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Article

Of Shares and Companies - Part 1

GOOD FIRMS AND BAD STOCKS

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This article is the first part of a series on equity investments.

I recently sat in a class where the lecturer asked the class to perform a macroeconomic, industry and company analysis on listed firms in order to determine whether they were overvalued or undervalued. The companies included Total Petroleum Ghana Limited (TOTAL), Ghana Oil Company Limited (GOIL), Benso Oil Palm Plantation (BOPP), Aryton Drugs (AYRTN) and Fan Milk Limited (FML). As the lecturer mentioned the names of the companies, a lady seated next to me humorously remarked "Eeiii Benso Oil Palm Plantation, that company are they still there, we have always heard about them…..". The message from this lady was clear, for some reason she was surprised BOPP was still listed and her comments suggest that she did not consider BOPP a "serious" company. The reason why this lady or the average Ghanaian would consider BOPP a weak company is because the company does not sound grand or glamorous compared to other listed companies such as Unilever Ghana Limited (UNIL), Guinness Ghana Breweries Limited (GGBL) or Standard Chartered Bank (SCB). Let us face it; when was the last time you heard of BOPP running an advert on TV, when was the last time you saw a news item on a Corporate Social Responsibility initiative undertaken by BOPP, where and when did you see any product that had the company's logo. The faulty generalization then is that such a company cannot be worth much on a listed stock exchange. At the time this lady thought nothing good could come out of "the ancient of days", BOPP, which is actually the best performing stock on the market this year, had recorded a YTD gain of 107%.

This begs a lot of pertinent questions: *What is a good company? Is a good company automatically a good stock? Can a bad company be a good stock? And finally, what is a good stock?* To answer all these questions, one would need to understand what generates investor interest in a stock.

What drives interest in a stock?

A stock exchange is the recognized market for the trading of equity securities. The Ghana Stock Exchange (GSE) is the designated market in Ghana for the trading of equity securities, commonly called stocks or shares. Stock exchanges are modelled like any market where buyers and sellers interact and in so doing establish the price at which a product will be bought or sold, much like what happens at the Tip Toe Lane at the Kwame Nkrumah Overpass when a phone is bought or sold. The price of a product is determined by its availability; the balance between buyers and sellers; bargaining power of buyers versus bargaining power of sellers; liquidity needs of buyers against that of sellers among other factors. This is exactly what happens on a stock exchange. As investors interact in the market place, sentiments around a stock are formed which goes to determine the price the stock will trade at on the exchange on any given day.

Due to the fact that there are several investors on the market, with varying expectations and needs, it is difficult to confidently say what investors look out for in demanding certain stocks. That notwithstanding, no one can run away from the fact that investors, the world over, would go in for a stock once it is ascertained to be selling below its actual value (called intrinsic value in investment parlance). The intrinsic value of a company is the

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theoretically established real worth of a company after considering all the value generating aspects of the company. "*Theoretically*", because it is very difficult to know the intrinsic value for sure; it may be different from the market value of the company. Investment analysts use various valuation methods and consider the future prospect of a business to arrive at an intrinsic value of a company. Once a share is trading above its intrinsic value, it becomes less attractive to investors, in the same way a consumer will not likely buy a mobile phone selling for higher than its value. The value investors attach to a stock is the price they are willing to pay for or sell the stock.

Suppose a smartphone manufactured by JPEG Limited, which is a listed company, has a factory value of GH¢1,750. If this same phone is sold at Tip Toe Lane at a price of GH¢870, the phone automatically becomes a good bargain and everyone in Accra would rush to grab theirs.

There are other factors that determine the level of interest investors show in a listed equity. One key factor is the dividend policy of a company. Dividends provide one of the real benefits investors get for investing in a stock and it has become a very important measure used by most investors in picking which stocks to buy.

There are other tangential or sentimental reasons that make certain stocks attractive or otherwise. Perceived political exposure of certain companies make them unattractive despite strong financial performance. Other companies also enjoy goodwill from investors because they may be national companies, have existed for long, have a specialized product or possess a superior technology. All these factors ensure relatively high investor interest in companies even though they may not be efficient or market leaders in their industries.

Whatever be the case, the overriding principle is that the company's stock must be trading below or close to its intrinsic value before any investor will look at any other factor.

What is a good company?

