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Earnings growth eagerly awaited

The price to earnings (PE) ratio of the Johannesburg Stock Exchange's All-Share Index is currently 17.25, more than one standard deviation above its 10 year average of 13.8. Its dividend yield, another commonly used measure of value, is currently 2.17% versus its 10 year average of 2.87%. At face value, when compared to its own history, the index is expensive. Whether it turns out to be depends on what happens to earnings and resulting dividend payments in future.

At this juncture it must be mentioned that a few large companies have suspended dividends since the onset of the crisis which artificially depresses the ALSI's current dividend yield. In order to be in line with its 10 year average PE, index earnings and dividends, however, need to grow by 25.5% and 32.2% respectively. To put this into context, up to July 2010, 10 year compound annual growth of index earnings and dividends was 12.3% and 13.1%, after being substantially lowered by the impact of the financial crisis. After all, index earnings and dividends dropped 33% and 42% from their peaks in 2009. It is interesting to note that before the onset of the financial crisis the compound annual growth rate of index earnings and dividends between 2000 and 2009 had been 19% and 21.5%.

Regular readers of this publication would be well aware that we avoid taking bets on the direction of the index and rather spend time on understanding individual companies and valuations thereof.

With this in mind we thought it would be of interest to see how a select group of companies of different sizes are valued relative to their own histories in order to determine if a different picture to that of the index valuation emerges. For this exercise we randomly segmented the market into companies larger than R10bn in market capitalization, between R5bn – R10bn and those smaller than R5bn. In each segment we selected the largest 10 companies, as measured by market capitalization. As a word of caution, earnings numbers and hence PE ratios get distorted from time to time due to once-off effects such as asset disposals or BEE deals, as well as very cyclical earnings changes.

The table below highlights the results of our brief study and a similar picture to that of the index emerges. The result for the ten largest counters above R10bn should not come as a surprise, as these companies represent 57% of the index. Companies in the middle segment told a similar story, one of above average PE ratios and below average dividend yields.

Table 1: % of companies per segment that resemble valuation characteristics of the ALSI

	above average PE	below average DY
10 largest stocks > R10bn	70%	60%
10 largest stocks R5bn - R10bn	60%	80%
10 largest stocks < R5bn	30%	20%

Source: I-Net; PSG Alphen AM

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However, smaller companies were the standout of the study. Only around 30% of the sample of companies below R5bn appear expensive from an earnings and dividend yield perspective, which is substantially lower than firms in the other size brackets.

Of other particular importance was the fact that basically all stocks that are trading at above average valuation levels also required growth in earnings and dividends that exceeded their historical growth rates to justify the ratios.

While the above is a relatively simplistic way to look at markets in general, it attempts to make the point that the index and the resulting majority of stocks are pricing in healthy growth rates, and disappointing economic data and resulting slower than expected resumption of earnings and dividend growth poses risk to share prices over the medium term.

As always, our preferred strategy is to largely be invested in companies that have strong sustainable business models that do not require the “earnings leap of faith” to justify current valuations. While the index as a whole does not satisfy this requirement, careful stock picking, in our view, does. As was briefly demonstrated in the table, the smaller company part of the market could prove especially fruitful to those willing to dig deep.

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