zara stores Inditex, premium spirits company Diageo and the performance carmakers BMW and Daimler Benz, among many more.

For investors who prefer more defensive investments, RBS Morgan's private wealth adviser Ben Silluzio suggested there was a lot to like about German enterprise software company SAP.

"SAP is growing revenues at a double-digit rate and between 60 and 70 per cent of its revenue comes from licensing and service contracts. It's one of those companies with almost annuity-like cashflows," he said.

"SAP also has good growth options in its Cloud product. In uncertain times companies want to manage their business more efficiently and create growth opportunities, SAP is the market leader in this field."

The drive for efficiency and growth is also the key challenge facing EU governments.

Having pledged to amend their profligate ways, there is a growing scepticism that the many EU nations that promised to reduce spending and rein in budget deficits will be able to make good.

The strong showing of France's Socialist Party candidate Francois Hollande at the polls last week is a case in point. Running against incumbent French President Nicolas Sarkozy, Hollande is critical of the austerity-at-all costs mantra.

A note from analysts at Bank of America-Merrill Lynch spelled out the changes Hollande intends to make in the first 100 days, which include immediate reversals on pensions that will push forecasts of a French surplus out until 2017 at the very least. If France breaks away from the fiscal pact made in Brussels last year, others will surely follow. Farther south, the Spanish government recently unveiled its toughest budget in 50 years. Bond traders, sceptical of the Spanish government's aim to cut the deficit from 8.5 per cent to 5.3 per cent, pushed the yield on the 10-year note just shy of 6 per cent, a level considered unsustainable across the long term. This could make it very difficult, and perhaps impossible, for Spain to continue funding itself in the markets, according to *The Economist* Intelligence Unit.

"Spain's economy is five times the size of Greece's, and the eurozone's firewall is not sufficiently large to deal with a Spanish bailout.

"If one were to become necessary, it would require much more funding from Germany and France, pushing the euro crisis into a new and much more dangerous stage."

Spain is considered not only too big to fail but too big to bail. Standard & Poor's move to cut its sovereign debt rating two notches to BBB+ has only intensified concerns.

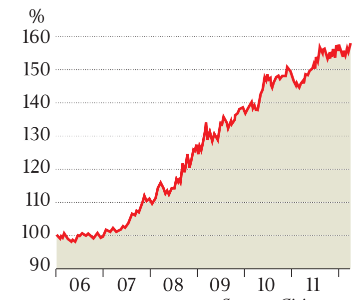
Any move from the European Central Bank to intervene on Spain's behalf would send investors of all types rushing for the exits, relegating any discussion of the merits of cyclical versus defensive investments to sideshow status.

With so many moving parts for investors to keep track of, it might pay to watch this space.

AFP

Shoes by Vuitton: Super-premium goods are remarkably resilient, and their quality European companies worthy of investment.

Citigroup's European World Champions stocks vs Europe's benchmark Stoxx 35 Index



Source: Citigroup

> 'When the recapitalisation process is completed, the European banking crisis will have come to an end'

MICHEAL KNOX
RBS MORGAN

Leighton shows risks of going for growth

RICHARD HEMMING

WHEN it comes to the destruction of shareholder value, it's hard to go past the $8 billion that has been wiped off the value of Leighton Holdings in the past two years.

This construction company was so desperate for growth it kept ratcheting up its work in hand until it was well over $15bn. Back in the 1990s its biggest projects were worth $200 million, but fast forward five years and in the mid-2000s it had three projects that were worth over $3bn each.

In its scramble to fill its order book, Leighton's management failed to grasp the complexity of these projects during tendering, and they underbid as a result.

Following a series of disastrous cost blowouts, Leighton was fined $242,000 by the Australian Securities & Investments Commission, which took the view that the company had been tardy in revealing financial problems it had with major contracts.

But as bad as this was for shareholders, the reality is that it is quite common for contracting companies to experience cost blowouts.

Many of the contractors that the Under the Radar Report has covered are, in fact, turning their operations around after such blowouts. Matching demand and supply for any company is difficult, but it's especially difficult for companies that have big fixed costs such as plant and equipment. And the heavy competition means contracting can sometimes be a low-margin business. The room for error is substantial.

But blowouts also mean opportunities. Some that we have tipped, including Neptune Marine Services and Southern Cross Engineering, have had a particularly tough time. But just six months later these two stocks are up 15 per cent and 89 per cent respectively.

It's important for contractors to have a lot of cash to be able to withstand fallout from a dud contract. There is also value to be had when you can buy at low multiples (PE of less than eight times), essentially benefiting from their past mistakes. These companies are also prospecting for funds. Their big clients often include the likes of BHP Billiton and Rio Tinto, which are among the richest companies in the world, and among the few that are spending.

> The reality is that it is quite common for contracting companies to experience cost blowouts

Trouble for contractors generally occurs when they go outside their comfort zone in the chase for cash. The companies we like all have very strong niches, such as Global Construction Services in scaffolding in Western Australia; and Swick Mining, in underground drilling for goldminers.

r.hemming@undertheradarreport.com.au

Richard Hemming is an independent analyst who edits a fortnightly newsletter, www.undertheradar report.com.au