



# Screening for Value (2): Valuation Approaches

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## Valuation - Overview

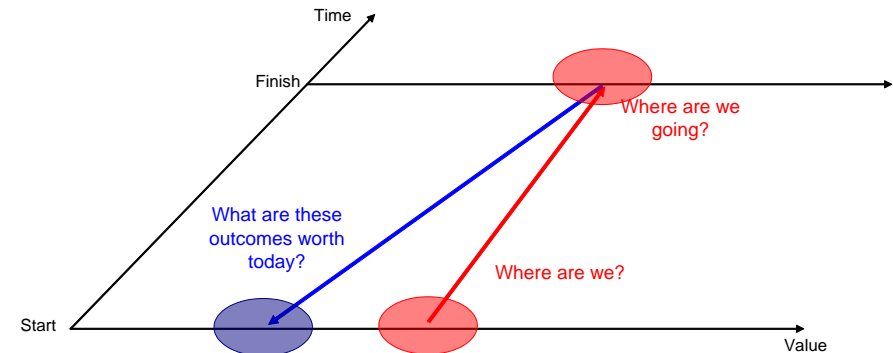
- Our valuation philosophy (as discussed in [Screening for Value \(1\)](#) ) can be summarised as:
  - Valuation is a probabilistic process where the parameters of the probability distribution are highly uncertain.
  - Because of this uncertainty, valuation should be approached as a concept rather than something capable of a precise solution.
  - Further, because this uncertainty varies by stock and relative to market price, valuation is an element of the screening process, not the solution to the investment decision.
- In this presentation, we provide an overview of our key valuation tools:
  - Tools we don't use: DCF, PER
  - Tools we do use:
    - » EV/Sales
    - » Price/NTA
    - » Value Creation Scenarios
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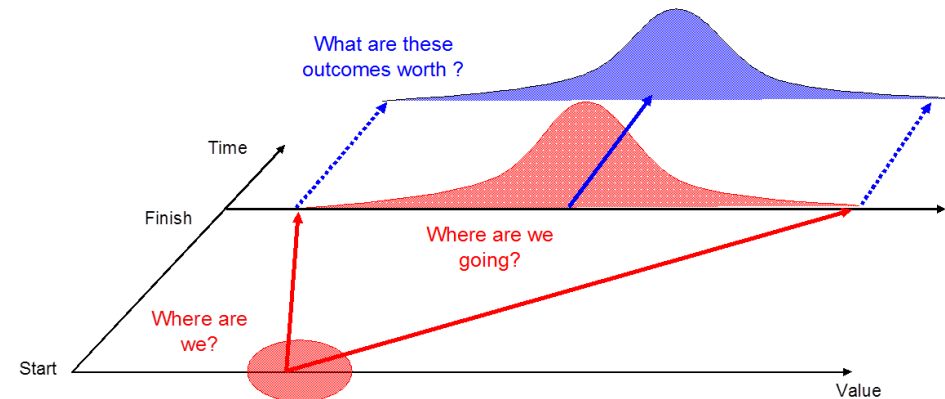
## Tools We Don't Use - DCF

- DCF's have many good attributes:
  - A focus on cash not earnings;
  - A focus on sustainable cash flow, not just current;
  - A focus on risk, not just return
- However, we believe these are offset by a range of problems:
  - Provide false precision;
  - Require too much quantification of an uncertain future (i.e. complex and time consuming);
  - Fail to take into account path dependencies of valuation;
  - Fail to take into account various feedback loops.

- DCF's focus on this...



- .... Rather than this:





## Tools We Don't Use - PER

- A simplification of the DCF is to use capitalisation of earnings multiples (PER, EV/EBIT etc).
- However, these have some theoretical problems:
  - Focus on earnings not cash;
  - Focus on current earnings, not sustainable earnings.
- In practice, earnings models do not work where current earnings are not a reliable indicator of future earnings.
- The market approach to this conundrum is to forecast future earnings.
- However, this has two problems:
  - The track record of long term forecasting is poor;
  - It relies on forecasts that are better than consensus. i.e. this is trying to beat the market at its own game.
- Therefore, whilst earnings forecasts can work in some situations, attaining a sustainable edge over the market using PER's is difficult.



