Chelverton
ASSET MANAGEMENT

Sex and Drugs and Rock & Roll

Actually, the title of this is Process, Intrinsic Value and Margin of Safety but that is a lot less likely to garner attention. Read on for tales of derring-do.

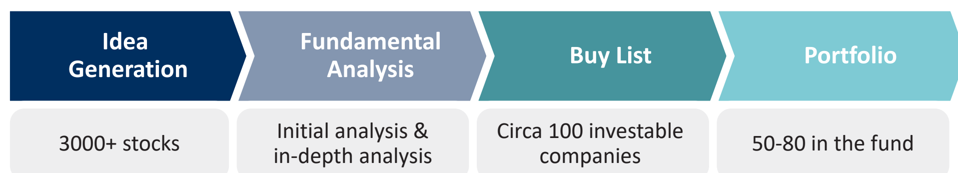
There is never a bad time to go back to first principles. This investment view reviews the way we think about valuations. At the heart of our thinking is the belief that we should be buying shares for considerably less than they are worth. Or in investment language, investing in shares with big discounts to their intrinsic value. This gives us a margin of safety:

Intrinsic Value – Price = Margin of Safety

"When you have margin of safety on your side, you have room for mistakes, errors in judgement and bad luck and can still achieve desirable results"
- Guy Spier

Fundamental – Initial - Analysis

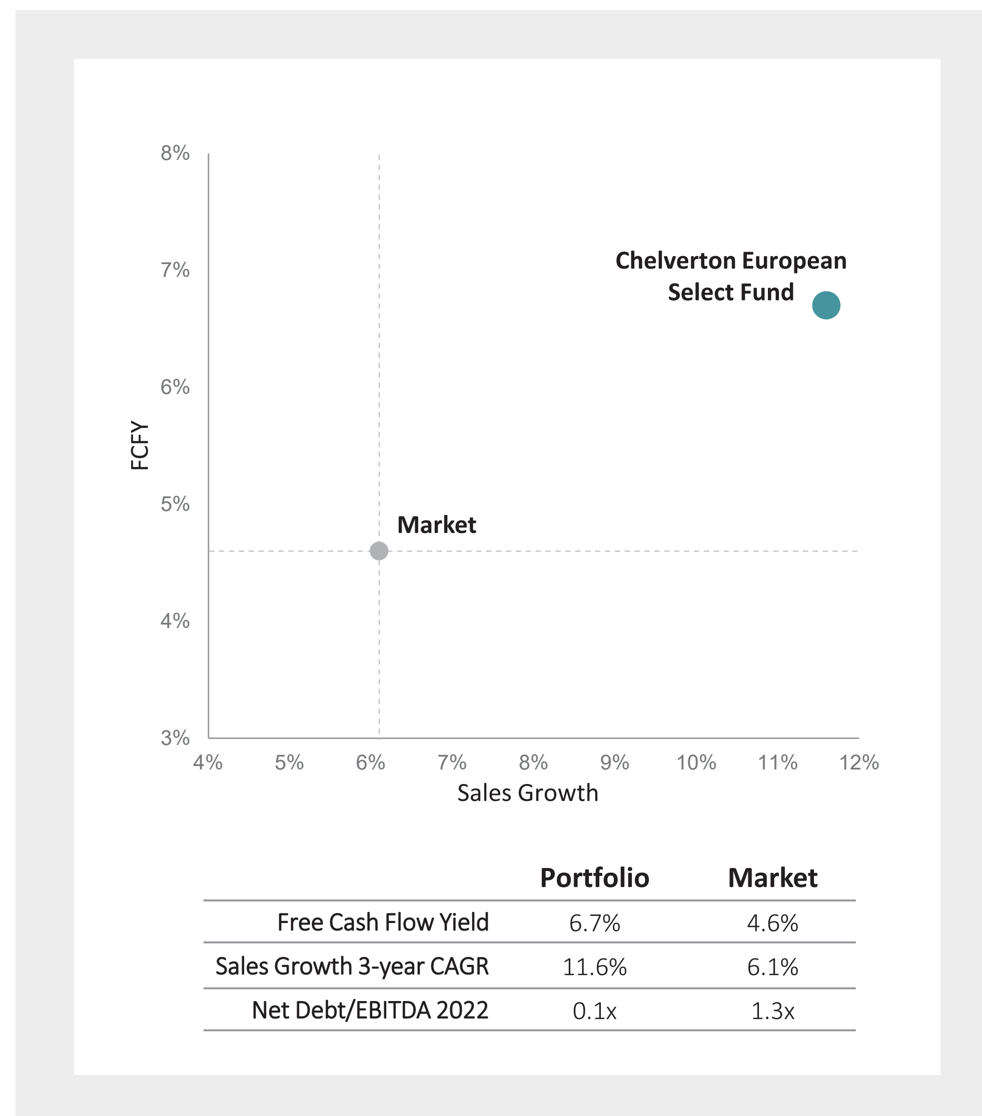
Let's start with a recap of our investment process. In overview it is as follows:



