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## Looking beyond the numbers

Ever since Benjamin Graham published his first book eighty years ago value investors have probably used two financial ratios more than any other tool to identify investment opportunities. The Price/Earnings (P/E) multiple – a ratio of a company's value to its historic or expected profitability – is probably the most popular and for good reason; it is easy to calculate and can offer an important insight into the degree of confidence that investors have in a business.

It can, however, often be misleading. The ratio can be deliberately manipulated or affected by non-recurring-items which distort profitability, such as the sale of a subsidiary. It is also of limited use when the underlying business is cyclical – semiconductor companies and car manufacturers are good examples – or when earnings are unpredictable or changing rapidly.

An example of the latter is Google, which traded at nearly 50x forward earnings during the financial crisis before bottoming out at 17x in 2012 as rapid earnings growth saw the multiple contract. It currently trades at 22x, which may seem high but we expect the high growth rate in its core search business to continue and earnings growth from the monetisation of its YouTube, Android, Chrome and Honeycomb arms.

**Bloated book values**

Another trusted friend of the value investor is the Price/Book (P/B) multiple, a ratio which indicates how much shareholders are paying for a company's net assets, with companies trading below book value often considered attractive. Like the P/E ratio, it is simple to use, intuitive and can be used to compare companies across the world, although different accounting standards across countries can limit their effectiveness. The P/B multiple offers a useful perspective on how the market values a company's

assets as compared to its earnings. This makes it particularly useful for valuing firms with large tangible assets such as factories and other production facilities or banks and insurers with significant financial assets.

A major drawback for investors is that Price/Book fails to reflect intangible assets such as intellectual property, often a large part of the value of technology companies for example. This leads to low book values and artificially high Price/Book ratios. Two examples of this are Microsoft and Lenovo, which trade at an elevated four times book value. Looked at in isolation this is misleading; we believe that Microsoft is undervalued given the growth potential in its enterprise software business and Lenovo, the world's largest PC manufacturer, is well-placed to use its strong position in China as a springboard for continued growth in an increasing number of new product areas i.e. smartphones and tablets.

An industry which has been in the news recently is the pharmaceutical sector where companies often have significant intangible assets in the form of patents and brand names. Swiss-based Roche currently trades at 13x book value, which would appear to be very expensive, but we think the company is undervalued on an earnings multiple basis (17x P/E), particularly given its focused franchise and leading positions in its chosen markets.

A further illustration is Gap, whose P/B of 5.9x would probably see it fail many value investors screening tests. The reason is that the clothing retailer's asset base has fallen significantly as shops have been sold and it now leases nearly all of its floor space. We think the company is undervalued as it is about to return to growth and boost margins after a long period of consolidation.

**A mix of art and science**

Ignoring companies because of seemingly high valuation multiples can mean that good investment opportunities are missed, as these examples demonstrate. The opposite is also true; buying a stock just because it has a low P/E or P/B is no guarantee of a good return.

Although both measures are useful and important tools in the equity investor's box, they shouldn't be relied upon in isolation but instead used in combination with other quantitative and qualitative valuation methods. The best risk-adjusted returns are often found by using a combination of hard financial analysis and intuitive logic; what we at SKAGEN call 'the art of common sense'.

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