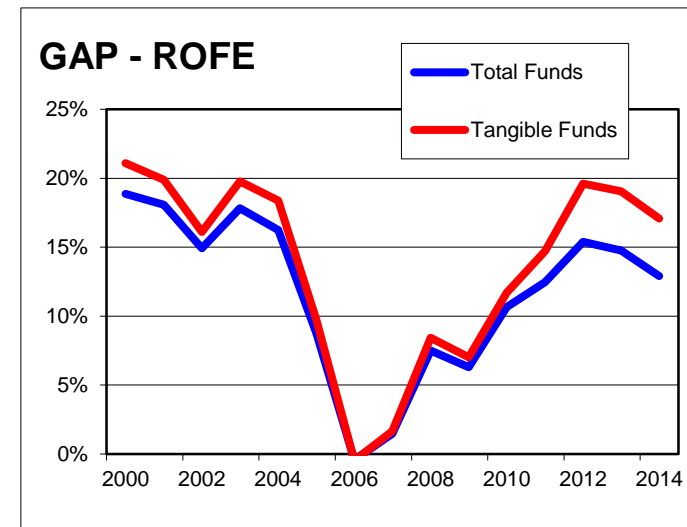
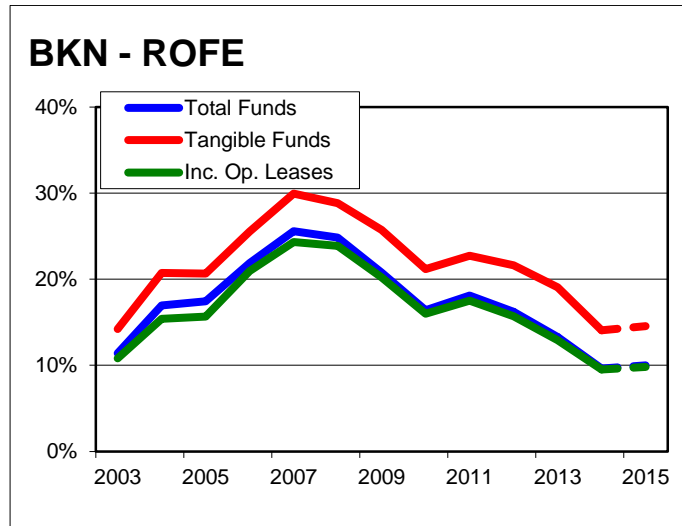
## Tools We Do Use

- We distinguish between two sets of tools:
  - Those used to determine Current Value;
  - Those used to understand Potential Value.
- When looking at current value, we use proxy's for earnings based measures that we believe improve on PER's because:
  - They focus on through the cycle, sustainable earnings;
  - Are second derivatives of earnings, so are less commonly used by the market.
  - Are more applicable to loss making/start up businesses.
- These metrics are EV/Sales and P/NTA (or other asset based multiples)
- Both these metrics are designed to be soft proxy's for future earnings, based on the premise that:
  - Returns for particular companies/industries will normalise at certain levels;
  - If returns do not normalise at these levels, there is potential via explicit/implicit takeovers to realise this value.



