

Value is in the eye of the share analyst

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There are many things fund managers keep in mind when considering buying a stock, but pretty high on the list is a company's share price relative to its real value. If a company is trading at a discount to what it's worth, it's obviously a lot more alluring than when it's trading at a hefty premium.

There's nothing new there: this common sense underpins the methodologies of the most famous investors in the world. Warren Buffett looks for businesses he can understand, with strong management — but only at a sensible price. Peters MacGregor, the Australian boutique fund manager that uses Buffett techniques, invests only in stocks trading at a 25 per cent discount to their fair value (and, partly as a consequence of this, hadn't bought a new stock in about a year when *The Australian Financial Review* spoke to its principal Wayne Peters last month).

But how do you work that out? Ord Minnett has compiled a ranking of the 155 Australian stocks covered by its partner JPMorgan's analysts according to their relative valuations. And we asked UBS to compile a similar ranking, showing the biggest differences ("upside") between today's share price and UBS's 12-month target.

On one level, this is a simple way to spot a bargain. On Ord's numbers, Adsteam Marine, Billabong, Boral and Sons of Gwalia are all trading at at least a 30 per cent discount to true value.

Other blue chips with at least a 10 per cent discount include News Corp, Virgin Blue, Harvey Norman, Qantas, Commonwealth Bank of Australia, Macquarie Infrastructure Group, Seven and Ten networks, NAB and AMP.

At the other end of the scale, the thoroughly bounced-back Aristocrat Leisure is by some distance the most overvalued major stock in Australia, trading at a 79.5 per cent premium, according to Ord, followed by Bank of Queensland, Tabcorp, Globe International and Southcorp (troubling to learn that a business that has hit the skids so badly is still apparently overvalued).

Blue chips at more than 10 per cent premiums include BHP Billiton, Rio Tinto, Macquarie Airports, Cochlear and Tab.

But this isn't the whole story. Buffett buys only cheap businesses but he doesn't buy them just because they're cheap. They have to be good, too, and there might be very good reasons that they are trading at discounts.

So it's informative to note that Ord Minnett's recommendations on the stocks don't follow their valuation. Ord Minnett is overweight on Adsteam Marine, Billabong and Boral but is only neutral on Sons of Gwalia, Foodland, Seven and Pacific Hydro despite their huge discounts. In fact, it's underweight the Commonwealth Bank despite the bank trading at a 12.8 per cent discount.

And although the broker thinks it's time to get out of Aristocrat, Bank of Queensland, Southcorp and Globe, it recommends buying more of Newcrest Mining — a stock apparently trading at a 36.5 per cent premium to fair value — and BHP Billiton, at 24.2 per cent.

It's also worth remembering there are many ways of assessing value.

And this ranking brings together the opinions on valuation by a variety of analysts who might not see things the same way. Not everyone, for example, would say Billabong, trading at a prospective 2005 P/E of 15.2 times, is 37 per cent undervalued, or that News Corp, trading at 25 times multiples, is at a 16.6 per cent discount.

That explains why UBS's ranking is radically different from Ord Minnett's. UBS believes Lihir Gold is trading at the biggest discount — a whopping 83 per cent — to its target value at the moment; Ord Minnett reckons it's only at a 2 per cent discount (and has an “underweight” recommendation on it).

Only one company appears in both top 10s: Sons of Gwalia, and even then both houses have different recommendations on it.

And Billabong, No. 2 on the Ord list, has an upside of minus 6 per cent on UBS's numbers — meaning that UBS thinks it's trading above fair value, not below it.

So full analysis of stocks needs to consider their merits as businesses, and their industries. For example, many resource companies are trading at premiums to real value but are still recommended as buys.

“That's a classic top-of-the-cycle paradigm for the resource stocks,” explains Ord Minnett senior analyst Quentin Timms. “They traditionally do trade at premiums to NPV [net present value] of up to 50 per cent, but it doesn't necessarily mean that the stocks have finished their appreciation.”