As Investors Panic: Calculating Intrinsic Value with a High Margin of Safety
August 10, 2011

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Dear Fellow Investors:

When markets get super difficult, as they have been the last couple of weeks, it is great to be able to lean on valuation methods with a high margin of safety. Ben Graham had a simple and beautiful formula for computing intrinsic value. Below is the formula:

$$V* = \frac{EPS \times (8.5 + 2g) \times 4.4}{Y}$$

V: Intrinsic Value
EPS: the company's last 12-month earnings per share
8.5: the constant represents the appropriate P-E ratio for a no-growth company as proposed by Graham
g: the company's long-term (five years) earnings growth estimate
4.4: the average yield of high-grade corporate bonds in 1962, when this model was introduced
Y: the current yield on AAA corporate bonds

While others are out there trying to predict the economy and short-run stock price changes, we at Smead Capital Management thought you might enjoy leaning on the greatest teacher that security analysis has ever known.

4.4 is the numerator Graham came up with after studying the affect that interest rates have on stock market intrinsic values. His numerator of 4.4 was designed to allow the change in the ten-year AAA bond interest rate to adjust the intrinsic value. Graham studied interest rates from 1900-1930 to get the right balance to his equation. The intrinsic value of a company is a long-term benchmark or guidepost. Companies rarely sell for their intrinsic value. Most trade below it, while some trade for significantly more than what this calculation might tell you.

There are two simple ways to get a high margin of safety when using Graham's simple intrinsic value calculation. First, you can use a much lower ten-year growth expectation than other stock market participants. Second, you could use a much higher interest rate than the current ten-year AAA corporate bond. We would like to look at a few of our current holdings through the prism of intrinsic value.

Mylan Labs has trailing operating earnings of around $1.84 per share. To have a high margin of safety we will use a ten-year growth rate in earnings of 10%, even though the First Call analyst consensus has an estimate of 14%. To have an even higher margin of safety, we will use a triple-A bond rate of 5.5% in all of our calculations (far higher than today's rate).

Intrinsic Value of MYL = 1.84(20 + 8.5).8

Mylan Labs Intrinsic Value = $41.95 Current Price $17.55

Despite a very bright future for the generic drug business, where major blockbuster drugs are losing patents to companies like Mylan, we used a very conservative ten-year growth rate in earnings. On top of that we used an interest rate more than 3% higher than today's 2.17% AAA bond rate and you still have a stock trading for 42% of our intrinsic value calculation!

Aflac earned around $6 in the last year. We will use a 5% earnings growth rate versus a First Call consensus growth rate of 12% and the same ten-year AAA corporate bond rate.

Aflac Intrinsic Value = 6(10 + 8.5).8

Aflac Intrinsic Value = $88.8 Current Price $36.20

In our opinion, Aflac is a forty-one cent dollar based on "very high" margin of safety estimates.

Cabela's has trailing earnings of $1.80 per share. First Call estimates a five-year earnings growth rate of 15%, so we will use a ten-year growth rate of 10% and the same 5.5% AAA bond rate.

Cabela's Intrinsic Value = 1.80(20 + 8.5).8

Cabela's Intrinsic Value = $41 Current Price $22.57

This means that Cabela's is trading at a 45% discount to its very conservatively estimated intrinsic value.

In conclusion, there are two main scenarios which could negatively impact earnings growth going forward. The economy could struggle the next five years, making earnings growth rates disappoint, and/or interest rates could rise significantly. In our opinion, either way, these stocks offer the possibility for above-average returns with a high margin of safety based on Ben Graham's formula.

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.