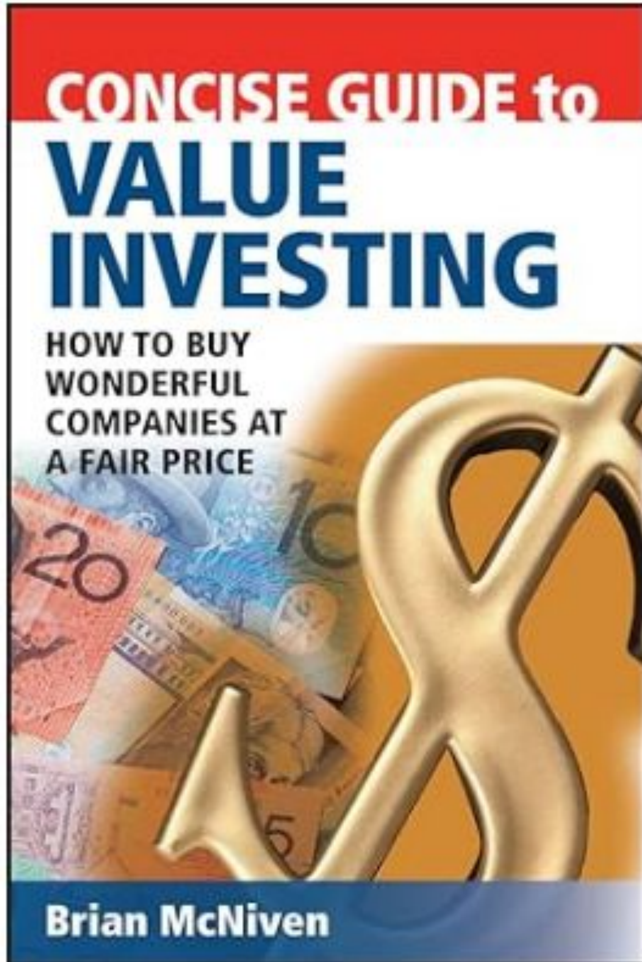


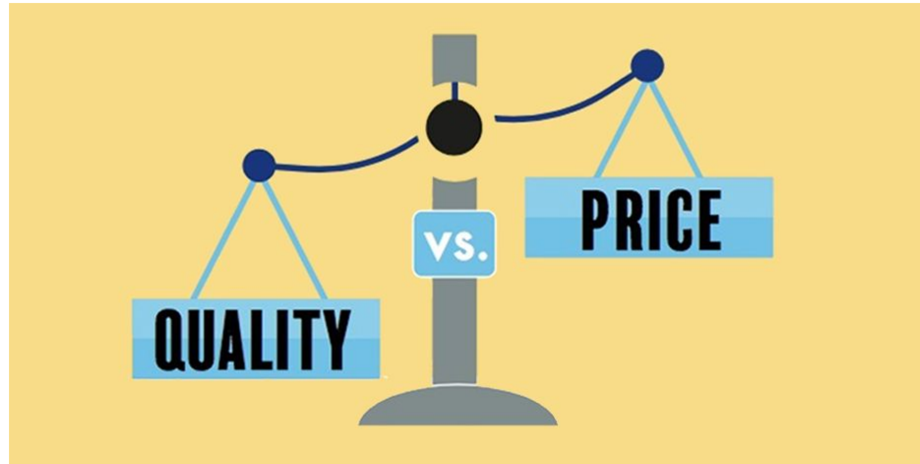
How to Buy Wonderful Companies at a Fair Price using McNiven's Formula

Rick Kowitz

Caution!
McNiven's Formula is just one tool in the toolbox. It's not the panacea for valuation and is designed for profitable businesses.

What is value investing?

"Investing with the intention to seek a Required Rate of Return (RR) relative to risk, based on an assessment of value" – Brian McNiven



Why is Rate of Return (RR) important?

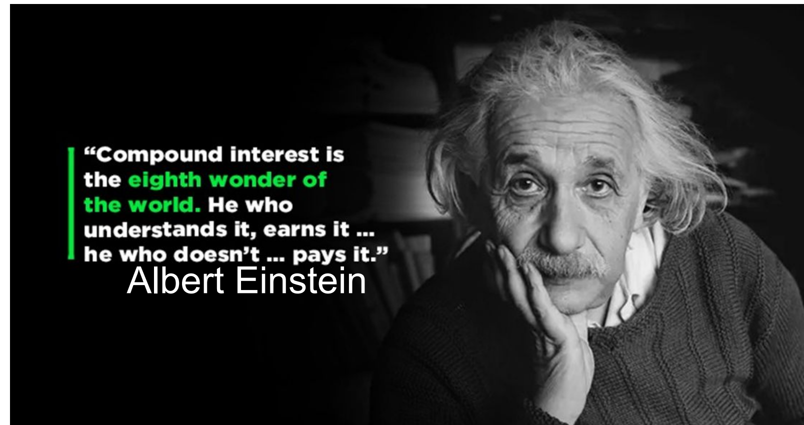
Rule of 72

Doubling time (years) = 72 divided by your rate of return (RR)

If you can achieve **RR of 12%** your investment will **double every 6 years**

If you can achieve **RR of 24%** your investment would **double every 3 years**

You can also work out your return by dividing 72 by the time taken to double your investment



McNiven's StockVal Formula

What's the logic behind the formula?

