

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

OFFICE EXPANSION

As we begin our fourteenth year of helping valued clients achieve their financial goals, we are most gratified by and grateful for the extraordinary business growth we have experienced over the years. We greatly appreciate your support — thank you! To accommodate and service the growth in our business, we're excited to announce that we have just added another office suite that adjoins Suites 400 and 405. Please do come by to say hello and see our new offices!

Analyzing Financial Companies

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Many financial companies are suffering heavily this year because of defaulting mortgages and massive credit problems infecting the markets. Consequently the stock prices of such companies have been decimated in some cases. As value investors, we have been naturally drawn to investigating this sector for possible investment bargains. However, as always it is important to distinguish between true values and “value-traps” (i.e. companies that appear attractive on a longer-term basis, but ultimately fail to rebound because of secular problems).

Evaluating financial companies requires a radically different analytical tool set, because their operations

Thanks for your referrals!

As we conclude our thirteenth year of publishing *Observations*, we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past thirteen years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

vary significantly from those of their non-financial counterparts. For one, financial companies are heavily regulated and subject to different accounting rules. Second, a significant part of reported income (or loss) for financial companies comes from investment related gains (or losses), which could vary drastically under different market conditions from one reporting period to another. Third, typically a large part of financial companies' asset base consists of investment assets and securities, often including complex securities that are difficult to value. Consequently, analyzing finan-

Inside This Issue:

- Analyzing Financial Companies p.1

cial companies requires an approach that recognizes their unique characteristics and risks.

While the price-to-earning (P/E) ratio is a popular valuation tool, it is not nearly as useful when it comes to valuing financial companies; in fact, using this ratio could yield conclusions that are downright misleading. Due to the nature of their businesses, financial companies typically hold a sizeable portfolio of investment securities, whose realized gains or losses (and in some cases even unrealized gains or losses) are included in reported earnings. While accounting rules require many types of gain or loss from investment activities to be included in reported income, for non-financial companies whose core business involves activities that are unrelated to investment and/or trading operations, such gain or loss should, for the most part, be excluded from reported income.

In contrast, investment and/or trading activities are generally integral to and a significant part of the core operations of financial companies. As such, gains or losses from such activities should be viewed as part of a financial company's normal operations and included in reported income. However, unlike other types of income earned from core operations, investment and/or trading gains or losses can and do fluctuate drastically from one reporting period to the next, based on market conditions. As a result, strong investment gains in good periods could easily mislead investors to overestimating a financial company's normalized earning power and accordingly overvaluing its shares. Similarly, it would be inappropriate to extrapolate unusually poor investment results for any period. This is because extraordinarily good investment or trading results are inevitably followed at some point by poorer outcomes; the long-term average is destined to be somewhere between the really good and poor periods. The volatility of investment gains or losses and their often significant impact on reported earnings greatly limit the usefulness of the P/E ratio as a valuation tool for financial companies.

Generally, the price-to-book value (P/BV) ratio is a more appropriate valuation tool for financial companies. The ratio is calculated as follows:

$$P/BV = \frac{\text{Market price per share}}{(\text{Reported book value} / \text{Shares outstanding})}$$

A company's book value equals its total assets minus total liabilities. As a gross simplification, book value takes into account, *on a cumulative basis*, the net income or loss generated by a company over its lifetime. As such, it is a rather crude, but still quite useful, method for tracking the cumulative profit/business progress that a company makes over time. To the extent that reported income retained to equity fluctuates widely from one reporting period to the next because of volatile investment results, examining the progression of book value over time helps smooth out such short-term volatility to gauge overall profit progress over time. As such, a financial company's book value can provide a more stable basis for measuring a company's value than reported earnings. For example, even if a company temporarily lacks earnings, rendering a P/E analysis meaningless, a P/BV analysis can be used to gauge the company's value range.

However, the prudent investor must overcome several significant hurdles in applying the P/BV ratio appropriately. Since book value equals total assets minus total liabilities, you must judge whether the respective values of these items are being accurately reflected on the balance sheet. Like reported income statement items, values of assets and liabilities reported on the balance sheet are determined by accounting convention and can deviate considerably from their true market values.

Liabilities tend to be relatively straightforward. Most short-term liabilities like deposits, accrued expenses, short-term loans etc. generally can be taken at their reported values. The reported amount of some long-

term liabilities overstates the true present value when market conditions require increasing the discount rate; the opposite is also true — as the discount rate drops, liability value is understated. However, it is impractical to make these adjustments on the balance sheet since rates fluctuate daily. The challenge is really in determining the market values of certain reported assets.

In valuing the assets of financial companies, both the composition and quality of the investment and loan portfolios merit special attention. As mentioned earlier, financial companies usually hold significant amounts of securities. Except for investment securities that are intended to be held until maturity, securities are required by accounting rules to be reported at fair market values. Financial companies usually obtain these fair values from quoted market prices in active and liquid markets. As long as there are multiple sources corroborating values, it is reasonable to trust the asset values as reported on the balance sheet, and the application of a P/BV analysis is relatively straightforward.

