Solid for the long term

Roger Montgomery finds a company that ticks just about every box

IMAGINE OWNING A BUSINESS THAT you kicked off with no debt and $1.5 million of your own money in 2002. In that first year, also imagine you earned $400,000. How would you feel if, without borrowing at all and without tipping in any fresh capital, those profits grew by 16%pa to $1.5 million today? In total you would have earned $8.5 million in profits after tax over the past 10 years, from your $1.5 million investment.

Sound good? I thought you might like it. Well, it's not an imaginary company at all. These attractive numbers are being produced by a little listed company called Embelton that is in the business of producing hardwood flooring for the building industry and distributing that timber through a national network of independent retailers. Commencing business in 1925, the company is now run by the founder's grandson.

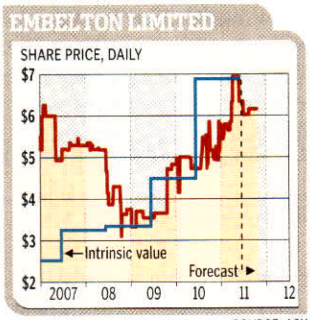
This business may never be huge if left to grow organically, as it has thus far. It earns $1.5 million but it was founded 87 years ago. As I have noted previously, short-term traders and CFD (contract for difference) "addicts" need not apply – they wouldn't be interested in a little company like this. Long-term investors who are patient and value oriented, however, would be very excited.

A pearl of wisdom the Dean of Wall Street, Ben Graham, left was paraphrased by Warren Buffett thus: "In the short run the market is a voting machine – reflecting a voter-registration test that requires only money, not intelligence or emotional stability – but in the long run, the market is a weighing machine."

In the long run, the price of a company's shares will follow the company's intrinsic value. If the value of that business is rising – even though in the short run the price may rise and fall on the back of what is frightening or popular – in the long run the price will follow that rising value.

At the opposite end of the building spectrum in terms of size is Leightons. It has also tripled its profits in the past decade, but it only achieved that growth by quintupling the amount of equity it asked

VALUE STOCK TO WATCH
Embelton (EMB)



SOURCE: ASX

the owners to contribute and increased the amount of borrowings by 28 times! Embelton has tripled profits with no increase in debt and not a single additional share being issued. I'll take a thousand Embeltons before I take one Leightons.

Because Embelton has not issued any new shares, the company's profit, as measured by earnings per share, has grown from 18¢ 10 years ago to 70¢ last year. Dividends in 2002 were 9¢ and reached 33¢ last year.

The company has $3.3 million cash in the bank and not a red cent of borrowings for a decade and arguably longer (there were borrowings of $65,000 in 1997).

The shares trade on a multiple of 6.5 times earnings and 1.2 times book value. With profits growing at about 16%pa, no additional equity contributed and about half the profits retained each year, "book value" has grown at about 7%pa and return on equity has risen every year.

The business now achieves a return on its equity of 15%. Skaffold.com rates the company an "A2", the second-best quality score possible. It's held an A2 or A3 rating every year, bar one, for 10 years. In 2002, Skaffold's estimated intrinsic value for the company was $1.22 and this has risen by 20.5%pa to $6.88 in 2011. Not many companies have been able to do that.

Find companies whose intrinsic values are rising and you will find much more easily companies whose share prices should rise in the long term. Unsurprisingly, this has been the case with Embelton. Ten years ago, Embelton's shares were trading at $1.48. Now they are at $7. Shares are tightly held – the founders and related parties own two-thirds of the company. Investors wanting to buy should watch for when the price again falls below the company's intrinsic value.

For all the positives there is a handful of negatives. The first is that it is listed. Listing fees would amount to about $20,000 a year – an expense Embelton arguably doesn't need. It is also in a business that can be affected by weather, consumer sentiment, building approvals and competition from cheaper overseas imports. And investors with the wrong temperament would find lack of liquidity infuriating.

Despite these pressures, a loyal distribution network of retailers has helped to ensure consistent growth in operating cash flow for the past eight years.

This column is all about finding extraordinary businesses, with bright prospects for intrinsic value growth, trading at a discount to their current intrinsic value. I reckon we just found one.

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