The word "good" is in itself quite subjective, as anyone can imagine. What makes something good differs from person to person and is mostly based on individual preferences and expectations. For the purpose of this article, we will define a good company as a company that, at the very least, is registered and operating legally under all known laws and regulations. A good company is one that scores high marks on an Environmental, Social and Governance (ESG) criteria. Such a company is a going concern, pays its taxes, makes good profits, avoids pollution, treats employees well, makes meaningful contribution to the society, has excellent customer relations and ensures diversity.

Is a good company automatically a good stock?

The answer to the above question lies in the value a market places on a company relative to its intrinsic value. *The only time a stock is considered good is when the stock is trading below its intrinsic value*. A stock can trade below its intrinsic value when all available information, including future prospects of the company, is not reflected in their market price. This results in a lower price for the share compared to its value. There is subjectivity with respect to what each investor deems the true price for a stock. The underlying rule however is that a stock is good if it is cheaper than what investors consider to be its true worth. Therefore, a company which has a high score on the ESG criteria may not necessarily make a good stock. This is because if a company is over-valued, regardless of the good attributes of that company, it becomes a bad stock.

Once a company is valued below intrinsic value by the market, there is interest in the company's stock and this will translate into trading activity (buy and sell decisions) that creates liquidity, a vital attribute all investors look

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out for before buying a stock. Even though speculators may drive up an over-valued stock, there is usually relatively low demand for such stocks, as it will not provide real value in terms of capital appreciation for shareholders who may want to cash out in the future and may have difficulty selling. It becomes worse if the company has a bad dividend payment history due to low profits, meagre reserves or constant losses.

Again, suppose JPEG is noted for providing several jobs for the youth through its distributor network and has experienced increased profits but has a market price that is above what the intrinsic value per share is, JPEG, in such a scenario, becomes a bad stock. Investors are not going to invest in JPEG shares and with time, JPEG will fade into insignificance on the market until the price drops to a level that is believed to be below intrinsic value.

Can a bad company be a good stock?

A bad company can be described as one that falls short on the ESG criteria. Debt overhung and net losses, however, are not necessary pre-conditions that make a company a bad one. There are companies listed on the Ghana Stock Exchange that reported losses in the 2016 financial year but have had market sentiment work in their favour. If all the things that supposedly make a company bad exist and the company is trading below intrinsic value, the company's stock automatically becomes a good stock. In the early 1990's, Nike came under a barrage of criticism for using abusive labour practices including low wages, poor working conditions, child labour, intimidation, harassment, unjustifiable dismissal and forced overtime in South Asian countries. At the height of the inquest, protests and vitriol on NIKE, the share price gained 72% in 1996. The bad press that qualified NIKE as a bad company based on its labour practices had little impact on its share price. The company was still highly valued and the share price responded accordingly - a good stock.

In the long-run, the share price of a supposedly bad company could fall to a level that is below the intrinsic value of the company thereby making the company's shares technically attractive. At this point, the decision to buy is dependent on other factors such as liquidity and risk of holding the stock of such a company.

A good stock is mainly determined based on price

The same way buying a mobile phone that costs GH¢1,750 for GH¢870 at Tip Toe Lane represents a good deal, a good stock is one that can be bought at a discount to its true value. The investor hopes that with time the share price will rise to its higher true level so as to record gains. This may not necessarily materialize as all investment decisions are associated with risk. It is possible that the phone purchased for GH¢870 may malfunction after 2 weeks. In that case, the buyer has lost out. A share bought at a discount may remain undervalued for a period longer than the investor's investment horizon.

There are other factors savvy investors consider when making stock picks. The necessary condition is price, but aside from this, there are other conditions that either strengthen or diminish the investors' decision to acquire a stock. Some of these conditions include liquidity, dividend policy, perceived political exposure and risk.

In another breadth, all stocks can be good stocks according to the Greater Fool Theory. This theory states that regardless of whether a stock is overvalued or not, there is a possibility of making a gain because there is always somebody (a greater fool) who will bid higher for the stock. This theory therefore discounts the fact that a stock is bad because at any point in time there is going to be a willing buyer who would bid higher for a stock that may already be over-valued.

In conclusion, there are exceptionally good companies that make bad stocks but there are bad companies that make good stocks. What makes a company a good stock is when it is selling for less than its true value and a bad

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stock is one that is either priced above its real value or for which the future prospects of the underlying company is bad.

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