

## Value Traps: Bargain Hunters Beware!

### Prelude:

Without any iota of doubts, the Nigeria equity market has received one of the most severe ‘bashings’ year-to-date (YtD) across the global markets, dipping about 26 percent in value. It will be recalled that the Nigerian Stock Exchange All-Share Index (NSE ASI) shrank by 45.8 percent to close at 31,450.78 points in 2008; ranking amongst the top losers in the world!

As a result of this outrageous share price plunge, Nigerian equities now trade at abysmally low prices. Some companies’ shares currently trade close to their 3 to 4-year low - a scenario that is unprecedented in the history of the Nigerian market. This development probably led to an upturn in market tempo in the early weeks of February and subsequently, participants and regulators heaved some sighs of relief, anticipating sustainable decorum and confidence. However, the upbeat was rather short-lived as index nose-dived again to near 21,700.00 points, the all-time low in the past 5 years.

### ...Once Beaten, Twice Shy?

There is no gainsaying that the persistent price slides have resulted in momentous value erosion on the Nigerian capital market. Consequently, this has seemingly unleashed some ‘rare opportunities’ for value investors who are ‘bargain hunters’. However, investors may need to be more diligent and meticulous in their stock picking strategies by looking where others are not in order to profit from the market-wide sell-off and low pricing regime.

However, while participants (investors, traders and speculators alike) return to the marketplace for renewed activity level, we would like to make case for extra caution as the state of the Nigerian equity market demands that participants tread more carefully than ever. In an attempt to stage a comeback, there is a high tendency for investors to be ‘**value trapped**’ while trying to seek solace in value stocks with a view to avoiding a repeat of the most recent past.

**SEE PAGES 8 & 9 FOR OUR FEW SELECTED ‘VALUE TRAPS’**

## ...Be Wary of Value Traps!

We admonish the Nigerian equity market participants to be wary of **'value traps'** syndrome, an aftermath of prolonged sell-off which is usually prevalent during a prolonged market meltdown.

**Value traps are stocks that have experienced huge price depreciation and are mistaken to be value stocks.** This happens when the market or a stock seems grossly undervalued and looks promising, thereby luring investor into purchase in anticipation of imminent resurgence. However, if **low pricing level** is the **single investment attraction** for considering the stock, such investor is faced with possibility of further portfolio diminution, as the stock's price will most probably dip further.

## ...any distinction between 'Value Stock' & 'Value Trap'?

**Value Stock is a stock that tends to trade for less than its intrinsic value.** Put differently, a stock that trades at a lower price relative to its fundamentals (i.e. dividends, earnings, sales, etc.) and thus considered undervalued by a **value investor**. **Common characteristics of such stocks include a high dividend yield, low price-to-book ratio and/or low price-to-earnings ratio.**

Value investors actively seek stocks of companies that they believe the market has undervalued. They believe the market overreacts to good and bad news, resulting in stock price movements that are not commensurate with the Company's long-term fundamentals. Hence, this provides an opportunity for value investors to profit by buying when the price is deflated.

**Conversely, Value traps** are seemingly cheap stocks that turn out to be **'stinkers'**. Investors are tricked into believing they have found a bargain-priced refuge only to end up in a real pitfall.

## ...Spotting 'Value Traps':

While we encourage medium to long term investing in the Nigerian equity market during this period, investors are strongly advised to **'hunt'** for detail information and in-depth equity analysis for investment guide. Without mincing words, investors are faced with the huge challenge of falling prey to **'value traps'** where cheap-looking stocks stay cheap until and unless there is any fundamental improvement in performance indices.

Below are a few amongst the several clues that help in identifying some 'value traps' in the Nigerian equity market.

## 1. Waning Bottom Lines:

This is one of the requisite performance indicators used to spot a value trap. A meticulous study of trend in gross and/or net margins and earnings growth of a company, quarter-on-quarter is very important. A company may record incredibly low trailing multiples (**such as P/E, P/CF, P/BV**) courtesy of some **catalysts** that point to good prospects such as modest or above-average growth in margins and earnings, most especially after a severe market-wide oversold. This is a common scenario during economic and financial crisis that lead to markets meltdown. However, some stocks seem like attractive investment candidates because of low price multiples without any catalysts on the horizon, but rather enjoy market sympathy or good sentiments due to low prices. **Buyers should beware; such stocks could lead into value traps.**

## 2. The Low Multiple Value Trap:

In addition to the performance indicator above, companies that have been trading at low multiples of **earnings, cash flow or book value** for an extended period of time may be justified by their consistent and/or prolonged lack lustre performance; hence they have little or no promise in the short to medium term - and possibly no future. For some quarters running, some of these stocks have been trading under or near book value and look cheap by several other measures.