## P/NTA

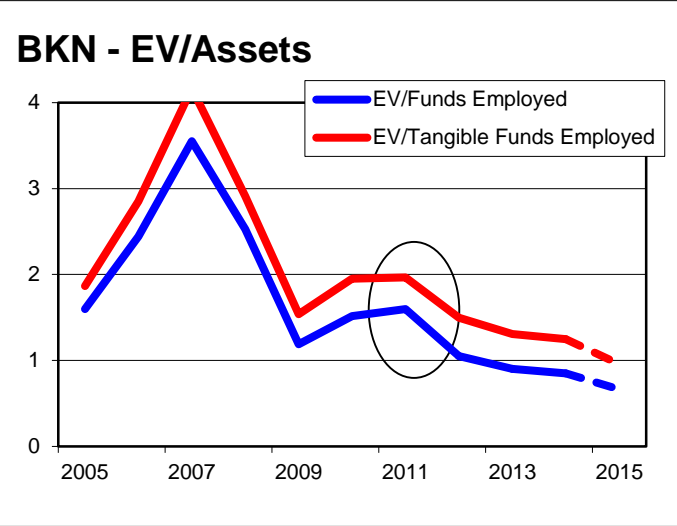
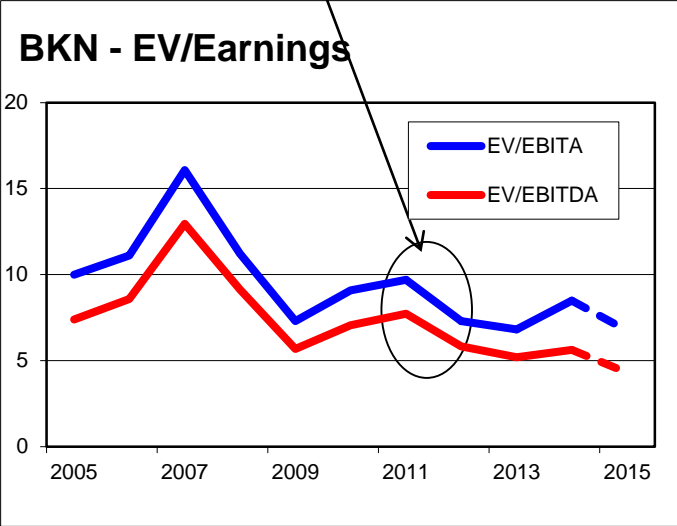
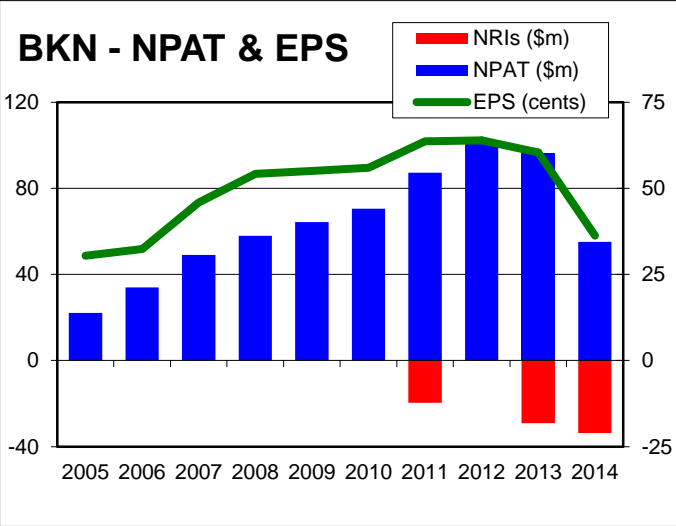
- Using an asset based model such as P/NTA serves two potential purposes:
- It uses assets as a predictor of future earnings: i.e. normalises for returns
  - $P/NTA = P/Earnings * Earnings/Equity$
- Note that this is not the same as saying returns will normalise to cost of capital, but rather, returns will normalise to a level that is reflective of both the industry and the company's position within that industry.





