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Value Line: Music to my ears

By Roger Montgomery

PORTFOLIO POINT: JB Hi-Fi and Cochlear post strong results, which leads to their intrinsic value being lifted further.

A quality portfolio of stocks doesn't always outperform the averages. Some lemmings actually survive the jump off the cliff and enjoy themselves. Buying only quality stocks, however, avoids the edge altogether and occasionally you miss out on the fun. But this hasn't been the case since the establishment of the Value Line portfolio.

The average, the return of the eight stocks selected has been 13.45% compared to the All Ordinaries return of 11%. But the Value Line portfolio hasn't invested in all eight candidates equally. At the time it was established, only one stock was at a significant discount to intrinsic value and that was JB Hi-Fi, which has since risen by 18%.

After analysing its recent results I have determined that its intrinsic value has risen by 22% and, based on forecasts for 2011, it will rise further in the future.

My estimate of its intrinsic value has risen from $17.80 to $21.70. Analysts looking at price/earnings multiples (P/Es) will tell you it's a little expensive. They said the same thing at $14.80. But remember this: estimating a company's value is not the same as predicting its share price. I have no idea what the shares are going to do. I simply follow a strategy that buys great businesses when they are cheap.

Another company that announced its results recently, causing me to update my valuation, was Cochlear. To cut to the chase, I have also increased my estimate of its intrinsic value by 21%, from $48.70 to $58.70.

Unfortunately, the price still remains slightly above intrinsic value so we won't be adding to the portfolio just yet. And in parallel with JB Hi-Fi, analysts are also pointing to Cochlear's high P/E as a reason for caution.

Cochlear announced that its core earnings rose by 12% to $137.9 million for 2009. This was in line with the market update it gave on July 14 this year. The final dividend increased 19% and was fully franked at 95¢ per share. Total dividends for 2008-09 were 175¢ per share.

Cash flow from operating activities was equally impressive, rising by 73% to $147 million. Free cash flow rose by 61% to $111 million. The strong cash flow was partly

Value Line portfolio, as at August 18, 2009

Company	ASX	July 1 price	Price today	Est value	Margin of safety	Shares purchased	Invested capital ($)	Capital value ($)	Divs rec	Total return	Total return
JB Hi Fi	JBH	14.8	17.51	21.7	19.3%	845	$12,500	$14,789	0	$2,289	18.31%
Cochlear	COH	56.36	61.15	58.7	-4.2%	102	$5,744	$6,232	0	$488	8.50%
The Reject Shop	TRS	11.62	13.62	11.45	-19.0%	513	$5,959	$6,984	0	$1,026	17.21%
Woolworths	WOW	26.16	27.24	22.86	-19.2%	206	$5,377	$5,599	0	$222	4.13%
Westpac	WBC	19.68	23.74	18.13	-30.9%	295	$5,811	$7,010	0	$1,199	20.63%
CSL	CSL	31.81	33.56	25.18	-33.3%	163	$5,197	$5,483	0	$286	5.50%
Reece	REH	17.8	20.35	12.81	-58.9%	236	$4,209	$4,812	0	$603	14.33%
Platinum Asset Mgt	PTM	4.06	4.83	2.18	-121.6%	854	$3,467	$4,124	0	$658	18.97%
Since July 1										Avg	13.45%
Security Value											$55,034
Cash Value											$51,736
Total Value											$106,770
Total Return ($)											$6,769.87
Return Invested (%)											14.03%
Total Return (%)											6.77%
XAO Change											11.00%
* Outperformance (I): Outperformance of Invested Portion											3.03%
* Outperformance (T): Outperformance of total portfolio											-4.23%
Under observation											
ISOFT	ISF	0.635	0.905	0.038	-2281.6%						-42.52%
Amcor	AMC	4.79	5.65	2.66	-112.4%						-17.95%

the result of better working capital management (better debt collection and inventory turnover) and allowed borrowings to be reduced by $25 million. Net debt now stands at $109 million and net gearing at 23%, which is down from 29% last year.

Interestingly, $17 million – a not insignificant sum in cash – was spent on the "acquisition of intangible assets". Hopefully it was for IP that will be commercialised in the not too distant future.

With the exception of a drop in 2004, reported profits have increased every year in the past decade – growing by a compounded 23% per annum – and are forecast to rise meaningfully in the next two years.

Fully franked dividends have risen every year for the past decade, growing by almost 500% (or 22% pa) since 2000. These are not numbers to be sneezed at, the company has produced an impressive and stable return on equity since 2004 of about 47% with very modest debt. Clearly this is a company worth some significant premium to its equity.

The dynamics of this industry are not too difficult to understand. A handful of manufacturers (William Demant and Med-El in Europe and Advanced Bionics in the US) spend a small fortune in absolute and relative terms on R&D to produce a near-miraculous technology that assists individuals with severe and profound hearing loss to hear. Those manufacturers with the latest, most advanced implant receive the accolades and the sales (demand builds as recipients defer buying implants toward the end of a product's life cycle), until one of the other competitors leapfrogs them again.

According to the World Health Organization, almost 280 million people suffer from moderate to profound hearing loss and an ageing population means this figure will rise. Cochlear has manufactured and marketed almost 140,000 cochlear implants and 50,000 bone-anchored (Baha) hearing implants. More than half of those devices have been implanted in the past six years. But while the prospects appear to be bright for participants in the industry, growth is limited by the high cost of the devices and therefore the reliance on insurance and healthcare schemes to subsidise the cost of the device and the procedure to implant it.

A complex web of pre-qualifications, restrictions and caps greets potential cochlear patients and differ according to their age, whether they have public or private health cover – and even which Australian state they live in.

In 2009, unit sales growth managed just 2%, to 18,553 units. Many are blaming slow China sales but this is hair-splitting as even stronger sales in China won't help unit volume growth reach the 24% achieved in 2007 and 14% in 2008.

The slowdown in sales is more likely to be the result of the market share dynamics alluded to earlier and to that end the company is rolling out new products, including the Cochlear Nucleus 5 system (yet to receive approval from the US Food and Drug Administration) and the already released Cochlear Baha BP100. Sales should also benefit from an end to the de-stocking that is claimed to have occurred across clinics globally.

Despite (or perhaps because of) a strong market share and cash flow, high return on equity and low debt, Cochlear is not a bargain at current levels relative to even my updated valuation, but it is not extremely expensive either. Its bright prospects and strong fundamentals will keep it in my sights. ◆

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