A reason for this can be that these companies have been having difficulty generating meaningful and consistent profits and are unlikely to attract interest of institutional or ultra-high net worth investors. This has deceived quite a number of retail traders and possibly some high net worth investors into believing that they are at their rock-bottom prices, hence selected into portfolio.

### 3. How Free Is The Free Cash Flow?

This is another crucial method to unearth value in a company or lack of it. Earnings can be massaged, manipulated or completely fabricated. But cash cannot. So, there is a need to make sure free cash flow is stable, or growing or at worst stable. If nothing less, it provides management with a little room for **'financial engineering'** or **'margin of error'** when considering ways to speed up a turnaround.

### 4. Lack of Near-Term Catalysts:

Undoubtedly, companies and stocks need catalysts in order to advance. If a company does not have new products on the horizon or expect to show earnings growth or momentum of some kind, investors should consider avoiding it.

A company's history should never be overlooked, and it should be compared to what the company's current financial statements look like. If the Company cannot improve upon its position operationally, it may have trouble competing with companies that can. Ultimately, the Company will probably also have trouble garnering attention from investors.

Many sophisticated investors and research analysts are usually on the look-out for a catalyst to hit the market before buying or recommending the stock. Once the catalysts disappear or become wide spread, they will abandon the stock.

### 5. Company's Market Share:

General economic outlook is one major consideration that will impact performance. However, when a company is losing market share, it may be an indication that its competitor(s) has (have) better strategies and know-how and invariably more efficient and profitable operational platform. While economic growth is cyclical, market share is not. Even if the economy or industry turns around, chances are the company's market share will not; hence, the possibility of diminishing earnings and reward to investors.

### 6. Small Floats:

There are many parameters that a company or stock must meet in order for the average institutional investors (like **Pension Fund Administrators (PFAs), Mutual and Hedge Funds Managers, Insurance Companies, e.t.c**) to take positions. Many institutional investors will not take position in a company unless its shares are very liquid. Companies with a small float or with few shares are unlikely to garner institutional attention because those investors will have difficulties acquiring and ultimately disposing of large quantities of stock. When institutions (who drive activity through volume) cannot participate in a stock, the shares tend to languish; by extension, they may become "value traps".

### 7. Watch The Yield! Does The Dividend Yield Seem Too Good To Be True?

**No doubt, the usual 'spikes' in capital appreciation may never return to the secondary market at least in the short to medium term.** Therefore, the ability of companies to give attractive cash dividend (and possibly cum bonus) remains a strong investment criterion for screening stock selection. However, it is most probable that many companies may not maintain their dividends payment culture during this period of economic downturn. Companies may begin to slash or cancel cash/bonus benefits altogether, just to stay in business.

No matter how tempting, there is need for investors to tread carefully when Companies' dividend yield hits double-digit levels. Due diligence is required here to determine whether the yield is computed based on forecast or historical earnings/dividend.

### 8. Is The Company Addicted To Debt?

Similarly, too much debt magnifies the impact of tough times. As sales decrease, interest payments take up more and more of the company's earnings. Besides, unwinding leverage (**deleveraging**) is a time-consuming process. *So, even if a company boasts new, fiscally responsible management, investors should beware.* **As the veteran investor- Warren Buffett observes, "When a management with a reputation for brilliance takes on a business with a reputation for bad economics, it's the reputation of the business that remains intact."**

## 9. Is The Company Just As “Cheap” Based On The Future?

At first glance some stocks appear dirty cheap, trading at a ridiculous price-to-earnings (P/E) multiples e.g. 5x or thereabout. But caution needs to be exercised in order not to be fooled or get too easily excited. Some analysts misrepresent companies’ P/E multiple using historical earnings, in lieu of the most recent 4 quarters’ earnings. **And generally, investment decisions are not to or should not be based on what a company *was* worth... but rather what it will be worth.**

Before taking any investment decision on stocks, it is most important to make sure the stocks’ **forward price multiples are** similarly attractive. Otherwise, such are value traps!