Amongst other things, our Initial Analysis of a company will give us a quick steer on what we think the value/growth equation of the company is. Readers should be familiar with the following graph and accompanying table to the right.

Our portfolio has a basic value/growth equation of 6.7% for 11.6%. If we came across a new idea and that company had an equation of say, 5% for 15% then we are likely to look at this further. 5% FCFY is higher than the market and 15% sales growth is well over the double the market. This looks like an attractive equation and depending on the type of company, the risk profile etc, it might offer something interesting for the portfolio.

5 for 15 is our shorthand. It is not an intrinsic valuation of the company, and this is what we must do next. We need to understand in much more detail the long-term nature of the cash flows, where we are in a company's cycle and many more things besides.

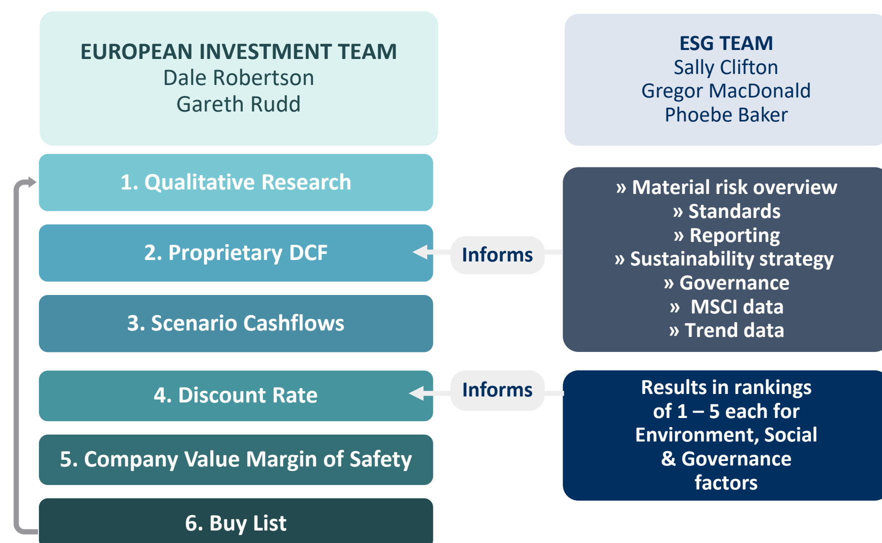


	Portfolio	Market
Free Cash Flow Yield	6.7%	4.6%
Sales Growth 3-year CAGR	11.6%	6.1%
Net Debt/EBITDA 2022	0.1x	1.3x

Source: Chelverton Asset Management, Factset, as at 30/06/23.
Market is comprised of the Factset Europe ex UK Universe

Fundamental – In Depth - Analysis

The next steps in our process look like this, with the calculation of Intrinsic Value ('Company Value' here) the key output from this stage in the process:



Source: Chelverton Asset Management

Despite the many challenges in valuing a company, we think it is an endeavour well worth attempting. Benjamin Graham's parable of Mr Market is relevant here. We are the part-owner in circa 65 companies. Mr Market comes to our office every day offering us a price to buy or sell our stakes at. Experience tells us Mr Market is a highly emotional and erratic character – sometimes wildly optimistic and excited and other days despondent and pessimistic. If we didn't have the anchor of intrinsic value, we would find it much tougher to resist the seductive blandishments of Mr Market's salesmanship.