# Asset Multiples

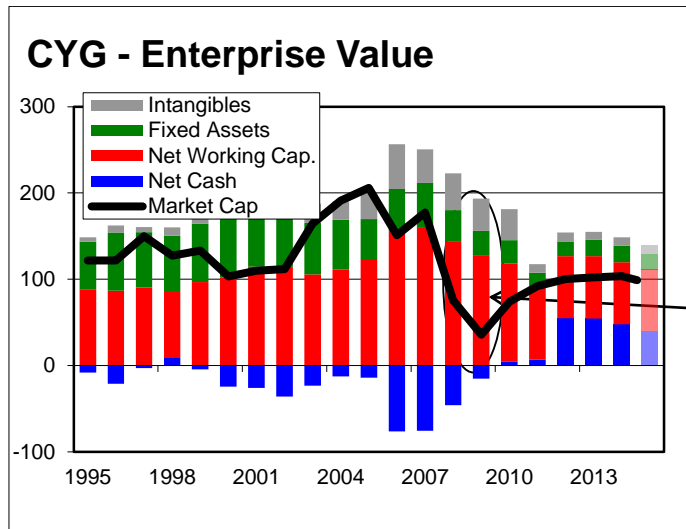
- For example, the volatility of Bradken's earnings makes earnings signals dangerous.
- In 2011/12 earnings multiples looked very cheap.
- But asset multiples looked expensive in 2011 and only fair in 2012.
- Ultimately, the asset base was a better predictor of earnings than the market.



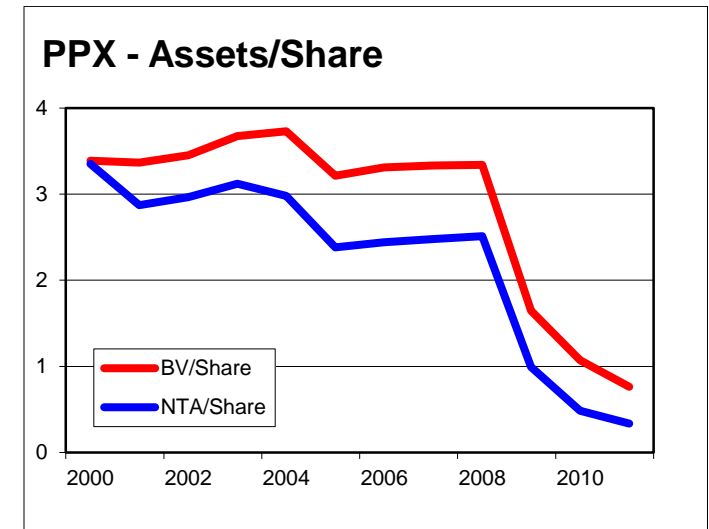


# Asset Multiples

- In certain circumstances, asset multiples may be used as a predictor of realisable value.
- The key in this situation is to understand both the composition of assets ...
- ... and the degree of leverage. High leverage means the ability of shareholders to realise value is often illusory.



- Low gearing, working capital assets, big discount to NTA = Good Opportunity.

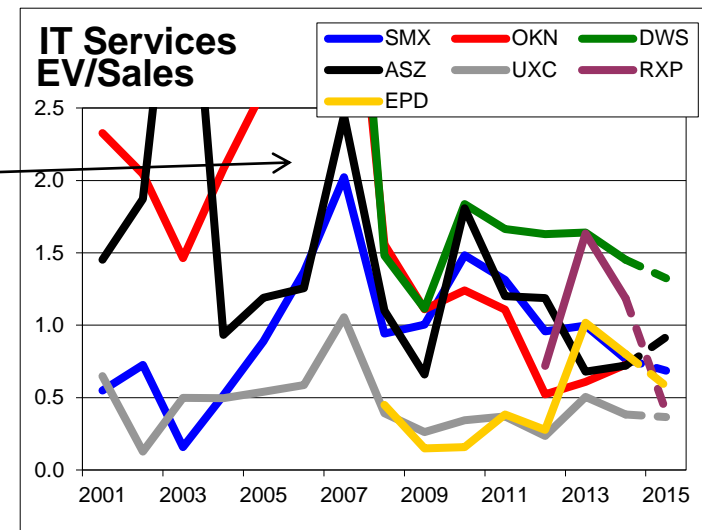
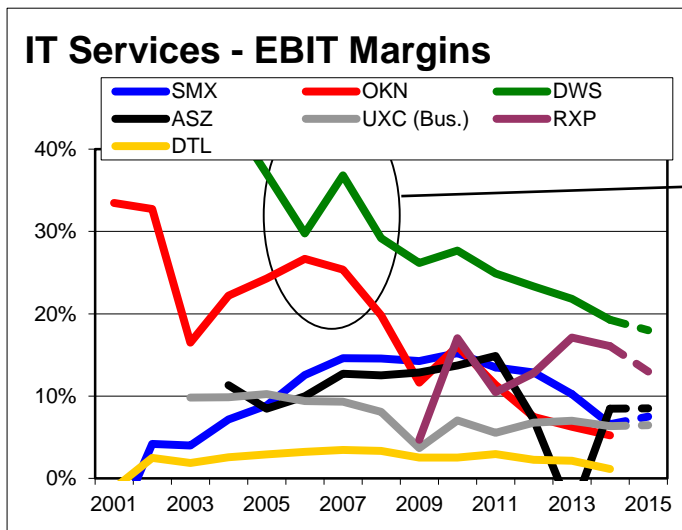