**By and large, detecting a value trap is not an easy task. Even the shrewd investors occasionally get trapped as there is no 100% fool-proof formula to help steer clear of value traps.** However, there are some performance valuation metrics that ‘spot’ such companies. Investors need to figure out whether the malaise affecting a company is a temporary setback or medium to long-term operational challenges or worse still, the start of a death spiral. **We strongly advise investors to avoid buying blindly, or on price alone.**

## 10. Avoid the Brand Based Value Trap.

**This explains the market-wide sentiments that popular or super brands are far from being value traps.** This may be far from being correct as super brands like **Merry Lynch, American International Group (AIG); Lehman Brothers** in the U.S. are gone today!

**It is a fallacy that a well known brand will keep a struggling company from failing, so you should grab the shares while they look cheap.** Designating a company’ stock as a value investment due to a seemingly cheap price and well known brand may sound like a good idea on paper, but this argument may be incorrect and costly.

Companies with well known brands fail all the time, often after having struggled to generate growth (or even profits) for an extended time period. Being well known does not make a strong

brand, rather a strong brand is one that (at least) generates profits and more specifically is one that consumers prefer over the competitors’.

Outside of situations where a poorly managed company is squandering profits through mismanagement, a struggling company does not have a strong brand, because while people are aware of the brand, they do not patronize its products and / or services.

Meanwhile, this is not to say that investors should not consider brand in equity selection, but rather, should be looking for true brand strength as opposed to mere awareness.

In the case of struggling companies, there is need to establish new potent strategies management is deploying to rehabilitate the brand and return the Company to the path of profitability. Selection should be truly based on current pricing and intrinsic value; relative to earnings, financial health and future growth prospects

**Below is a selection of a few companies that exhibit some of these characteristics.**

### OUR TOP PICKS 'VALUE TRAPS': Company & Performance 'Traps'

#### ● FLOURMILLS

- The Company's recent Q3-2008/09 results triggered legitimate doubts on profitability at least in short to medium terms. **Hence investors will most probably be poorly rewarded or worse still, should not even expect any cash dividend this FYE March 2009.**
- Flourmill's BVPS=N20.52, EPS=N2.03 while P/E ratio=5.41x. **In Q3-2008; PAT fell precipitously from N3.65bn to N76m, owing to a strange foreign exchange loss of N6.66bn reported in Q3-2008/09.**
- The Stock has dipped over 88% (NSE: 64%) in 52 weeks till date. There is possibility of further price declines, thereby driving the price to historic all-time low of below **N10 (all-time high: N106.50, Mar.4, '08).**
- **Low pricing may tempt and 'entrap' investors, especially those who want to go short to medium term. Traders should also beware of this trap!**

#### ● STARCOMMS

- **Starcomms' shares were offered to the market at the price range of N10-N16 late 2007.** The Company's shares sold massively through **Private Placements (PP)** on the heels of the market sentiment for **telecoms sector** rather than **Company's specifics.**
- The Company has **excitingly grown revenues** yet accumulated losses are mounting in **'leaps and bounds'** quarter-on-quarter. **However, this is a sharp contrast to other unquoted telecoms companies.**
- **Its Q2-2008 showed loss before tax (LBT) of N1.85bn against LBT of N381mn in equivalent quarter of '07.**
- Investors, most especially, short term; and traders alike, should be wary of **'brand based' value trap in Starcomms as we do not see any near-term catalyst, such as earnings surprises in the interim.**
- Starcomms **forecasted N2.46bn profit in 2010 after offsetting its accumulated losses which stand at N7.17bn as of 2007FYE** as contained in its **PP's Memorandum. Possibility of dividend is remote until 2010.**