Valuing a company involves an inherent conflict that needs to be recognised and then addressed. The conflict is that on the one hand, theory suggests that the value of a company is the sum of future discounted cash flows. However, all empirical evidence suggests people can't accurately forecast in the future. How then can we value a company if we know we can't forecast?

Our response is to systematically codify protections against these failings. Accordingly, when we value a company, we have 3 main checks and balances to ensure we think in risk-adjusted terms:

1 We use 3 scenarios – worst case, central case, best case. This encourages us away from thinking about being right (and invariably being wrong) towards thinking about a range of outcomes – somewhere in between how wrong could things sensibly go, or indeed if all the stars align - how well could things reasonably go.

2 In assigning probabilities to the 3 scenarios, we go with a uniform 30%/40%/30%. There are pros and cons of this approach, but this response again deals with overconfidence and prevents 'gaming' of a 'preferred' outcome.

3 We will then systematically review the forecast cash flows relative to a more stable benchmark, in our case, revenues. This is another way of anchoring our valuation work in the past.

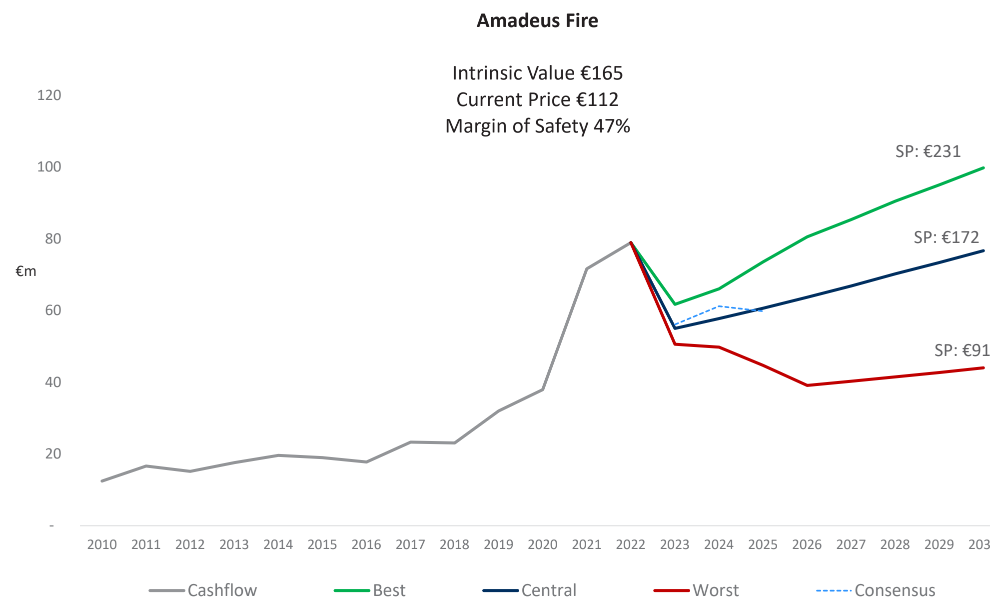
Example - Amadeus Fire

Amadeus Fire is a c.€600m market cap specialist German recruitment and training company. The specialism is in the placing of accounting, finance, and IT professionals with clients. These are all sectors in structural short supply. The company slogan is 'We will find what you are looking for. Faster than expected. More suitable than imagined'. The company have an excellent long term track record, but just before Covid they bought Comcave, a provider of modular training services. It's a good business, a high proportion of training is government funded retraining with IT skills and the rationale was to access qualified candidates for the recruitment business as this was the main bottleneck to faster growth. The acquisition was debt funded and the timing of this brought the shares down. We made our initial purchase in 5/20 at €89.5.

Our current shorthand assessment of the company is 8 for 8 – an 8% FCFY for 8% top line growth. Let's look a bit closer at our calculation of intrinsic value.

