



# Screening for Value (1): Philosophy

*“It is the mark of an educated man to rest satisfied with the degree of precision that the nature of the subject admits, and not seek exactness where only an approximation is possible.”*

Aristotle

January, 2015

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## Overview

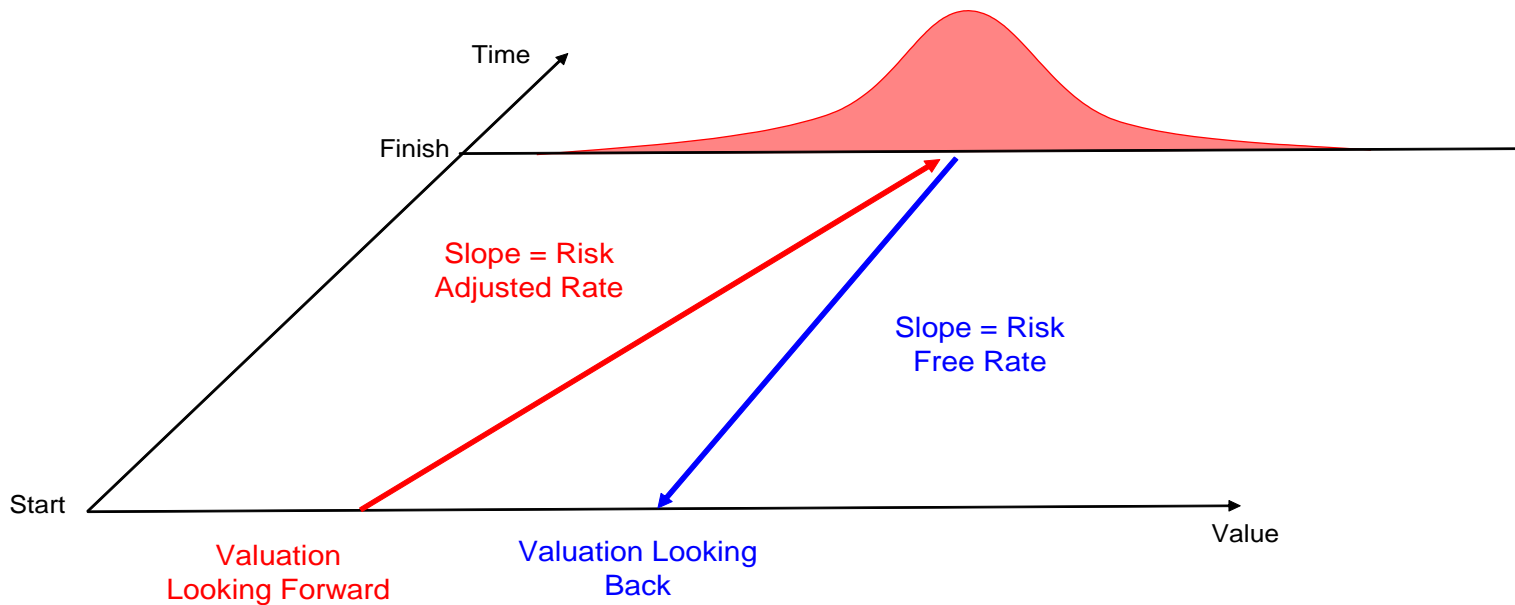
This presentation provides an overview of our valuation screening process:

- The Nature and Concept of Valuation
- Screening for Valuation
  - Distinguishing between Current & Potential Value
  - Overview of The Pup Valuation screen
  - The Pup Valuation Screen in context



## The Nature and Concept of Valuation

- The valuation process is probabilistic.
- Valuation attempts to define fair value of this probability distribution.