#### ● DUNLOP

- **There are no near-term catalysts for Dunlop, the indigenous tyres and tube manufacturing company. Dunlop has been haemorrhaging for close to 2 yrs and yet no end seems in sight in short to medium term.**
- Operations are stifled by prohibitive costs of doing business while govt. policy continues to make business life more difficult.
- Dunlop has remained in operational loss for about 2yrs. Operating losses stood at N1.5bn in Q2-2008 up from N500m in previous yr's Q2. **Margins are negatives while EPS and P/E are meaning less.**
- Dunlop's outstanding shares stand at 4.62bn units and 52-week price dips=84.5% (NSE: 64%). Its all-time high is N7 (Mar. 6, 2008) while historic low is N0.57k (Feb. 2, 2009). **Short to medium term investors should be wary of the stock. Dunlop rather looks more expensive on prospect outlook as the future looks bleak for now.**

#### ● ASHAKACEM

- Ashaka Cement's (Ashakacem) operations have being in **'coma'** towards the tail end of 2006FYE when top line grew by margin **BUT** profit margin shrank considerably by 25% throughout the year.
- This condition became worse off in 2007FYE as both top and bottom-lines plunged all through the year, culminating in 49% and 53% dips in PBT and PAT respectively, over previous year's.
- Net Margin fell to 9.7% in 2007 from 20.4% in 2006 while EPS stooped to N0.81k from N1.98k in 2006. Ashakacem has 1.99bn shares in issue with a BVPS of N5.29k. Ashakacem's 52-week high & low are N55.70k (Feb. 8, 2008) and N8.40k (Feb.18,'09) respectively.
- Current price may signal a **'value trap'** as **investors may be overly excited despite lack of near-term catalysts in the offing. The company has not released any quarterly results in this financial year.**

### ● NAMPAK

- Nampak, **the metal containers and crown corks manufacturer**, is currently faced with daunting operational logjam.
- The Company's performance metrics are waning with no immediate catalyst to gladden investors' expectations.
- Its restated audited accounts for FYE 2007 showed accumulated losses of **N360m made up of 145.9m loss after tax and N213.8m for exceptional items**.
- Nampak currently trades at N8.13 (**at the last trade date: February 5, 2009**). The stock should have probably dropped significantly further, save for its illiquidity.
- For traders and short term investors, Nampak seems like a value trap as any positioning in the stock will surely take a much longer term to mature.

### ● EVANSMED

- Evansmed is one of the stocks that appear severely oversold with a 52-week price plunge of 74%; making it a likely candidate on which investors can play an **'appeal to pity' strategy**.
- Despite the seemingly value erosion, the stock is currently priced at 18x trailing earnings, which makes it one of the most expensive stocks in the Nigerian equity market.
- In our view, this high valuation level is unwarranted in the face of blurred view of **earnings momentum**.
- Though, the Company has exhibited some sparks in top line, significant bottleneck remains in its operations as reflected in severe pressure on margin falling from 9.57% in Q1-2008 to 5.43% in Q3-2008.
- **Overall**, current valuation appears overstretched despite the lack of near term catalyst to justify the current pricing level.

### ● NIWICABLE

- NIWICABLE has witnessed a 52-week **price plunge of 70%**.
- The Company has been bedeviled with **chronic internal operational challenges** resulting in consistent red bottom lines since 2003 and a gross diminution in **shareholders' funds to -N437m**.
- The company's working capital shortage has engendered a **severe debt overhang** and unbearable gearing position culminating into receivership in 2007.
- Nonetheless, the assurance of the going concern of the Company remains an acid test for the new core investor (**True Bond Investment and Capital Limited**), which is expected to **inject N1.24bn to acquire 1.1bn units of the Company's shares**. This makes the outstanding shares stand at a **ballpark figure of 1.5bn shares**.

## Appendix

### Analyst's Certification and Disclaimer

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#### Fair Value Estimate

We estimate stock's fair value by computing a weighted average of projected prices derived from intrinsic and relative valuation methodologies. The choice of relative valuation methodology (ies) usually depends on the firm's peculiar business model and what in the opinion of our analyst is considered as a key driver of the stock's value from a firm specific as well as an industry perspective. However, we attach the most weight to discounted cash flow valuation methodology.

#### Ratings Specification

- BUY:** Fair value of the stock is above the current market price by at least **20 percent**
- HOLD:** Fair value of the stock ranges between **-20 percent and 20 percent** from the current market price.
- SELL:** Fair value of the stock is more than 20 percent below the current market price.

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