LINDSELL TRAIN

How to Value £1 of Sales

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After a market dislocation of such magnitude all one knows for sure is that something is wrongly priced. The moves have been wrenching – up as well as down - and hindsight will confirm some "once-in-a-generation" opportunities. How to pick 'em, though - not least knowing that, in all likelihood, we sit on the verge of an economic dislocation, one foreshadowed and exacerbated by the turmoil in financial markets?

We suggest that now is the time to turn to one valuation measure above all others – the Enterprise Value/ Revenues Ratio (EV/R). You are, no doubt, familiar with it. Take the market capitalization of a company, add to it its net debt (or subtract from the market cap its net cash), then divide by historic revenues. The resultant ratio tells us what value investors place on a unit of a given company's sales.

This is always a useful thing to know, but in current circumstances especially so. This is because of all the "moving parts" in a P&L, the revenue line is the least volatile. Of course, all companies' sales rise and fall, but the magnitude of this fluctuation is far lower than for operating margins, profits and earnings. Analysts recognise that a relatively small dip in sales, less than 5%, say, may have a levered impact on earnings, which can fall many times the percentage of the revenue decline – it's called operational gearing.

In addition - a cynical observation – the "Revenue Line" is one of the toughest in the P&L to fiddle. Sales are a matter of record; profits and earnings are an opinion. A valuation based on reported sales is more likely to be roughly right, than one derived from a notional earnings figure, which can be exactly wrong.

When thinking about ascribing strategic value to a corporation it is important to aim off for the extremes. It is a commonplace that it is just as wrong to attach a high P/E to earnings that have been boosted by unsustainable operating margins, as it is to penalize a company with a low valuation, because its earnings have been temporarily depressed—a commonplace, but surprisingly difficult to avoid in practice. But here the EV/R ratio comes into its own, because it requires the investor to look through earnings volatility, up or down, and to consider and then put a value on, that without which there can be no company, let alone any earnings – its sales. Admittedly, EV/R is of little use in determining tactical, short term opportunities, because it ignores earnings, the prime focus of most active investors. However, as a broad measure, to help establish whether investors fundamentally over- or undervalue a company on a multi-year view, it is invaluable.

Experience teaches that the EV/R ratio has a long term relationship with a corporate's operating margins. For reasons that may be mysterious, an operating margin of 10% tends to result in an EV/R ratio of c1.0x. For instance, in today's FTSE 100 (from which all the examples in this note are taken — any errors identified may be blamed on Bloomberg, from whence I have extracted the data) BP and Tate & Lyle each report historic margins of 10% and trade on EV/R ratios of 1.06x and 0.9x respectively. Alternatively, a company with a structurally lower operating margin will command a lower EV/R, but in approximately the same ratio. Thomas Cook's margins of 5.5% justify an EV/R today of 0.4x, roughly half 1.0x, for a margin roughly half of 10%. Contrariwise, but consistent, Whitbread's margins were 18% last year and, neatly, the EV/R is 1.9x.

This relationship can break down when margins are extraordinarily low or high, but predictably so. For instance, Sainsbury's 2.5% margin is valued at an EV/R of 0.47x, not 0.25x. Shire Pharmaceutical's margins of well over 30% command a 4.5x value and this may be fair, given how accretive marginal sales growth can be when channelled through super-charged, but stable, pharmaceutical margins.

However, as a general proposition we submit it is rare that any EV/R much above 3.0x ever signals a company is really cheap, although that does not necessarily make it a "sell". In addition, caution is called for when the EV/R is "higher" than the operating margin. For instance, Cobham's margins are 15% and you would expect an EV/R of c1.5x. In fact Cobham's rating is 2.3x. Meanwhile, an EV/R below 0.5x almost always demands consideration. The real trick of course, is to spot companies on low EV/Rs, where either revenues or operating margins may rise.

There are some fascinating situations in today's FTSE 100. First, some stocks where the EV/R is flashing dear. Tobacco shares are understandably popular today. They offer virtually recession proof cash flows, with participation in one of the best growth stories around – consumption in Emerging Economies. BAT and Imps are encouragingly profitable too, with operating margins of 29% and 44% respectively. However, one does have to gulp a bit at the EV/Rs investors have rewarded them, of 4.6x and 6.6x. Is each £1 of Imperial Tobacco's revenues really worth £6.60? Perhaps, but it is hard to argue that investors are missing anything in that rating.

Demonstrating that I'm prepared to throw stones in Lindsell Train's glass house, I note that Diageo's sales, earning an admirable 29% margin, are valued at 4.0x. Not obviously cheap. The consolation for Diageo bulls like us is that Pernod has just paid 5.5x sales to acquire Absolut vodka and Heineken and Carlsberg 3.0x to own S&N's brands. The conclusion seems to be that for exceptional brands (and in S&N's case not so exceptional) with global opportunities, valuations are deservedly high.

Utilities are intriguing. Of course they are reliable. But can National Grid's sales base of £8.8bn really sustain an enterprise value of £35bn in perpetuity? Margins are an alluring 28%, but 4.0x sales is no longer cheap. Severn Trent's £1bn+ of sales sits at the bottom of a capital structure worth £6.5bn, for an EV/R of 5.75x. Margins are 25%, but the margin for error in the valuation looks thin.

Telecom shares have, until recently, been defensive favourites too. British Telecom looks fairly valued, assuming current profit margins are sustainable (a heroic assumption, we think). At 13%, its margins, with pleasing symmetry, sustain an EV/R of 1.3x. Vodafone is a different matter, though. Margins of 23% are terrific for telephony, but the EV/R of 3.2x suggests investors expect those margins to rise, or for sales to accelerate markedly. We are less sure. Similarly, it is hard to see why Cable & Wireless' puny operating margin of 6% deserves an EV/R of over 1.1x.

