

ValueLine: Goodwill hunting



By Roger Montgomery

PORTFOLIO POINT: Goodwill comes in two forms: economic and accounting. Don't over-pay for accounting goodwill.

This week, a brief dissertation on goodwill. Brief, because my column rarely allows me the space to give all my thoughts on a subject; and on goodwill, because it is a natural extension of last week's column on Transurban.

The recent bid for Transurban by two Canadian pension funds highlights the absurdity of the conventional approach to valuing companies, and the prices willingly offered – in the name of goodwill.

Economic goodwill can exist in a company that is disliked by its peers and even its customers. Conversely, a company that is admired, such as Qantas, can have no economic goodwill of value.

When one company acquires another, the total purchase price may be well in excess of the fair value attributed to

the identifiable assets (less liabilities). In such cases, the accountants assign an amount to goodwill.

Accounting goodwill indicates that bean counters are far more creative than they have been given credit for. To understand accounting goodwill and how dissimilar it is compared to economic goodwill, we may turn to the ValueLine portfolio for a demonstration.

In 2004, I bought shares in The Reject Shop at a market value of \$58 million. Its earnings in that year were \$5.6 million, its cash flows were significantly higher and importantly for this discussion, it had \$17 million of net tangible assets. Its earnings seemed to underestimate the future likely earning power and I paid a lower multiple for this business than Warren Buffett famously paid for See's Candy.

Few businesses can generate an after-tax return on net tangible assets of more than 33% without using large amounts of debt. It is obvious then that when a business can generate returns well in excess of rates available elsewhere, they are worth far more than their net tangible assets. Bruce Greenwald, professor of finance and asset management at Columbia University's Graduate School of Business, suggests the capitalised value of this excess return is the economic goodwill of The Reject Shop.

You see, it wasn't the \$17 million of net tangible assets – the inventories, the debtors or the property plant and equipment – that was generating these excess returns. These

The ValueLine portfolio, as at November 24, 2009

Company	Paid	Today	Est value	Margin of safety	Bought	Invested	Cap value	Divs rec	Total return	Total return
JB Hi-Fi	14.8	23.5	25.76	8.8%	845	\$12,500	\$19,848	0.29	\$7,593	60.74%
Cochlear	56.36	63.01	56.3	-11.9%	102	\$5,744	\$6,422	0.95	\$775	13.48%
CSL	31.81	31.63	32.87	3.8%	163	\$5,197	\$5,168	0.4	\$36	0.69%
Woolworths	26.16	28.01	26.85	-4.3%	206	\$5,377	\$5,758	0.56	\$495	9.21%
Reece	17.8	22.02	14.83	-48.5%	236	\$4,209	\$5,207	0.33	\$1,076	25.56%
Platinum Asset Mgt	4.06	5.45	3.95	-38.0%	854	\$3,467	\$4,654	0.12	\$1,289	37.19%
CommBank	46.51	52.41	52.81	0.8%	215	\$10,000	\$11,268	0	\$1,269	12.69%

Since July 1

Security Value										\$58,325
Cash Value										\$56,635
Total Value										\$114,960
Total Return (\$)										\$14,959.58
Return Invested (%)										31.00%
Total Return (%)										14.96%
All Ordinaries change										19.60%
* Outperformance of invested portion										11.40%
* Outperformance of total portfolio										-4.64%

Negative watch

Company	July 1	Today	Est value	Margin of safety*	Divs rec	Total return
ISOFT	0.635	0.785	0.19	-313.2%		-23.62%
Amcors	4.79	5.62	3.63	-54.8%		-17.33%

physical assets can be purchased and replicated by anyone. Rather, it was the intangible assets – the reputation for good value, the brand and the combination of people, skills and systems – that produced the excess returns, the capitalised value of which is the economic goodwill.

Now for some accounting. Had I bought the whole business and paid \$58 million, the excess above \$17 million (\$41 million) would have been allocated by my accountants to an asset on my company's balance sheet also called goodwill. But this is not economic goodwill.

Thanks to some handy forecasting on my part, my purchase price left me with far more economic goodwill than the accounting goodwill suggested.

In the ensuing five years, profits looked like this: \$6.5 million in 2005; \$9.1 million in 2006; \$12.3 million in 2007; \$16.7 million in 2008; and \$19.1 million in 2009. On my purchase price of \$58 million, the returns are 11.2%, 15.7%, 21.2%, 28.7% and 33%. Comparing these returns to those I could have obtained elsewhere on my \$58 million, which included \$41 million of accounting goodwill, the only conclusion that can be reached is that I got a very good deal. The difference between what I paid and the price above which a “good deal” would no longer be evident, represents the excess of economic goodwill over accounting goodwill.

This happy situation is not always the case, however. Take, for example, a company that also earned \$5.6 million, but needs \$237 million of net tangible assets for “normal” operations. The return of 2.3% on net tangible assets suggests Qantas possesses virtually no economic goodwill and that such a business should sell for no more than its net tangible assets, arguably for a lot less.

Take yet another business that also earned \$5.6 million but required \$56 million of net tangible assets. This third business earns 10% on its net tangible assets and is probably worth its net tangible assets. But in buying the Reject Shop, I paid more than that for a business with far less in net tangible assets. This is because whether there is inflation or not, there will be far more cash left over for growth, for acquisitions or for distribution to owners in a business with high returns on net tangible assets. The higher returns indicate greater economic goodwill and thus a higher intrinsic value.

It is for this reason that investors who look to book values as an indicator of whether they are getting a bargain are looking in the wrong place and why investors, both individual and corporate, need to be very careful of over-paying for companies with large amounts of accounting goodwill but precious little of the economic variety. ◆

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