## The Nature and Concept of Valuation

- However, the parameters of our probability distribution are highly uncertain.
- Value is therefore not a point solution but a **concept**.
- Even the “founder” of value investing recognised this.
  - *“The essential point is that security analysis does not seek to determine exactly what is the intrinsic value of a given security. It needs only to establish either that the value is adequate – e.g. to protect a bond or to justify a stock purchase – or else that the value is considerably higher or considerable lower than the market price. For such purposes an indefinite and approximate measure of the intrinsic value may be sufficient”*
  - *“Security Analysis cannot presume to lay down general rules as to the “proper value” of any given stock. Practically speaking, there is no such thing. The bases of value are too shifting to admit of any formulation that could claim to be even reasonably accurate.”*

- Ben Graham



## The Nature and Concept of Valuation

- This uncertainty varies by stock:
  - *“Our notion of the intrinsic value may be more or less distinct, depending on the particular case. The degree of indistinctness may be expressed by a very hypothetical “range of approximate value” which would grow wider as the uncertainty of the picture increased e.g. \$20 - to \$40 for Wright Aeronautical in 1922 as against \$30 to \$130 for Case in 1933. It would follow that even a very indefinite idea of the intrinsic value may still justify a conclusion if the current price falls far outside either the maximum or minimum appraisal.”*
    - Ben Graham
- Therefore the statistical significance of each valuation varies depending upon:
  - The difference between the share price and the “valuation”.
  - The variance & skewness of our probability distribution (i.e. the nature of the stock).
  - The bias in our estimates



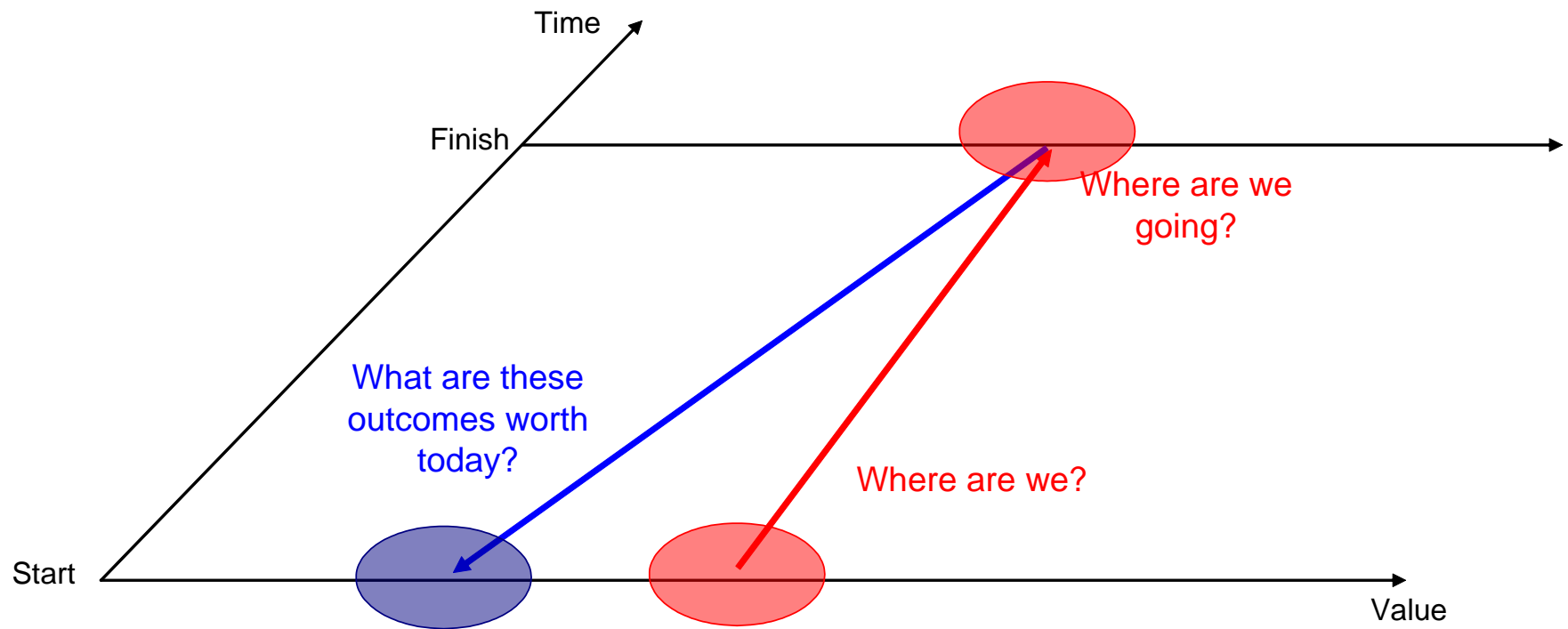
## The Nature and Concept of Valuation

- In addition, value is not static – it is constantly moving driven by:
  - Passage of time
  - Changes in opportunity cost (“risk free rate”).
  - Changes in risk (actual and preferences).
  - Changes in operational outcomes which impact the probability distribution.
- Should a valuation:
  - Also move with these factors? If so which ones?
  - Or attempt to estimate a long term/equilibrium value for these factors?
- The share price constantly adjusts to these factors but a valuation does not
  - ie. Valuation and Momentum are part of a continuum.