# EV/Sales

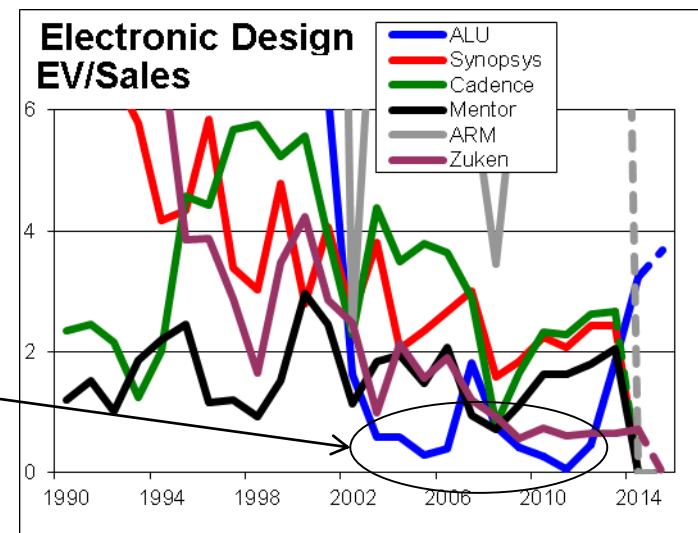
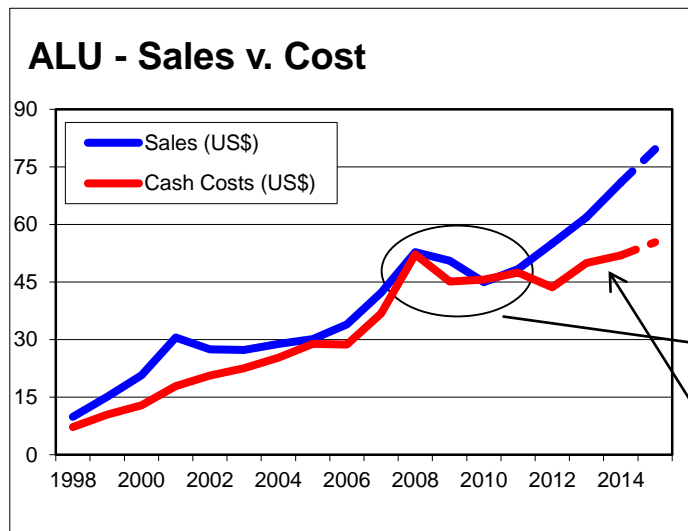
- Where the business is cyclical, but asset light in nature, then Asset Multiples are inappropriate.
- In this situation, EV/Sales performs the same function, normalising for sustainability of margins, rather than returns:
  - $EV/Sales = EV/EBIT * EBIT/Sales$
- These metrics work very well when margins (either at a company or industry level) are unsustainable:





# EV/Sales

- Sales multiples also work well where the business is not currently profitable:
- Good sales growth, but ongoing reinvestment prevented profitability.
- But multiples of sales were significantly below industry history of >2x sales.