"Intrinsic Value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life"
- Warren Buffet

"An accurate estimate of intrinsic value is the essential foundation for steady, unemotional and potentially profitable investing"
- Howard Marks



Source: Chelverton Asset Management, Factset, as at 24/7/23

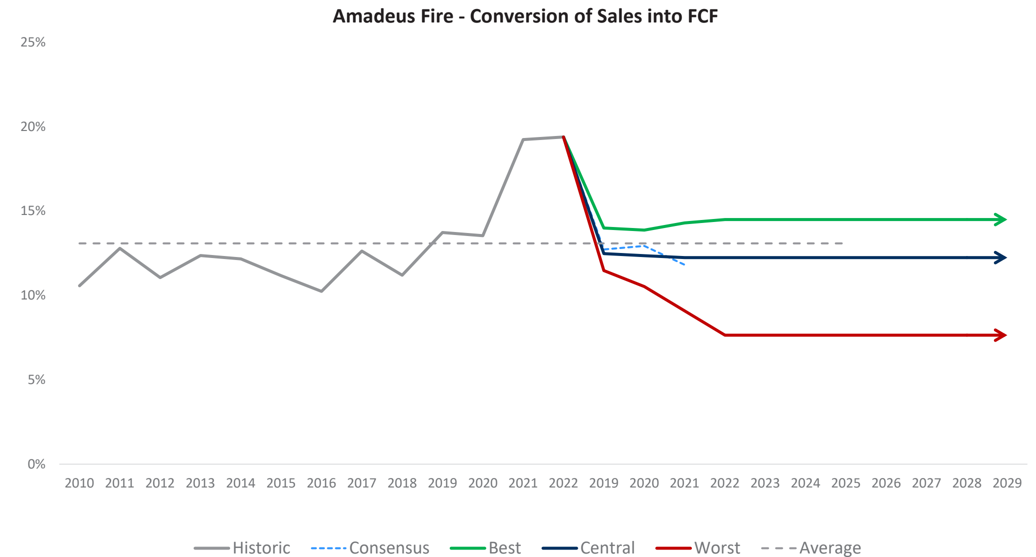
Our calculation of intrinsic value is based then on a discounted cash flow calculation. We use as few inputs as we can get away with (sales growth, margins, capex, interest, tax) to derive three possible patterns of future cash flows then discount all these back to a current value.

Above we see our 3 future scenarios grafted onto the company's historical free cash flow. As mentioned, there was an acquisition as well as an accounting change and this accounts for the blip up and then back down in 2020/2021. In our central case, AF will grow FCF from €55m to €77m over the next 8 years. In the worst case, FCF declines over 8 years to €44m and best case FCF reaches just shy of €100m. For us, this passes a reasonableness test. As can be seen, our central case is in line with consensus.

As an additional check that we have not got too carried away in any direction we also review the FCF/Sales ratio under each scenario to make sure we haven't gamed our modelling. Here is the resultant output:

Historically the company has been a very consistent converter of sales into free cash flow. Ignoring the blip up and then down from the accounting change, our long-term assumptions appear sensible, if anything slightly more skewed to the downside compared to history..

The calculation of Intrinsic Value then is (30% x 91) + (40% x 172) + (30% x 231) = €165. Current price is €112, so we have a margin of safety of just under 50%.