V = (APC x RI / RR + D) x E / RR

V = Valuation of the business

E = Shareholder equity per share (ie. Book Value, eg. $1)

RR = Your required rate of return as a percentage (eg. 10%)

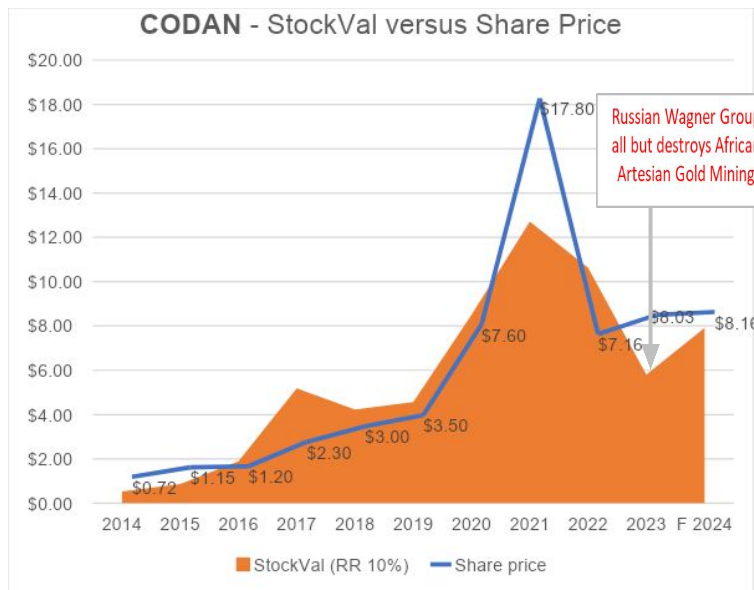
APC = eg. normalised ROE expressed as a percentage (eg. 20%)

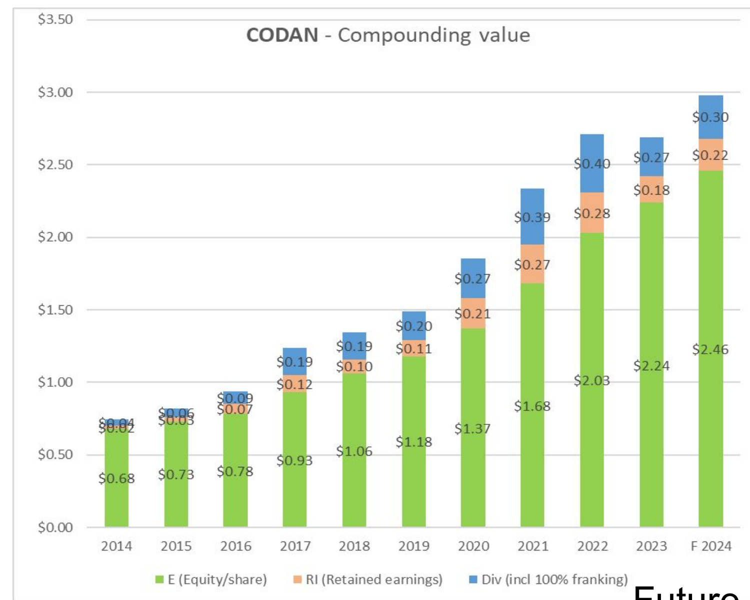
RI = Portion of APC reinvested (eg. 20% x 30% = 6%)

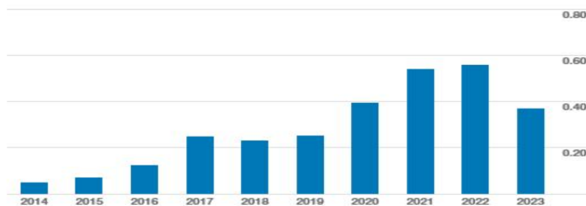
D = Portion of APC as dividend (e.g. 20% x 70% = 14%)

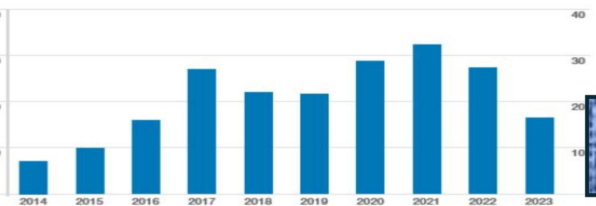
If D is franked it is adjusted to reflect the higher value to shareholders (eg. 70% franked)
D(f) = (D x % franked /0.7) + (D x % unfranked)
For the example above, D(f) = (14% x 70% franked / 0.7) + (14% x 30% unfranked) = 14% + 4.2% = 18.2% with 70% franking

Codan – StockVal v. Share price









Future ROE 20.4%, based on analyst forecasts earnings

FY 2014

Limitations and Cautions

1. McNiven's Formula is NOT the panacea for all valuations
2. Designed for profitable businesses
3. Compare with other methods, eg PE x forecast earnings, DCF
4. Garbage in, garbage out!
5. You must know the business well –past, present, future headwinds / tailwinds.
6. Look for trends. Is ROE improving, stable or declining?
7. Your ROE estimate is MOST CRITICAL to your valuation
8. Watch for overstated earnings, normalise if required
9. Consider business risks (eg debt) when selecting your RR
10. Don't rush into selling your highest quality compounders based on lower indicated returns (e.g. 6% to 8%). If you find proven high quality businesses indicating a 10% return…back up the truck! This is rare. Earnings predictability and your ability to see what's ahead is the key.