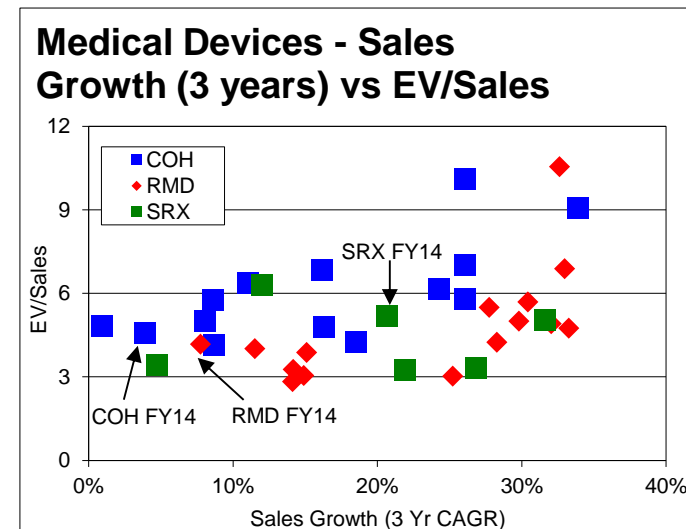
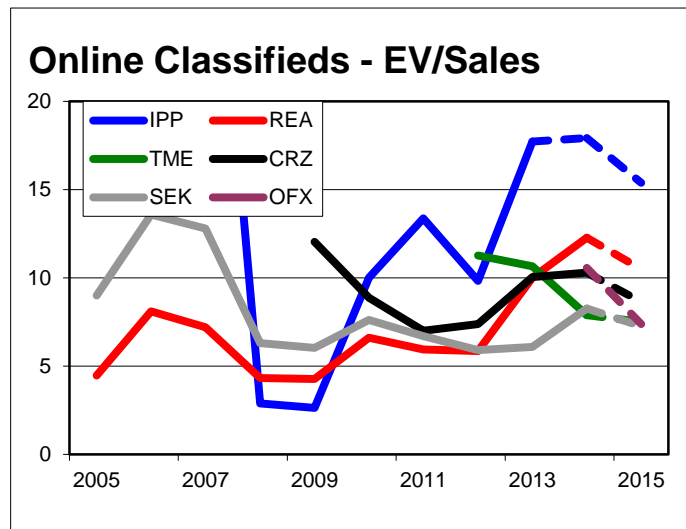


- Value ultimately realised by a change of management strategy...
- ... but a takeover was always an opportunity.



## EV/Sales

- Much like P/NTA – the issue isn't necessarily the absolute level of EV/Sales, but rather, the level relative to both company and industry history.
- Thus multiples can be compared to other companies at similar stages of development....
- ... or relative growth rates.





## Potential Value

- Obviously, asset or sales based multiples are better at capturing the Current Value of a business, rather than Potential Value.
- Potential Value arises due to the combination of two factors:
  - The ability of a company to invest at high incremental rates of return;
  - The feedback between earnings momentum, risk and operational performance that may impact both fundamental and perceived value.
- We attempt to capture this process in two ways:
  - Explicit value creation models.
  - Share price scenarios.



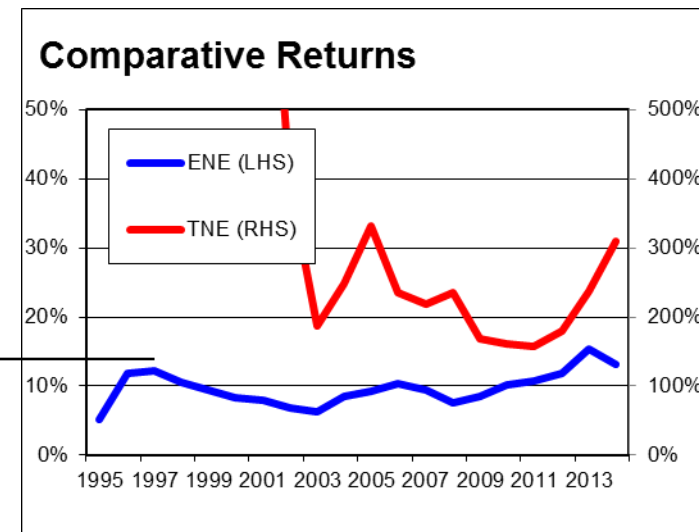
# Potential Value – Explicit Value Creation

- As a company grows, value is created by the following process:
  - Gross Value = Incremental Earnings x Appropriate Capitalisation Rate for Earnings
  - Net Value = Gross Value, less Capex required to generate earnings:
- Thus companies with high returns generate much greater value as they grow. Valuation can be explicit...