## The Nature and Concept of Valuation

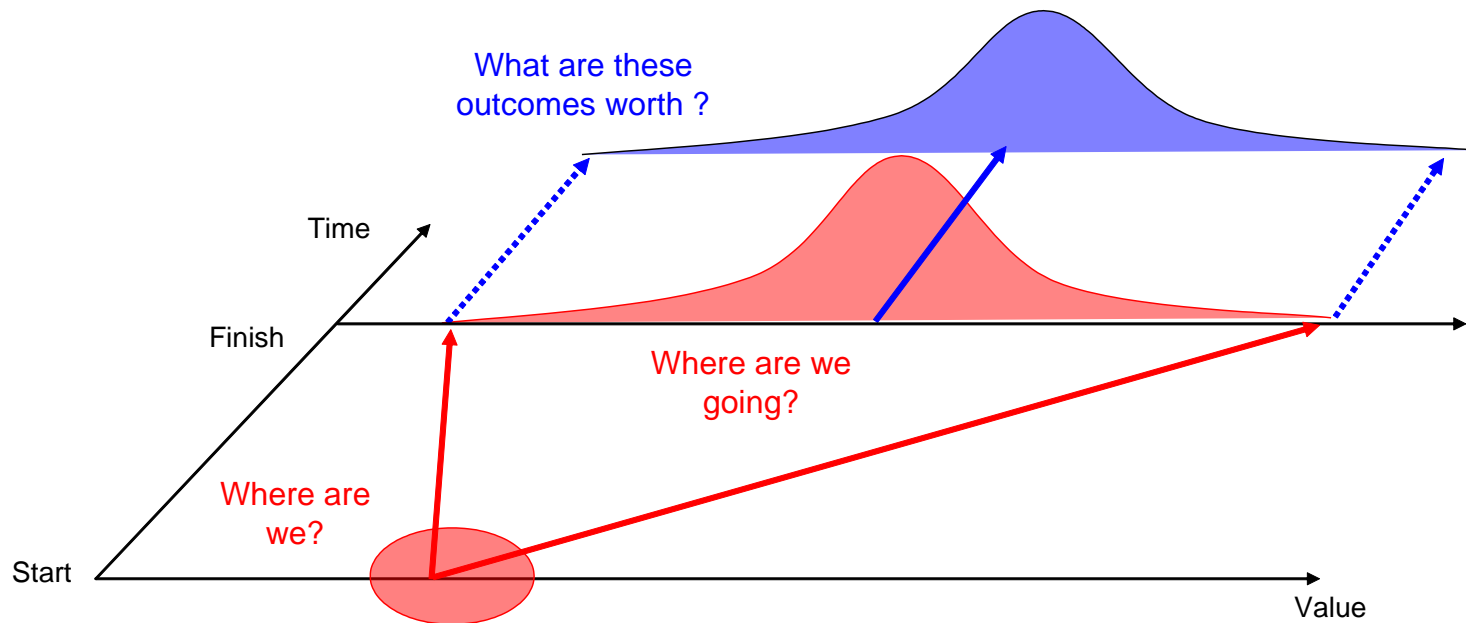
- As a result, should we be trying to work out what future outcomes are worth today?





## The Nature and Concept of Valuation

- ... or should we be focused on what possible outcomes might be worth tomorrow?







## Screening for Valuation

- To reflect the probabilistic nature of valuation, our screening approach attempts to do three things:
  - **Current vs Potential Valuation:** Distinguish between companies where valuation is mostly a function of current operations and those where there is significant future optionality;
  - **Conceptual vs Precision:** Focus on broad concepts of valuation (ie. Very good, good etc) rather than specific point values;
  - **Contextual vs Absolute:** Recognise that because valuation is uncertain, it needs to be understood as an element of the investment process, not as the solution to the investment decision.