Source: Chelverton Asset Management, Factset, as at 24/7/23

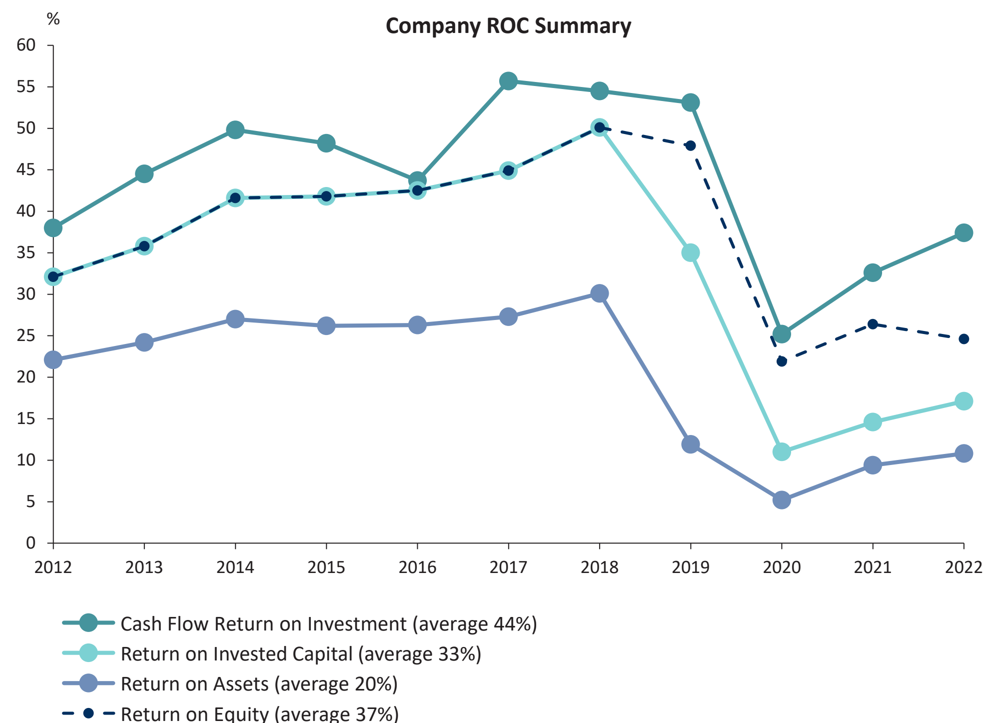
Assumptions

Behind these output graphs is of course our qualitative assessment and financial forecasts. In short, we think the company's unique approach to its market and its moderate market share mean it can replicate history and keep growing and converting cash at decent rates. The scenario that we are wrong appears to be covered by our harsh looking downside scenario but even in this scenario there is only 20% or so downside to the price.

With AF, we also think it is worth pointing out its very strong quality metrics. The various long-term return on capital metrics we consider are shown in the table and chart to the right.

All these metrics suggest a company doing a great job at creating value for shareholders.

On the risk side of the equation, we would include a range of considerably worse German economic outcomes, a poor integration and therefore strategically questionable acquisition of ComCave and a more capital-intensive business mix shift which would lower the range of returns noted above. We think we have addressed these risks in the outputs seen above.



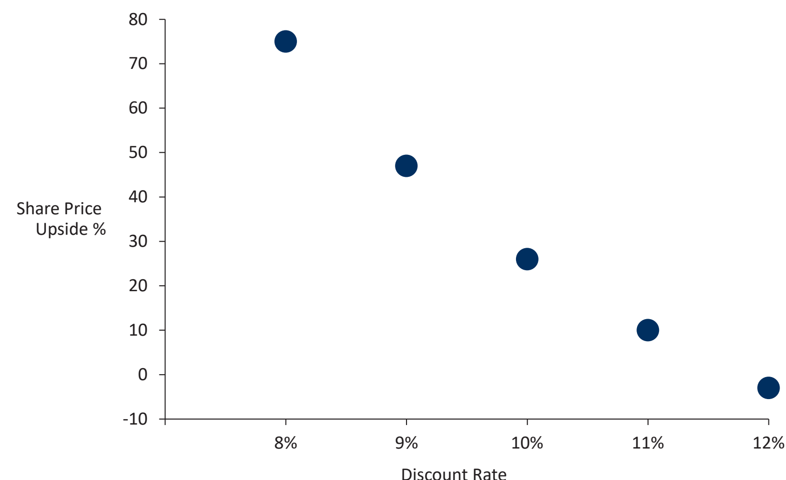
Source: Chelverton Asset Management, Factset, as at 24/7/23

Discount Rates

Anyone who has done any discounted cash flow modelling will tell you that the discount rate used is a key input. As in all valuation concerns, in our opinion, any form of precision should be discouraged. We have always believed in checking valuations over a range of discount rates. For our first 5 years we used a range between 6% and 10%. Nearer 6% would, for example, be justified by a company with a long and stable history. 10% would be used where a relatively new company to market had a volatile cash generation track record. Last year we recognised the move up in inflation and moved our discount rate range to 8% to 12%.

We had been using an 8% discount rate for Amadeus Fire but moved this up to 9% recently. It is the 9% which underpins the outturns we discussed. The discount rate is subjective and for AF, given its stable history, the quality and consistency of returns and the now ungeared balance sheet there was an argument for staying at 8%.

