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CSL: healthy, wealthy and overlooked

By Roger Montgomery

PORTFOLIO POINT: CSL is delivering strong returns, has world-class management and bright prospects, yet its shares are below their level of March 6.

Short-term prices mean a great deal if you are speculating or benchmarking yourself against what the index is doing every month, but if you are investing – buying businesses on the basis of a high return generated from the after-tax profits of that business compared to your outlay for it – then near-term price changes mean very little.

Take CSL, a company in the ValueLine portfolio: despite its high rates of return, world-class management, modest gearing and bright prospects, it is trading at a lower price today than when the market hit its nadir on March 6 this year.

Since then the All Ordinaries index has risen 47% while CSL shares have fallen 13%. Whether it is because of the weaker US dollar, short-selling into the buyback, the failure to acquire Talecris, fears about regulatory action in the US against CSL's dominance or the market's short-term penchant for "cyclicals" rather than "defensives" (a nonsense I feel dirty saying), I don't know. What I do know is that this may be one of those opportunities investors look back on and say, 'Gee, that was obvious' but did nothing about.

Back on October 28, I wrote: "What do I really think? I think the stockmarket has got ahead of itself and the high-quality businesses that I look at are now trading above their current valuations and are trading at their valuations two years out." But this was not and is not the case for CSL.

CSL's revenues rose 32% and its profit rose 63% to $1.15 billion in 2009 thanks to favourable currency gyrations, influenza vaccine sales and royalties and sales of the Human Papillomavirus (HPV) vaccine Gardasil.

Importantly, there is more expected in 2010 with profits before any currency impact tipped to rise by double digits, thanks in no small part to increased sales of the Novel A (H1N1) influenza or Swine Flu vaccine. Some tipsters are also suggesting the US dollar may have a rally over the next few months, which, if correct, would further boost profits – although this last point is pure speculation.

Notwithstanding the risks outlined above and the fact that I see patents as a relatively weak form of competitive advantage, this company will produce better than 20% returns on equity for at least the next couple of years.

The ValueLine portfolio as at November 3, 2009

Company Name	Buy price	Price today	Est value	Margin of safety	Shares bought	Invested ($)	Capital value ($)	Divs rec	Total return	Total return
JB Hi Fi	14.8	20.81	21.7	4.1%	845	$12,500	$17,576	0.29	$5,321	42.57%
Cochlear	56.36	62.18	58.7	-5.9%	102	$5,744	$6,337	0.95	$690	12.01%
CSL	31.81	31.07	28.99	-7.2%	163	$5,197	$5,076	0.4	-$56	-1.07%
Woolworths	26.16	27.91	26.7	-4.5%	206	$5,377	$5,737	0.56	$475	8.83%
Reece	17.8	24.19	13.7	-76.6%	236	$4,209	$5,721	0.33	$1,589	37.75%
Platinum Asset Mgt	4.06	5.41	2.84	-90.5%	854	$3,467	$4,620	0.12	$1,255	36.21%
CommBank	46.51	51.5	51.36	-0.3%	215	$10,000	$11,073	0	$1,073	10.73%
Since July 1										
Security Value										$56,139
Cash Value										$56,635
Total Value										$112,774
Total Return ($)										$12,774.34
Return Invested (%)										26.47%
Total Return (%)										12.77%
All Ordinaries change										14.80%
* Outperformance of invested portion										11.67%
* Outperformance of total portfolio										-2.03%
Under observation										
Company Name	**July 1 price**	**Price today**	**Est value**	**Margin of safety**				**Divs rec**		**Total return**
ISOFT	0.635	0.76	0.19	-300.0%						-19.69%
Amcor	4.79	5.55	2.84	-95.4%						-15.87%

