A Few Moments With . . . Value Line

by Mark Robertson, BI Senior Contributing Editor

My colleague and NAIC co-worker, Gerrie Ford, is a member of an investment club. Gerrie, like many members of the NAIC staff, participates in an investment club. It's not unusual to share ideas and educational tidbits as we all prepare for our meetings and discussions.

In this case, Gerrie shared a copy of a Value Line Investment Survey for American Power Conversion with me. She wondered if it was "worth" studying for presentation to her club. I took a quick look, checked some key characteristics, and handed it back to her. I said, "Sure. It looks good enough to me."

She said, "Thanks. I appreciate your thoughts, but I'd like a few more. If you would please, could you please help me understand what you just looked at for 30 seconds or so to reach that judgment? I'd really like to know."

In my opinion, the information on a *Value Line Investment Survey* is a formidable partner in support of our stock studies. Ken Janke reminds us that it represents the work of only one analyst, while other services deliver a consensus of information, particularly when it comes to the forecasts. However, I still feel very comfortable knowing that the Value Line analyst has already "shaped" the data, making an effort to account for unusual things.

American Power Conversion was featured as the Stock to Study in the July 1999 issue of *Better Investing*. Therefore, I had somewhat of a "head start" on this stock study. But the checkpoints are the same for most any company, and it's possible to decide whether to continue the study fairly quickly.

ANNUAL RATES of change (per sh)	Past 10 Yrs.	Past 5 Yrs.	Est'd '96-'98 to '02-'04
Sales	47.0%	38.0%	21.0%
"Cash Flow"	47.0%	32.5%	21.0%
Earnings	47.0%	31.0%	21.5%
Dividends	- -	- -	Nil
Book Value	54.5%	42.5%	25.0%

Sales & Earnings Expectations

Since this is a "snapshot" quick tour of the Value Line information, start the clock and we'll visit the important checkpoints that I use to screen for study candidates.

Our first stop is expected sales growth. Value Line provides a forecast in the left-hand column, approximately two-thirds down the page *(see figure above).* The 3-5 year forecast is 21 percent. This is a robust expectation for a mid-size company. The earnings forecast checks in at 21.5 percent. These are both solid. In a few moments, I'll build my own EPS forecast, but for now, this is sufficient to warrant further study.

Investor Expectations and Value

The second checkpoint relates to price. NAIC investors like to buy growth companies "on sale." Quality is good. Quality at a really good price is even better. A quick comparison of the price-to-earnings ratio with our expected earnings per share (EPS) growth rate is a start.

Value Line provides its "version" of a P/E ratio right at the top of the page, in the center.

P/E RATIO	18.4

(Value Line calculates its P/E with the price at the time of publication using the most recent two actual quarters of earnings and their forecast for the next two.) With an EPS growth rate of 21.5 percent and a P/E of 18.4, I note that they're fairly close to each other and proceed. (I'd consider stopping if the P/E ratio was more than twice the EPS growth rate.) This can be tricky. Higher P/E ratios usually are the result of higher expected growth rates and the "collective psychology" of higher expectations for the company.

Collective psychology is a very powerful thing. We see it manifested as "momentum" in widely popular stocks. Wouldn't it be nice if we could just assume that today's collective psychology, or P/E, for any stock would hold true five years from now? But we can't. Expectations can be elusive.

Ralph "Repair Shop" Seger speaks of the "power of P/E expansion" with a visionary long-term perspective. In fact, he attributes much of the historical success of NAIC investors to "capturing this power." That's why I feel it's worth checking the Value Line analyst's opinion about the future high P/E ratio while I'm screening. It's also one of the judgment influences that I use when completing Section 4A of my SSG, so I might as well check it now.

2002-04 PROJECTIONS	Price	Gain	Ann'l Total Return
High	45	(+150%)	26%
Low	30	(+65%)	14%

In this case, the Value Line analyst expects a future high price of 45 in 3-5 years. It's not five years, but it's close enough to provide me with some guidance. The 3-5 year forecast for earnings per share is $2.05. *(See the figure at the top of the next page that displays details for sales, cash flow, earnings and dividends for 1999, 2000 and 2002-04, or 3-5 years from now.)* This future high P/E is 45 divided by 2.05, or 22.0.

"Bolting" to Our Bottom Line

The secret of success of our time-honored Stock Selection Guide (SSG) is that

1998	1999	2000	© VALUE LINE PUB., INC.	02-04
5.87	7.20	8.80	Sales per sh	15.80
.93	1.10	1.35	"Cash Flow" per sh	2.40
.80	.95	1.15	Earnings per sh A	2.05
--	Nil	Nil	Div'ds Decl'd per sh	Nil

we carefully develop expectations for the companies that we study. In the process, we develop expectations for the contributions that our purchases will make to the success of our portfolios. We strategically buy them. We strategically hold them. We set our holdings "free," weeding our portfolios, when the fundamental characteristics change for the worse. We also consider selling when a stock becomes substantially overvalued.

