The numbers game

Roger Montgomery demonstrates how to assess the value of a business

IN THE SHORT RUN, SHARE PRICES move up and down for all sorts of silly reasons. People need to renovate their bathroom so they sell their shares or a news story saying Greece might exit the euro causes them to panic. Whatever the reason, share prices can be moved around in the short-term for reasons that have nothing to do with the underlying business or its prospects.

But, in the long run, prices always seem to follow business performance and, if that is mediocre, then no matter how popular the shares are today they will drop back to their long-term value. Understanding this behaviour is the first step in determining if you are getting a bargain or merely following the herd off a cliff.

The second essential ingredient is being able to estimate a business's true value. Once you have that, it's relatively easy to see whether a share has run up too far or whether it is still good value.

Let's take the recent run-up in the price of Telstra shares as an example. Many commentators are lauding management, but long-term memory loss is common in financial markets. Back in 1999, more than 800,000 people became first-time shareholders of Telstra in the T2 float. The price was 60% higher than it is today.

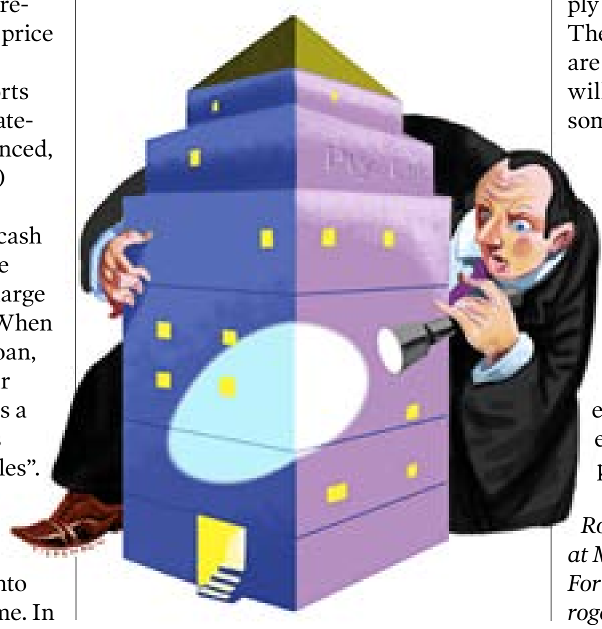
And while many investors and reports have focused on the profit-and-loss statement and the growth in profits announced, we note that cash flow (the real profit) declined 17%.

One of the reasons that profits and cash flow are not equal over the years is the fact that the balance sheet has a very large intangible item recorded as an asset. When you or I go to the bank to apply for a loan, we would show our assets as being our property, cash in the bank and perhaps a car and a few personal items. Telstra's assets include $7.4 billion of "intangibles". A large proportion these intangibles include software development expenses. That's right – money that was spent over the years but not put into the profit-and-loss statement at the time. In other words, roughly two year's worth of profits are an actual expense still sitting on the balance sheet as an "asset" waiting to be expensed. It means previously reported profits have been artificially boosted.

In the first six months of this financial year, Telstra generated $3.3 billion in cash from operations. The problem with this huge number is that Telstra chooses to exclude interest payments from this figure and reports interest expenses elsewhere. If we take away net interest expenses of $431 million from the reported operations cash flow, we end up with $2.8 billion operating cash flow, not $3.3 billion.

Telstra also has about $60 billion worth of assets (at cost) that need to be maintained, so we have to remove the $2 billion the company spent in the half-year on capital expenditure and investing, leaving cash flow of about $800 million.

When it's all done and dusted, we reckon free cash flow is about $900 million. So what, you may ask? Well, it's from these funds that dividends can be paid and the dividends are the reason why the shares are so popular. But here's the thing: while our estimate of the real "take-to-the-grocery-store" cash flow is about $900 million, the dividend of 14¢ a share when paid to every shareholder amounts to $1.7 billion.



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The $800 million gap is not really a big issue and dividends will continue because Telstra is about to receive regular payments from the government that will eventually total more than $20 billion as it decommissions its copper network and shifts its customers to the NBN. The point is that, while the piece of paper called a Telstra share may be attractive from a dividend perspective, the business is less so.

More importantly, what are the shares worth? Assuming you were buying the equity of the business, what is a reasonable price to pay for it? Well, the equity (of which there is estimated to be about 94¢ a share at June 30, 2013) produces a return of about 31%pa. All that return is being paid out to shareholders in the form of dividends. If we were to say the company is stable, as were the profits and dividends, we might use a required return (the return that we would accept for the risk) of, say, 8%.

To estimate the value of Telstra's shares we simply divide the return on equity of 31% by the required return of 8% and multiply the result by the equity per share of 94¢. The result is .31/.08 x $0.94 = $3.64. If we are happy with a 7% return, we might be willing to pay $4.16. The estimated value is somewhere between $3.64 and $4.16 today.

At Montgomery we look for opportunities that are cheap when we use a required return of 10% or even 12%. Telstra wouldn't meet that criteria and, now that we have an estimate of value, we can see the share price – it has been above $4.40 since the start of the year – for what it appears to be: the result of irrational short-term exuberance towards its dividend in an environment of low interest rates and poor returns from term deposits.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*