The 9% decision was influenced by our ESG assessment of the company. In general, there is low ESG risk at AF, but our sense is the company is more focused on compliance with rules than it is in really believing that ESG offers an opportunity to improve its operations wider contributions. This is not unlike a number of our smaller-cap holdings and accordingly, we have targeted AF for engagement on these matters. This is how the margin of safety looks at the different discount rates:



Source: Chelverton Asset Management, as at 24/7/23

We feel comfortable with this range of outcomes. Even increasing the discount rate to (a very harsh) 12%, AF is still fair value.

It's a cheap stock!

It should be noted that the total return we can reasonably expect from AF is, at some point a 50% or so closing of a valuation discount PLUS the annualised 9% discount rate. Without trying to be too precise, AF could have 50-100% of upside, and this is how we think of it. AF also contains what is a critical element of any investment case - a risk profile strongly skewed to the upside – limited downside and potentially significant upside. Heads we win, tails we don't lose much. In the words of Falco. Our FCFY/Growth equation and our calculation of intrinsic value are our 'key metrics' but we usually triangulate with more conventional metrics to see how others might be seeing the stock. AF trades on a 2023 PE of 13.6x, a 4% 2022 DY and 6.3x EV/EBITDA another popular but flawed valuation metric.

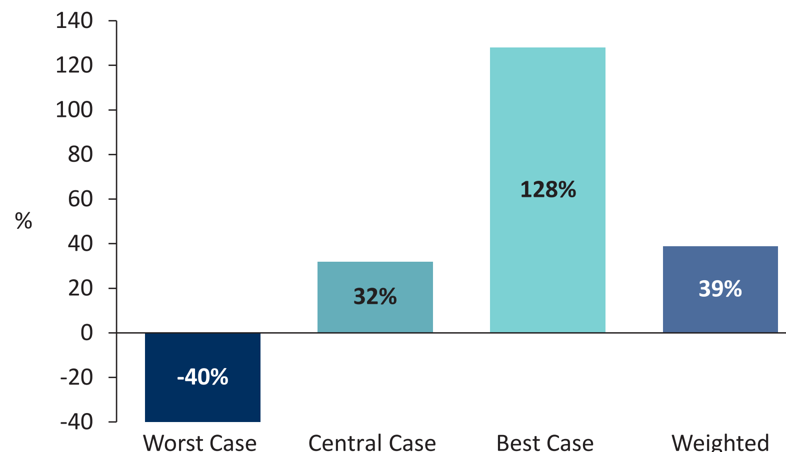
Portfolio Intrinsic Value

We switch focus now to thinking about intrinsic value at the portfolio level. As with our FCFY and sales growth equation, we can aggregate the DCF information to the portfolio level and weight it by current stock positions. The chart on the right shows the output.

So, the portfolio is c.40% 'cheap'. The weighted average discount rate we use in the portfolio is 8.8%. If you believe, as we do, that valuation discounts tend to unwind over 3-5 years or so, it is not unreasonable to expect 50%-80% or so upside from the current portfolio over the coming years, i.e., including the annualised 8.8% return. This triangulates with a current FCFY between 6% and 7%, which we think should really be closer to the market level of 4.6%.

When we look at discount rates that are getting used in practice, we tend to observe lower levels than our 8.8%. If we used lower discount rates our upside would be higher. In rough terms if we dropped the discount rate by 1%, we could add another c.30% to the upside.

In this instance we prefer to err on the conservative side. If inflation and interest rates are to settle at much lower levels, then our margin of safety would only increase.



Source: Chelverton Asset Management, Factset, as at 24/7/23

Conclusion

Our FCFY/G equation is our shorthand. Every stock has its FCFY/G equation, but this is supported by an in-depth analysis and full assessment of intrinsic value.None of this is a precise science, it is at least as much art, but it gives us confidence in the belief that we have a cheap (and fast growing, although we haven't focused on growth much here) portfolio. Sure, it has downside possibilities, but the long-term risk skew is strongly to the upside.

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Chelverton Asset Management Limited
11 Laura Place, Bath, BA2 4BL
Tel 01225 483 030 (Bath)
Tel 020 7222 8989 (London)
Tel 0131 357 1041 (Edinburgh)
Email cam@chelvertonam.com
Visit chelvertonam.com

Spring Capital Partners Limited
Basildon House, 7 Moorgate, London EC2R 6AF
Tel 020 3307 8086
Email chelverton@springcapitalpartners.com
Visit springcapitalpartners.com