However, often some securities are highly difficult, if not impossible, to value, when the market liquidity dries up or the inherent complexity of the securities prevents easy valuation. This is precisely what happened this summer with collateralized debt obligations and certain types of mortgage-backed securities.

When the value of securities cannot be estimated within reasonable ranges, it is important to be conservative and mark-down the values by taking adequate impairment provisions or reserves. These are essentially charges that address the risk that the stated asset values are in fact too high; their true value, for whatever reason, is lower than that stated on the balance sheet.

A company can inflate the value of its securities intentionally or in good faith. In the former case, the company might have held off recognizing the decline hoping values will rebound, even if such an outcome is highly unlikely. While the accounting rules govern when companies have to mark down asset values, there is still considerable wiggle room as to the timing. At other times, the value impairment is more nebulous and unclear, and management may delay writing down the value of the asset in good faith, though in hindsight they should have done so earlier.

Certain financial companies, like banks, generally also hold a large portfolio of loans that are held either for sale or for investment (i.e. until the loans mature). Loans that are held for sale, similar to investment securities, are reported at fair values that are generally based on quoted market prices of similar instruments. The difficulties associated with and the need for a conservative approach for valuing investment securities discussed earlier also apply here.

Loans that are held for investment are reported at fair market values as well, but such values are generally based on the present value of the future cash flows that the company expects to receive. This calculation is dependent on prepayment and discount rates, among other things. Reported values can be overstated when the prepayment and discount rates assumed by the reporting company are too low.

More importantly, the value of such loans can be inflated by understating the risk of credit losses and failing to provide adequately for future loan losses. Yet what is sufficient is mostly subjective and extremely difficult to determine in times of market stress, as evidenced by the current market conditions for subprime loans. In extreme times like these, loan loss provisions based simply on historical write-off patterns would certainly be inadequate. To estimate conservatively the fair values for such loans would require escalating the loan loss provisions substantially.

Not all required asset adjustments negatively impact book value. Companies that have long-lived assets

that are recorded at historical cost (e.g. appreciated real estate) would be understating the current asset value. In this event, reported book value should be adjusted upward to reflect the appreciation in market value of these assets.

After the necessary adjustments, you can compute the price to adjusted BV ratio. In isolation, this ratio is meaningless. This metric must be analyzed in the context of the normalized return-on-equity (ROE) that the underlying business is able to attain over time. The ROE is simply net income divided by the book value. The higher the ROE, the more profitable a company. As a corollary, companies with higher ROE's deserve to be valued at higher P/adjusted BV ratios.

In contrast, a company selling at a discount to book value does not necessarily indicate undervaluation. A company trading at a P/BV ratio less than 1 generally shows that investors believe its book value is inflated or expect the company to continue generating poor returns (often losses) in the near future. But if a low P/BV ratio is the result of a temporary event that induced excessive pessimism on the company's future growth prospects, and the company continues to possess certain competitive advantages that would eventually help it rebound, then the company could potentially be a value opportunity.

An example would illustrate the interrelationship between ROE and the P/BV ratio. Let's say a company is highly profitable, earns a 20% ROE and reinvests all its net income back into the business each year (rather than paying part of it out in dividends) to take advantage of ample growth opportunities. If you are able to buy this business at one times book value, you will earn 20% the first year on your capital. The 20% return is then plowed back into the business to grow the capital base and the business earns 20% again the next year, but on a higher capital base. In this example, you would earn 20% compounded each and every year on your initial investment.

Now let's say the market recognizes the attractiveness of this company and bids the market price up to two times book value. You are now having to pay double the price, cutting your first-year return in half to 10%. However, after the first year the profitability of the business you bought into will continue to grow at 20% per year. In this example, while the higher price you pay for the shares will reduce your initial return, the value of your interest in the company will grow at a much faster rate than many other alternative investments. Both the initial return and the subsequent growth rate should be compared to a risk-free instrument like an intermediate Treasury note. To the extent the initial return and the growth rate from the equity investment are much higher than the yield on the Treasury note, you have potentially identified an undervalued investment.

Another crucial factor to examine in valuing financial companies is the availability and reliability of their funding sources. Since financial companies are by nature extremely leveraged, maintaining liquidity to meet debt and liability obligations is of paramount importance. It is therefore critical, when valuing financial companies, to examine the reliability of available funding sources, in addition to assessing the quality and composition of its assets.

While the business models of financial companies might not be all that difficult to understand, the accounting is very complicated and asset composition and values can be highly opaque. Analyzing financial companies is therefore generally a much more difficult task compared to analyzing non-financial companies. A great deal of conservatism is essential.

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