AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive 14th August 2015

The Curse of a $100 stock price?

Last week the financial press was full of breathless articles about $100 stock prices, as biopharmaceutical company CSL hit $102 per share and these articles were full of speculation as to whether Commonwealth Bank, Macquarie Bank or Cochlear could also join CSL in having a three figure share price. As a former institutional shareholder of both Incitec Pivot and Rio Tinto during their period of having share prices greater than $100, what we saw was missing in these articles was the subsequent performance of stocks that have enjoyed these lofty per share prices. In this week's piece we are going to look at the performance of past market darlings that have enjoyed a price greater than $100 per share and over-valuation in general.

Price vs Value

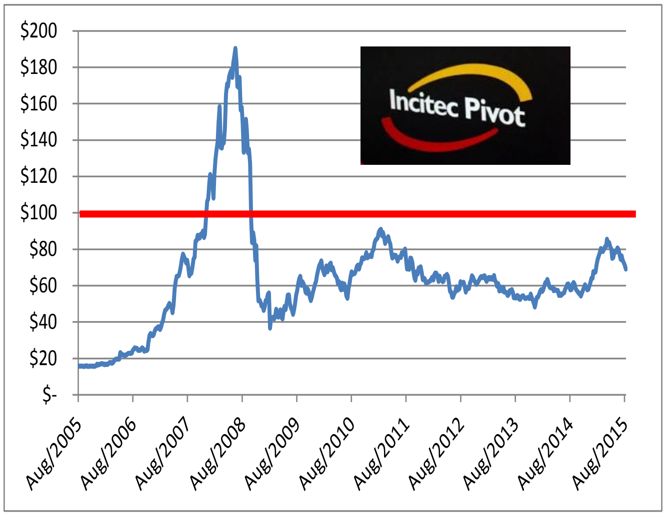
Fundamentally the actual dollar price per share means very little in deciding whether to buy, sell or short a stock. This decision is most often made by comparing a stock's price with the expected distributions as an owner you can expect from owning a fraction of a company. These cash flows are then discounted for both their timing and the risk of the company. Here a $10 per share company could be much better value than one priced at $150 per share, if the expected dividends discounted for inflation are higher than the price being quoted on the ASX.

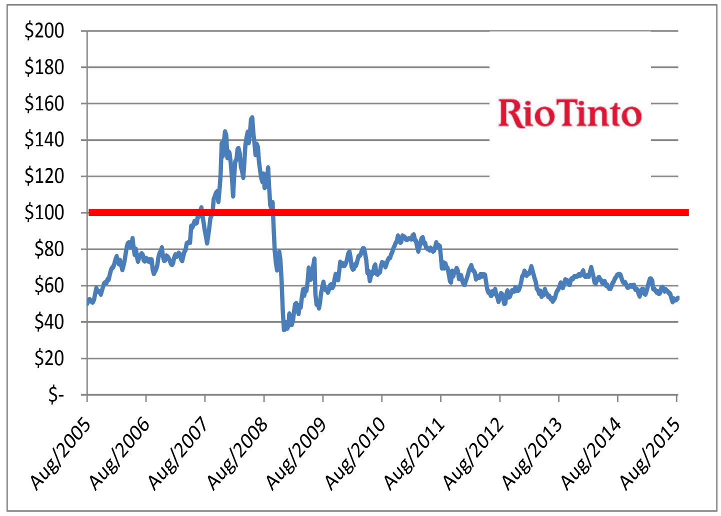
Momentum

When CSL hit $102, one of our favourite West Australian clients put down his afternoon glass of Leeuwin Estate Art Series Chardonnay to debate share prices with me. He correctly pointed out that in the short term, valuations of stocks like CSL have minimal influence on the share price, what matters is momentum. This occurs as a range of institutional funds use momentum as a key part of their investment strategy. Momentum investing is based on the principal that stocks that have been rising (or falling) in the past will continue to do so in the future and has nothing to do with the fundamentals of a company, but rather with the human propensity to extrapolate the flimsiest of trends into the future. This tends to work well as an investment strategy until it suddenly abruptly stops working, as like Icarus flying towards the sun, when these high-flying share prices melt there is often little valuation support.