*“It is better to be roughly right, rather than precisely wrong.”*

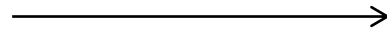
Warren Buffett



## Current vs Potential Valuation

- One of the factors that creates uncertainty in the valuation process is the ability of companies to create value via growth:
  - *i.e. the ability to deploy capital at rates of return above the cost of capital*
- In theory, this process works via the mathematics of the DDM:

$$\begin{aligned} V &= \frac{D_1}{PVF_1} + \frac{D_2}{PVF_2} + \dots + \frac{D_n}{PVF_n} \\ &= \frac{D_1}{K_e - g_d} \\ &= \frac{D_1}{K_e - bR} \end{aligned}$$

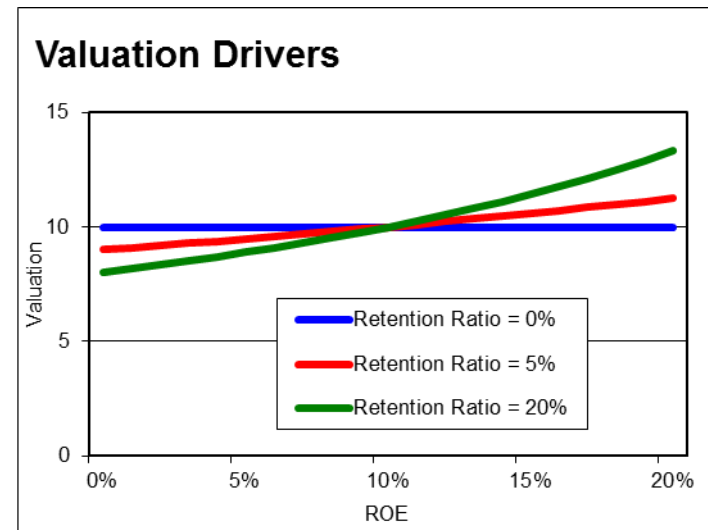


$g_d$  = constant growth rate in dividends

$K_e$  = cost of equity

$b$  = retention rate of earnings

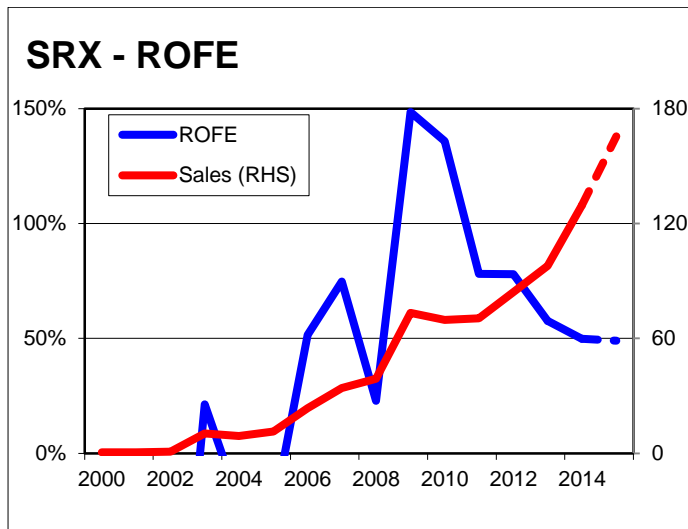
$R$  = Return on Equity



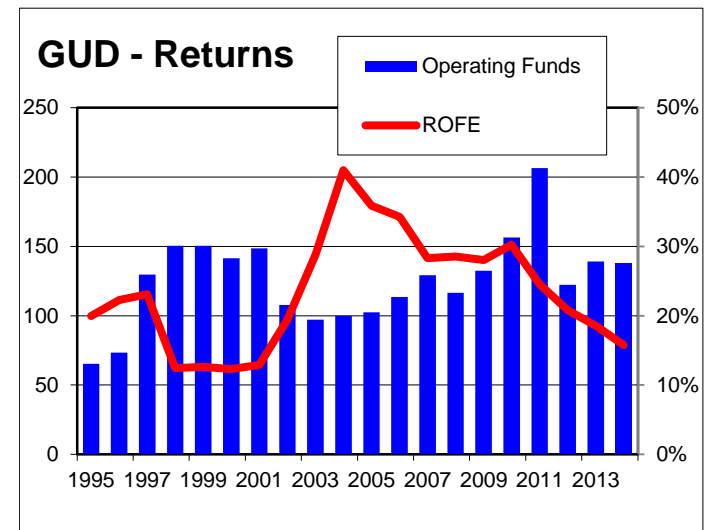


## Current vs Potential Valuation

- In practice, quantification of this process is difficult given uncertain inputs.
- However, even if quantification is difficult, it is usually possible to distinguish between the nature of companies:



- Optionality to create value via growth at high returns.