- Eg. ENE, with long term average Returns of ~10%, creates no net value via growth.

### Value Creation Scenarios

	ENE	TNE
Incremental Earnings	20	20
Value Multiple	10	10
<b>Gross Value</b>	<b>200</b>	<b>200</b>
Less: Capital Required	-200	-10
Incremental ROFE	10%	200%
<b>Net Value</b>	<b>0</b>	<b>190</b>



- Or implicit via a proxy. E.g. with capital light businesses, a simple shorthand is to assume that sales have 50% growth potential – therefore Potential Value = Current Value \* 1.5x.



## Potential Value - Scenarios

- An alternative is to construct a share price scenario.
- This captures the interplay between earnings momentum and market multiples.
  - In one sense, it may be thought of as more a potential price target rather than a technical valuation.
- However, given that share prices can create value via high priced capital raising etc, these scenarios are a useful way of understanding this potential.
- These simple scenarios overcome a key problem of DCF models – namely that they don't tell you what cash flows will be worth in the future.
- A key benefit of these scenarios (both upside and downside) is they help expand our understanding of the range of possible outcomes – this is invariably much larger than intuitive assessments or explicit DCF modelling, will contemplate.

### Sirtex Medical

Year End	2012	2013	2014	2015	2016	2017
<b>P&amp;L Scenario</b>						
<b>Sales</b>						
Asia Pacific	4	5	5	6	7	8
North America	59	72	88	110	144	173
Europe	22	23	25	29	35	42
<b>Total Sales</b>	<b>84</b>	<b>98</b>	<b>129</b>	<b>145</b>	<b>186</b>	<b>223</b>
% Chg	19%	16%	32%	12%	29%	20%
<b>Vol Growth</b>						
Asia Pacific	37%	29%	12%	12%	20%	20%
North America	32%	21%	22%	20%	20%	20%
Europe	4%	9%	6%	10%	20%	20%
AUD/USD	1.03	1.03	0.92	0.88	0.80	0.80
AUD/EUR	0.77	0.79	0.68	0.66	0.65	0.65
Gross Margin	81%	82%	84%	84%	84%	84%
Gross Profit	69	80	109	121	156	188
Total Costs	-49	-58	-80	-84	-99	-112
<b>Total EBIT</b>	<b>20</b>	<b>22</b>	<b>29</b>	<b>38</b>	<b>58</b>	<b>76</b>
Cost/Sales	58%	59%	62%	58%	53%	50%
EBIT Margin	24%	23%	23%	26%	31%	34%
<b>P&amp;L</b>						
Net Interest	2	2	2	4	5	7
Pre-Tax Profit	22	25	31	41	62	83
Tax	-5	-6	-7	-10	-15	-19
<b>Reported NPAT</b>	<b>17</b>	<b>18</b>	<b>24</b>	<b>32</b>	<b>48</b>	<b>64</b>
Shares on Issue	57	57	58	59	61	63
EPS	0.30	0.32	0.41	0.53	0.78	1.01
EPS Growth	48%	7%	28%	29%	46%	30%
PER Rating - Low	14	19	26	25	25	25
PER Rating - High	22	42	43	30	40	30
<b>Share Price - Low</b>	<b>4.10</b>	<b>6.15</b>	<b>10.78</b>	<b>13.37</b>	<b>19.51</b>	<b>25.29</b>
<b>Share Price - High</b>	<b>6.55</b>	<b>13.40</b>	<b>17.61</b>	<b>16.05</b>	<b>31.22</b>	<b>30.35</b>



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