The Curse of $100 share price

In the mid 2000s Incitec Pivot went from a sleepy fertilizer manufacture (70% owned by now arch rival Orica) with a share price consistently in the teens to a $100 and then almost a $200 per share company. This occurred due to the combination of the purchase of an unwanted diammonium phosphate plant that BHP had acquired as part of buying WMC. As a result of escalating global fertilizer prices, Incitec Pivot recouped their $165 million purchase price in profits in a mere 8 months! Fertilizer prices continued to rise in response to a step change in demand for corn. This was fueled by the construction of ethanol plants in the US, designed to both subsidize famers in Iowa and reduce dependency on Middle Eastern oil. The GFC and the development of the US shale gas industry caused this “*Dot Corn*” bubble to be pricked along with Incitec Pivot’s share price, and culminated in a deeply discounted rights issue being priced at the equivalent price of $50 (adjusted for a stock split).





Miner Rio Tinto’s share price once also enjoyed such rarified air. The table on the right shows Rio Tinto’s share price which peaked at $157 in 2008. At the time RIO was enjoying supernormal margins in iron ore, was almost debt free and was viewed as having the best management team in the resource sector. However in 2007 RIO ended up “winning” the US$38 billion bidding war with Alcoa and Vale for Canada’s Alcan Aluminum. Rio’s share price steadily retraced the over $100 high’s set in 2008 courtesy of writing off the bulk of the Alcan acquisition, a fall in commodity prices and a jumbo US$15 billion rights issue in 2009 to pay off debt priced at only $28.29!

Valuation and what does the Current Share Price imply?

One of the best ways I have used over the years to analyse expensive companies like CSL is to back-solve what earnings growth the current share price implies. This is a good sanity measure for investors, because while even the best companies can deliver high earnings growth for a short amount of time, inevitably this growth falters either due to new competitors, management hubris or even the mathematics of compounding growth. Even for the most wonderful company it is becomes progressively harder to grow those earnings at a high compounded rate as the addressable market for a company’s products is always finite! The last company to achieve a compounded growth rate of 10% over a 10 year period was Microsoft in the period ending 2004.

CSL Implied Growth using a 7yr Growth Period

		<< --- 3yr Predicted Earnings --- >>			<< -------------------------- 7yr Growth Period -------------------------- >>							Terminal
Year		2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	to Infinity
EPS Growth			12.0%	9.7%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	2.50%
EPS		$4.231	$4.738	$5.196	$5.683	$6.215	$6.798	$7.435	$8.132	$8.894	$9.727	$9.970
Rf		4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
Beta		0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80
ERP		6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
DR = Rf + B (ERP)		9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%
DF = 1 / (1+DR)^n		0.91	0.84	0.77	0.70	0.64	0.59	0.54	0.49	0.45	0.41	0.41
PV = EPS * DF		**$3.87**	**$3.97**	**$3.98**	**$3.98**	**$3.98**	**$3.99**	**$3.99**	**$3.99**	**$3.99**	**$4.00**	**$60.26**
NPV	**$100.00**											
Market Price	**$100.00**											

Looking at CSL and using the current broker consensus earnings numbers for the next 3 years (*which look far too high for me*) and using a terminal growth rate of 2.5% from 2026 to infinity, a share price of $100 for CSL implies a compound growth rate between 2019 to 2025 of 9.4! CSL is a good company, but this level of implied growth is far ahead of both the company forecasts and indeed their addressable market of plasma-derived therapies.

CSL has declined by 9% since hitting these giddy highs last Wednesday and Cochlear has fallen 7% over the past week after forecasting future profit growth that was below market expectations on Tuesday. Further a large capital raising this week that

will increase the number of CBA shares outstanding by 4% will probably preclude Australia's largest bank from joining the $100 club in the near future.

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