- Value primarily due to fluctuating returns on existing assets.



## Current vs Potential Valuation

- Where companies exhibit optionality, this can create feedback effects:
  - High valuations improve EPS accretion of acquisitions
  - Network effects of businesses
  - Multiple re-rating as earnings and market cap growth
- Attempting to quantify a current fair value of these effects is extremely difficult. Rather than aiming for false certainty...
- ... we aim to understand the nature and potential of these effects, whilst observing performance milestones (momentum).
- In contrast, for cyclical companies without such optionality, valuation is less uncertain and often a more important signal.



## Current vs Potential Valuation

- In our screening model, we reflect this ability by distinguishing between:
  - **Current Value:** Valuation of current assets and operations of the business, assessed based on sustainable margins/returns at nominal growth rates.
    - i.e. we allow for returns to normalise (up or down), but don't take account of growth options (i.e. ability to deploy capital/grow sales).
  - **Potential Value:** Ability of company to create value either through reinvestment of capital or de-risking of future growth options.
    - i.e. What the value of the company might be if they can successfully deploy capital, or deliver sales growth.
- For investors, **Fair Value** is most likely to be a price that sits between current and potential value – i.e. includes some probability weighted inclusion of future growth options.

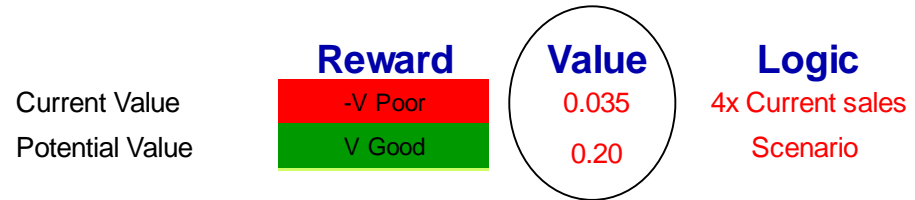


# Current vs Future Valuation

- This process is not perfect, but some examples:

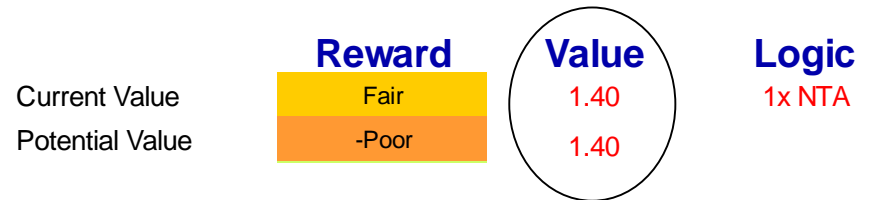
## Adslot (ADJ: \$0.10)

- Start up business, so current value is minimal, but...
- Capital light model creates high value if successful.
- “Fair value” depends on assessment of relative likelihood of these two opportunities.



## Aus. Agricultural Co (AAC: \$1.40)

- Ability of company to deploy capital at high returns is minimal.
- Therefore, no growth optionality and Potential Value = Current Value.
- In this scenario, to reflect the lack of optionality Future Value defaults to Poor.





## The Broad Nature of Valuation

- In our screening model, whilst we assess a Current and Potential valuation that is entered as an exact dollar amount ...
- ... to reflect the conceptual nature of valuation, we screen based on broad interpretations of these factors. So for **Current Value**:

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<b>V Good</b>	<50% of assessed fair value.
<b>Good</b>	50-75% of assessed fair value.
<b>Fair</b>	75 - 125% of assessed fair value ←
<b>-Poor</b>	125-150% of assessed fair value
<b>-V Poor</b>	>150% of assessed fair value

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- E.g. any share prices within +/- 25% of valuation are assessed as Fair.



