

MEDIA RELEASE

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SA equities not cheap despite bear market – big rally not likely

Surprisingly, despite the sharp declines experienced in the past year, the local equity market has never been truly “cheap”, with the current level probably representing fair value, according to the extensive valuation analyses done by Old Mutual Investment Group SA (OMIGSA), reports Steve Minnaar, head of the group’s Investment Research team. As a result, investors anticipating a big general equity rally driven by fundamental valuations in the coming months are likely to be disappointed.

“Even though the FTSE/JSE All Share Index fell by 23.3% in 2008 and another 4.2% in the first quarter of 2009, even at its worst levels in February and November the market has not necessarily been too cheap,” he says. “This is because, based on our valuation framework using cash flow returns on investment (CFROI), share prices were so unrealistically high in mid-2007 at the peak of the bull market - pricing in corporate returns far above the long-term average – that they have now only fallen to levels where returns on investment are closer to the long-term average.”

“In other words,” stresses Minnaar, “if you believe that companies’ returns on investment will fall back to long-term average levels over the next five years (which is a very likely scenario), the equity market is fairly priced right now. For the FTSE/JSE All Share Index to rally significantly from its current level of around 20,000 pts, real earnings would have to be much higher than consensus forecasts are now indicating. This requires much better fundamental economic conditions than what is currently expected.”

However, for investors still hoping for bargains, there is some good news. Whereas the market as a whole may be fairly priced, it contains many mispriced counters. Minnaar has identified a few selective companies where the market is too bearish, and pricing in unrealistically negative prospects. “The prevailing uncertainty around company earnings, given the poor macroeconomic conditions, has made it very difficult for the average investor to do their own stock-picking,” he notes. “The simplistic price-earnings ratio (P/E) and dividend yield indicators are not sufficient to give an accurate measure of company value – both earnings and dividends have been plummeting at unprecedented rates in many cases.”

Take the example of platinum producer Amplats, where consensus earnings forecast for the December 2009 year end dropped from over R93 a share to the current expectation of about R3 per share; which forecasted “E” do you use for a P/E valuation?

This is where the HOLT cashflow valuation framework used by OMIGSA's Investment Research team is invaluable. They have pinpointed several companies with better prospects than those currently being priced into the shares (and therefore strong potential for outperformance), including Anglo American and Sappi. In each case, the current share price is used as the starting point from which the expected cashflow return and asset growth are analysed.

Anglo American – The current share price of R170 is pricing in that the company will not even meet its cost of capital in five years' time, while also not growing its asset base at all. Although they did overpay for assets recently, such a bearish expectation is way off their multi-decade track record.

Sappi –The paper industry is notorious for destroying value; in the past 20 years Sappi has not once beaten its cost of capital. The industry has too much capacity; yet no one has blinked and been first to shut production facilities. The current market turmoil will hopefully be the needed catalyst to finally close capacity to ensure the future of the survivors. Sappi has relatively high debt levels after its M-Real asset purchase, but they are well-placed to survive. In this case there is much upside.

At the other extreme, there are shares that are simply priced for too optimistic a future, especially some of the more defensive shares like Shoprite. Says Minnaar: "Although Shoprite is a good company with excellent management and good growth prospects, its current share price of around R53 is reflecting expectations of perfection from the company across all of its operations over the next five years. They have to continue to deliver record margins and asset turns while strongly growing cash flows and aggressively extending their footprint (a proxy for asset growth), just to justify today's share price. Without taking anything away from management's abilities, the expectations are too high. This reminds us of the construction stocks a mere 12 months ago, when they too priced in a perfect future. Most have fallen by more than 50% since then."

Looking ahead, Minnaar says, market conditions will remain difficult for equity investors until the global economic outlook becomes less uncertain and clear signs of recovery are apparent. "Although equity markets around the world have rallied in anticipation of a recovery, and we may have already seen the bottom of our market, it's still too early to say for sure - the JSE could be experiencing a 'bear rally' (a rally within a bear market). Sentiment and momentum are driving share prices, with valuation clearly out of favour amid this turmoil. It is critical, however, to stick to your proven valuation methods and not to get tempted by short-term momentum. In the long run, valuation will return as the major driver and then you need to be ready with a proven, disciplined framework for valuation."

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