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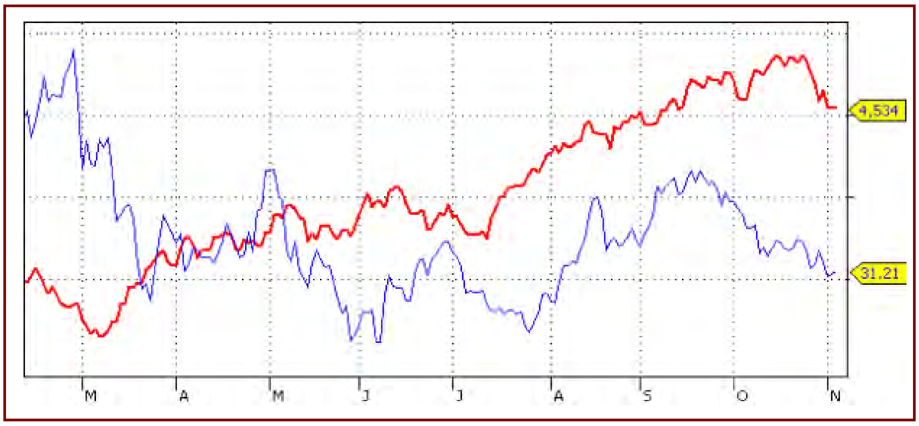
I can be a little more specific than that because the company raised a net $1.73 billion at (the majority at $36.75 per share) in 2009, for the ultimately failed acquisition of Talecris. This significantly increased the company's equity but it is now returning the money to shareholders through a $1.6 billion buyback and at the time of writing has purchased just under $1 billion worth of shares, for which it is currently paying $31.80.

Selling something for a high price and buying it for a low price always has financial benefits. In this case the benefits can be estimated to increase the returns on equity and the intrinsic value of CSL meaningfully over the next few years.

As always, the focus by the majority of investors is on the price and on the short term, but Ben Graham's reminder that in the long run the market is a weighing machine suggests there is a very good reason CSL's share price is 3700% higher than it was 15 years ago.

CSL's share price (blue line) and the ASX 200 (red line)



CSL is the world's largest participant in a $17 billion market for therapeutic blood plasma products; the company has a demonstrated track record of earnings power, $700 million of borrowings compared to over $5 billion of equity, an intrinsic value that is rising materially over the next few years and – as I will soon be moving valuations to 2010 numbers – will also discover the shares are at a discount of about 13%.

Remember, if you live in the country I want you to imagine assessing the possible purchase of a commercial farm. If you live in the city I want you to imagine you are considering buying a fast-food franchise. Would you base the decision to buy either on an assessment of the earnings power of the business or would it be based on how much you might think you can flick it for in a few days, weeks or months?

When you are buying a business, whether it be a farm or a franchise, you don't think about what it is going to sell for tomorrow or next week or next month. You ask yourself: how is this business going to do? How many salad rolls or tonnes of wheat or head of cattle am I going to sell, how much is it going to cost to produce and deliver them and what are my taxes going to be? You look at the stream of income that the asset is going to produce and you compare the net return to how much you're outlaying. That's investment.

The stockmarket, however, with its great sea of liquidity and with prices changing every day, lures both amateur and professional investors or distracts them into a focus on the prices themselves. And once prices take centre stage, the tendency is to try and discern some meaning from them. JB Hi-Fi was up today and Telstra was down. What does that mean? It must mean something. NAB was down but Westpac was down more. Surely that must mean something? The folly becomes clear when someone comments that a company's shares are cheap because their price is relatively lower than their peers: 'Myer has a lower P/E than David Jones and JB Hi-Fi – it is certainly the cheapest retail stock.' Never mind that the whole lot of them could fall in a mass of P/E "deratings" tomorrow. Never mind that they may all be ludicrously expensive and Myer is simply the least so.

I cannot therefore claim any kudos for switching to CBA when, as I write this, CBA rises almost 1% on the same day the NAB falls almost 2%. And, please don't be too quick to congratulate me on my recommendation to avoid the Myer float or for buying JB Hi-Fi and eschewing Telstra. You see, short-term prices mean very little, if anything at all. Myer's shares could go to $5 before they approach anything resembling intrinsic value. ◆

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