## The Broad Nature of Valuation

- Further, reflecting that Potential Value is even less certain than Current Value, the focus of screening is on the size and nature of the potential value creation opportunity, not just differential with current share price.

<b>V Good</b>	Potential Value > Current Value & > 2x Share Price	• Growth companies with positive returns - Ranked in accordance with Share price vs Potential Value
<b>Good</b>	Potential Value > Current Value but < 2x Share Price	
<b>Fair</b>	Potential Value > Current Value but < Share Price	
<b>-Poor</b>	Potential Value = Current Value	• Cyclical Companies, or highly capital intensive.
<b>-V Poor</b>	Potential Value < Current Value	• Structurally challenged industries with negative re-investment risk.





## Contextual Valuation

- Because valuation is a solution to a probabilistic function...
- ... the statistical significance of the value signal will vary according to other factors.
- Therefore, we need to incorporate these other factors when interpreting the value signal.
- Very simply:
  - **The statistical significance of valuations improves as the price moves further from value...**
  - **... but reduces with high leverage and/or poor earnings quality.**

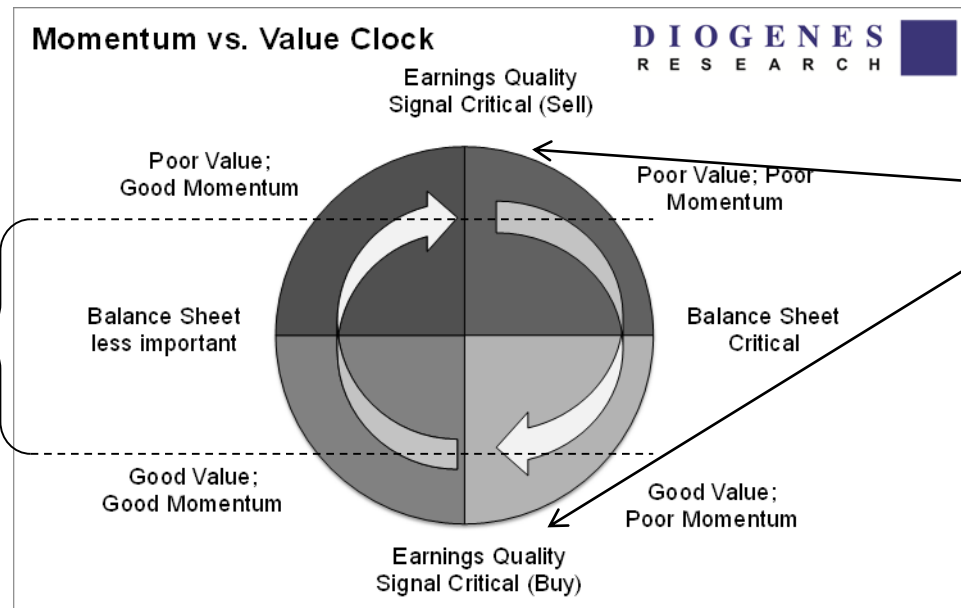


## Contextual Valuation

- We can visualise this in the trade off between value and momentum:

- Most stocks trade around fair value - ...

- ... in this fair value range, momentum not value is usually the key share price driver.



- Value becomes more important at high and low extremes...
- ... but must be considered in context with earnings quality and balance sheets.

- **i.e. In short, the relative importance of various factors will change depending on share prices and company specific factors.**



## Contextual Valuation

- For this reason, valuation is an element of our screening, not the solution to the investment decision. For example:
- A company with an excellent balance sheet, earnings quality and growth optionality, but expensive valuation....

Ticker	Price Current	Mkt Cap	Risk Measures				Reward Measures				Total Score	Current Value	Potential Value	Current Value	Potential Value
			B/S	Ops. & Gov.	EQ	Total	Val. Curr	Potential Val.	Mo	Total					
TNE	3.32	1,027	V Good	V Good	V Good	6	-V Poor	Fair	V Good	0	6	60%	90%	2.00	3.00
WDS	0.20	28	-V Poor	Fair	-Poor	-3	V Good	-Poor	-V Poor	-1	-4	231%	231%	0.45	0.45

- Might still represent a better risk/reward trade than a cheap, but highly leveraged business with poor earnings quality and momentum.



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