In my opinion, the most powerful guidance is provided by my SSGs in Section 5. During my stock studies, I carefully explore what the company intends to do and under what conditions. Is it a perfect crystal ball? Obviously not. But it does represent the summary of some comprehensive reviews, assumptions and judgment. All of these considerations end up at one place:

The Expected Total Return in SSG Section 5.

This is where I'd like to discover 15 or 20 percent expectations. This is THE FIFTEEN PERCENT that we seek, and it sometimes has very little to do with the sales or EPS growth rates. Show me a quality company with an expected sales growth rate of 8 percent, an expected EPS growth rate of 10 percent that I understand — and an expected total return of at least 15 percent, and I can assure you that I'm interested. Quality is good. Quality at a really good price is even better.

In the case of American Power Conversion, the Value Line analyst expects the high price to be approximately 45 in four years. This provides an annualized total return of 26 percent and is shown in its 2002-04 Projections box at the upper left on its Survey. In this case, there are no dividends, and the 26 percent is the result of a future price of 45 — starting at the price of 18 on Oct. 22, 1999 — and growing at 26 percent for four years.

If you hate math, you can stop reading now and hand the sheet back to Gerrie.

Prefer A "Deeper" Snapshot?

If math gives you the heebie jeebies and you're still reading, be reminded that I warned you that you don't NEED to keep reading. You've got all that you need for your screening and ought to be starting your SSG or ordering that annual report already. But for the rest . . .

I PREFER (pun intended) five years instead of four. Plus, I want to get a deeper sneak preview of my SSG.

The BOTTOM LINE of the SSG is the expected (annualized) total return in Section 5. This result is the sum of price appreciation and dividend yield. With no dividends, the only factors at work are the current price, the expected high price and our five-year period.

The current price was 24 1/2 on 11/11/99 when Gerrie handed me the sheet. It had risen from 18 in less than three weeks. What we don't know is the expected high price. What is the Value Line analyst's "implied" five-year forecast, using the current price?

We build our expected high price in five years in Section 4A of the SSG. We need two things — an expected high P/E and expected EPS in five years. We already have an expected P/E, and use 22.0.

I wanted to start my forecast close to the end of 1999 — and I used the most recent four quarter total for annual sales. *(In this case, it is $1,385 million, as shown in the table below.)* If sales grows at 21 percent for five years, sales will reach $3,592 million.

Cal-endar	QUARTERLY SALES ($ mill.) Mar.Per.	Jun.Per.	Sep.Per.	Dec.Per.	Full Year
1996	141.6	161.4	193.8	210.1	706.9
1997	172.0	203.6	246.1	251.7	873.4
1998	218.9	260.6	327.4	318.9	1125.8
1999	277.2	315.5	*400*	*392.3*	*1385*
2000	*330*	*390*	*480*	*470*	*1670*

What does the Value Line analyst expect for pre-tax profit margin? With an expected net profit margin of 13.7 percent and an expected tax rate of 30 percent, we can calculate this with our 2A formula. 13.7 percent divided by (1 – .30), or 13.7/0.70 equals 19.6 percent.

Since the Value Line analyst also shares an outlook for expected outstanding shares, we can now calculate EPS in five years:

Sales in five years: $3,592 million
Times Pre-Tax Profit Margin: 19.6%
Times (1 - Tax Rate): 70.0%
Divided by Shares Outstanding: 190 mil.
Equals EPS in Five Years = $2.59

My snapshot expected high price is 22.0 times $2.59, or 57. Since a price of 24 1/2 grows at a rate of **18 percent** over five years to reach 57, I told Gerrie that it "**still** looks good to me . . . based on good EPS expectations, a favorable P/E of 18.4 vs. 22.0 in the future, good financial strength (B+ or above) and a healthy expected total return."

None of this meant to suggest that it can be a substitute for a complete SSG analysis. It can't — there are no shortcuts to successful investing. But Value Line can help to discover good prospects. I don't use Value Line's timeliness, safety or beta for anything, at any time. But Value Line is a formidable partner in my stock studies, and one of my favorite resources that helps to take the mystery out of investing.

'NAIC Most Active'

Here is a look at the companies attracting the interest of NAIC investors, according to their recent buy and sell decisions, as reported by a small, informal sampling — about 120 clubs and individuals — for the trailing two months ended Dec. 4, 1999.

Company	Buys-Sells
1. Amer. Power Conv. (2)	**20-0**
2. Clayton Homes (1)	**18-0**
3. Diebold (7)	**8-0**
4. Lucent Technologies (*)	**7-0**
5. Gentex (9)	**6-0**
6. Watson Pharm. (5)	**5-0**
7. Office Depot (*)	**4-1**
8. RPM (*)	**2-3**
9. ADC Telecom. (3)	**4-0**
TetraTech [WATR] (9)	**4-0**

Note: Figures in parentheses provide last month's ranking. (*) denotes unranked in previous month. This listing is presented as a source of stock study ideas in the current market. No investment recommendation is intended.

Please consider sending your investment transactions (including date, bought or sold, and company) to: manifest@better-investing.org or by postcard or letter to Better Investing, Box 220, Royal Oak, MI 48068.