Fundamental analysis
during high uncertainty

International Insurance-Reinsurance Forum, 12th edition
May 26, 2009

Bogdan Bilaus, CFA
CFA Romania

Summary

- Fundamental analysis – definitions, role;
- Valuation methods;
- Impact of uncertainty;
- What can be done?;
- Conclusion

Fundamental analysis – definitions, role;

Portfolio management

- asset allocation (x% stocks, y%bonds, z%cash);
- securities selection (a%StockA, b%StockB……);
- implementation, rebalancing;
- performance measurement.

Fundamental analysis – definitions, role;

Fundamental analysis - a collection of methods that attempts to determine a security's value by focusing on underlying factors that affect a company's actual business and its future prospects

Key facts

- it's not about price, it's about value;
- value is subjective;

Valuation methods

Discounted cash flows

- cash flow to the firm
- cash flow to the equity
- dividends

Multiples – not really “fundamental” analysys

- P/E
- P/B
- P/S

Multiples problems

- short sighted
- no local peer group
- cross border comparison is not relevant

Valuation methods - DCF

The value of an asset is the present value of its future cash flows

	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal value
Cash flow	X	Y	Z	W	S	TV
Discount rate	a	b	c	d	e	f
Present value	x	y	z	w	s	tv

Discount rate = risk free rate + risk premium

$$w = \frac{W}{(1+d)^4} \qquad TV = \frac{S(1+g)}{f-g}$$

$$Value = \frac{x+y+z+w+s+tv}{shares\_no}$$

Impact of uncertainty on DCF

- **CF difficult to estimate: sales, costs, taxes, interest rates;**
- **cost of risk is higher;**
- **risk free rate fluctuates;**
- **creative accounting;**
- **risk of fraud and penalties;**

What can be done?

- use DCF for relative value, not for absolute value;

- set up clear system to asses the risk of each company;

- adjust risk free rate according to market movements;

What can be done? – relative value

Stock	Target price (value)	Market price	Upside potential %	Rank
A	15	12	25.00%	4
B	22	15	46.67%	2
C	17	11	54.55%	1
D	90	68	32.35%	3
……	…….	……..	……..	
R	145	122	18.85%	5

What can be done? – risk

Purpose: differentiate the risk premium;

- identify the risk factors and signals
  - sales volatility;
  - concentration of customers;
  - concentration of suppliers;
  - leverage – too high or too low?;
  - liquidity;
  - use of provisions;
  - Intragroup transfers;
  - quality of fixed assets;
  - management experience;
  - audit – Big4 or no name?
- build a system of scoring and ranking

Conclusion

FA is a usefull instrument, as long as we understand that:

- models do not provides answers, just help to ask the right questions;
- a model is a way to structure our toughts about a company;
- the result depends on the analyst, not on the model;
- there is no model to predict reality, but some models help improve our estimates;
- results cannot be better than the inputs

Questions and Answers