Of course, the really sobering valuations are to be found in the commodity sectors, because here the operating margins are almost certain to be volatile – at least over the time horizon of an EV/R investor. BHP's outsized margins of 35% are rewarded with a man-sized EV/R of 4.8x. Xstrata has reported margins of 30% and, rationally enough, if the margins are sustainable, an EV/R of 3.0x. But think this through. Xstrata's most recently reported sales were $28.5 billion. The company has $11.5bn of debt. Let's assume that one day Xstrata's season in the sun has ended and that investors now value each $1 of its sales at 50c or 0.5x, for a warranted enterprise value of $14bn. Subtract the $11.5bn of debt and the market capitalization at this juncture "should" be $2.5bn. Today's market cap is, in fact, $77bn. Rio's enterprise value is $230bn, while last year's sales amounted to less than $30bn. Investors, and to be fair this includes BHP and sundry "strategic" Asian institutions - who ought to know what they're talking about, value this company at over 7.0x historic sales. Those of us who have missed out on the metal bull market have no business in voicing our concerns. But, surely, a huge swathe of market value is at risk if mining sector margins do return to mean? Don't start me on Tullow Oil, with an EV/R of 9.0x, £500 million debt and trading at 7.5x book value – "I just don't get it" (to reprise a phrase from the late 1990's).

Happily there are some attractively low EV/Rs in the FTSE too. We own some of what follow and at the least are considering the others.

Retailers have been thuggishly beaten up and, as a result, some substantive franchises can be accessed at below 1.0x sales, despite current operating margins into double digits. M&S is a standout, on an EV/R of 0.9x and margins still 12%. Next is on the same valuation, with margins even fatter at 16%. If Home Retail can get its margins back up above 6% and deliver sales growth, its stock on 0.4x will be a bargain.

The two pharma leaders deserve consideration. Astra trades on 2.4x and Glaxo 2.9x, with margins of 31% and 35% respectively. These ratings are cheap relative to history, but also to comparable companies in the FTSE. We've noted Shire, twice as highly valued as Astra, but look at Smith & Nephew, valued on 3.8x sales, with margins of 21% - that's 30% more highly valued than Glaxo, for margins 40% lower. Glaxo looks cheap compared to Reckitt Benckiser too, which is also valued at 3.8x sales, for 23% margins. If you assume Glaxo's OTC business, with £3.5bn sales is worth as much as RB, or over £13bn, then its remaining pharmaceutical revenues are even more lowly valued.

We remain big bulls of Unilever, whose shares would double if the business were valued at Reckitt's 3.8x, currently 1.8x for Unilever. Accelerating Emerging Market revenues should be the catalyst for the steady rerating that has still only lifted

Unilever's shares 60% since 2004, which, in turn, were levels it traded at as long ago as 1998. We enjoyed the enthusiasm expressed for his business in the Economist by Harish Manwani, head of Unilever's Asia and African division. He notes Unilever is the world's biggest deodorant manufacturer, with brands such as Rexona and Shield, with a clear and present opportunity because only 7/100 Asians use them; meanwhile the Russians roll on or spray, he says, only on special occasions, like weddings. Good for Unilever shareholders to know, without being patronising, that the world wants to become less odoriferous. On this theme, Cadbury's EV/R is just wrong at 1.9x, relative to any other owner of global consumer brands.

Other "proper" companies with what look to be modest EV/Rs include Rolls Royce, under 1.0x, AB Foods at just over 1.0x and Wolseley at 0.4x. Relative to the history of their sector, ITV and Pearson, each at 1.6x look cheap.

One more FTSE stock that strikes us as interesting is Schroders. Here operating margins are 29%, delivered off an unlevered balance sheet, but the EV/R is 1.8x. Other valuation approaches to Schroders confirm an opportunity, notably FUM/EV. But to be bullish on Schroders clearly means not only being bullish on the markets, but having the appetite for further exposure to the Financial sector, which for many investors is unpalatable. However they should overcome their distaste. Excuse me while I proselytise.

In December last, a new listing was introduced to the London Stock Market — Eurasian Natural Resources, at a first day price of £5.40 and market capitalisation of £7.0bn. Four months later ENRC is a FTSE 100 constituent, the share price has more than doubled and the cap is £18.3bn (giving an EV/R of 7.3x, by the way). Next month Fresnillo, a Mexican silver mine is slated to list, with a £4bn capitalisation and immediate FTSE 100 berth. Next up is New World Resources, the Czech coal miner, set for a June London launch. Why are they coming and why to London? They're coming because for the Emerging Market bull story to work, for the mining and commodity boom to play out with earnings, rather than just speculation, for the world to make its next industrial and social leap forward—for all of this to happen capital markets need to function. Capital markets need to be buoyant, deep, transparent and, preferably, going up more than going down. ENRC and Fresnillo and BHP and RTZ need access to investment capital— because their businesses are notoriously capital intensive and building out the world is going to be expensive. They're coming to London, because London is the closest the world has to a global exchange. Great news for the LSE, whose shares have fallen 36% this year, despite this wonderful outlook for listings and volumes (though its EV/R is still as high as 9.0x, with margins over 50%). Great news for Schroders, which has demonstrated its franchise and placing power recently by raising £3.0bn for a soft commodity fund (adding 2% to FUM in one swoop). Great news for financial companies, especially asset gatherers and capital allocators. Probably even great news for the banking industry, heretical though that may read (EV/R, unfortunately, has no relevance for bank valuation).

If you retain any bullishness for Capitalism, buy securely-financed financials now.

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