

# Value Line: Why I don't buy iSoft



By Roger Montgomery

**PORTFOLIO POINT:** Cash in the bank offers better returns than iSoft, which is still trading well above its intrinsic value.

This week I had intended to announce a change to the portfolio, but in the past few days I've had the pleasure of corresponding with David, a Eureka member with expertise in the Health IT sector. He expressed concern about Value Line's valuation of iSoft, a company in that very space.

iSoft is not in the Value Line portfolio. Instead it is a company that sits next to Amcor as one of the two examples of the sorts of companies that, using the rather conservative value investing approach I adhere to, I would not invest in.

There are two parts to a desirable stockmarket investment: it needs to be a great business and a great bargain. I want both. Of course, you can make money with one, you can even make money with none, but gambling is not something I am good at.

Acting within your "circle of competence" is also a key part of success in this line of work; where many go wrong is in believing that the odd racetrack-style win makes them an investor. Gambling is not investing, so saying you are a value investor but then buying, for example, an emerging energy explorer or producer, is the sort of clumsy inconsistency that can lead to pain and suffering.

With that in mind, I cannot tell you what iSoft's share price will do. If a takeover bid emerged tomorrow or the company released a version of its software that took the world by storm, the share price might surge, but these are largely

unpredictable events. Speculating, by definition, is betting on the unknown. Investing, however, deals with what is known and what Value Line does know with some confidence is that iSoft's current share price is far above its current value.

Following the release of iSoft's 2009 annual results, Value Line's valuation is now about 20¢ (see table) – a massive increase from the 4¢ Value Line estimated as intrinsic value before the full year result, but still a long way from the current traded share price of 85¢.

The reasoning behind the valuation is simple. The business currently has 73¢ per share of equity (which is entirely represented by accounting goodwill) generating a return on equity (ROE) of a mere 5%; it only returned 2.5% last year, hence the very low valuation. These are very low rates of return (you can get this return in a bank account for virtually no risk), and substantially lower than the mid-teens recorded between 2005 and 2007.

The reason for the lower rates of return on equity is an equity and debt-funded acquisition. In 2008, when the company was called IBA Health, shareholder equity rose from \$156 million to \$585 million and borrowings rose from \$7 million to \$333 million to fund the purchase of the UK company iSoft (whose name IBA then adopted). The resultant low rates of return suggest the price paid for the acquisition was well and truly on the enthusiastic side – a similar problem to that faced by the ASX or Wesfarmers (see [Value Line: ASX and Telstra](#)).

Perhaps more importantly, the business's equity valuation is now being tested, being made up of 91¢ in intangible assets. More than \$500 million of that intangible asset is accounting goodwill and \$31 million is capitalised software development expenses, cash spent on building software that has not gone through the profit and loss statement. There is also \$194 million of IP as well as customer contracts, patents and trademarks valued at \$165 million.

David, with his expertise in health IT, would be worth talking to about the validity of the two latter items. But while accountants and auditors may try to estimate what these assets are worth in isolation, their economic value is only related to their earnings power. Given that the business is currently generating returns commensurate with a low-risk bank account, the carrying value of the intangible assets is hard to justify.

It will be interesting to read the auditor's sign-off in the next few annual reports if there are no write-offs and return on equity doesn't improve meaningfully.

It is not uncommon to find great ideas or assets buried in a business burdened by debt or massive amounts of share capital because managers and directors have simply paid too much.

## Valuation changes

Name	Date	Previous	New	Change
The Reject Shop	26/08/09	\$11.45	\$11.27	-1.57%
Amcor	26/08/09	\$2.66	\$2.84	6.77%
CSL	26/08/09	\$25.18	\$28.99	15.13%
JB Hi-Fi	19/08/09	\$18.10	\$21.70	19.89%
Cochlear	19/08/09	\$48.70	\$58.67	20.47%
Platinum Asset Mgt	26/08/09	\$2.18	\$2.92	33.94%
iSoft	26/08/09	\$0.04	\$0.19	375.00%
Woolworths	2/09/09	\$22.86	\$26.70	16.80%
Westpac		\$18.13		
Reece	2/09/09	\$12.81	\$13.70	6.95%

**Value Line portfolio, as at September 1, 2009**

Company	July 1 price	Price today	Est value	Margin of safety	Bought	Invested (\$)	Value (\$)	Divs rec	Total return	Total return
JB Hi Fi	14.8	18.18	21.7	16.2%	845	\$12,500	\$15,355	0.29	\$3,100	24.80%
Cochlear	56.36	58.83	58.7	-0.2%	102	\$5,744	\$5,996	0.95	\$349	6.07%
CSL	31.81	32.02	28.99	-10.5%	163	\$5,197	\$5,232	0	\$34	0.66%
The Reject Shop	11.62	13.4	11.27	-18.9%	513	\$5,959	\$6,871	0	\$913	15.32%
Woolworths	26.16	28.6	26.7	-7.1%	206	\$5,377	\$5,879	0.56	\$617	11.47%
Westpac Banking Corp	19.68	24.85	18.13	-37.1%	295	\$5,811	\$7,337	0	\$1,527	26.27%
Reece	17.8	21.65	13.7	-58.0%	236	\$4,209	\$5,120	0	\$910	21.63%
Platinum Asset Mgt	4.06	5.1	2.84	-79.6%	854	\$3,467	\$4,355	0.12	\$991	28.57%

**Since July 1**

Security Value										\$56,145
Cash Value										\$51,736
Total Value										\$107,880
Total Return (\$)										\$8,439.50
Return Invested (%)										17.49%
Total Return (%)										8.44%
All Ordinaries change										14.30%
* Outperformance (I): Outperformance of Invested Portion										3.19%
* Outperformance (T): Outperformance of total portfolio										-5.86%

\*adjusted for buyback

**Under observation**

iSoft	0.635	0.86	0.19	-352.6%						-35.43%
Amcor	4.79	5.72	2.84	-101.4%						-19.42%

There are, however, some positives. Profits, while unchanged from 2005, are significantly better than the losses recorded between 2000 and 2003. Cash flow is also vastly superior to previous years and analysts are forecasting a return to dividends in 2010 and 2011.

Irrespective of the positives, the spread between valuation and price keeps my own money in the safety of cash. Unless returns on capital improve significantly (and experts and auditors may know something that I do not), the valuation is unlikely to rise materially in the next 24 months and, from a purely investment perspective, I cannot see any justification for the current share price.

In the short run, the market is a popularity contest; in the long run, anything can happen – share prices follow value. Many investors may ask how long such a situation can persist. In answer I remind readers about Telstra, whose share price at \$9 was nearly triple the company's intrinsic value at the time. iSoft's value has to rise dramatically to justify the current price. It will remain one of the stocks we will watch with interest, tracking the changing relationship between price and value.

Finally, turning to the portfolio as it stands today, the Value Line stock picks are doing a phenomenal job of trouncing the market, returning 17.1% since July 1, versus the All Ords 14%.

For the month of August, Westpac rose 14.5% and Platinum, 11.6%. Dividends have started arriving as well.

So chalk one up for the "Blind Freddy" portfolio of quality companies Value Line selected.

The Warren Buffett approach, that only buys when a company is trading below its estimate of intrinsic value, is also doing well having fully invested its 12.5% per stock allocation in JB Hi-Fi, which has returned slightly less than 25%.

Overall, of course, the Buffett-approach is lagging the market because it is not fully invested. You might recall Value Line did not commence until July 1 and by then the current rally was well under way. ◆

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