A share worth 1 dollar purchased for 60 cents

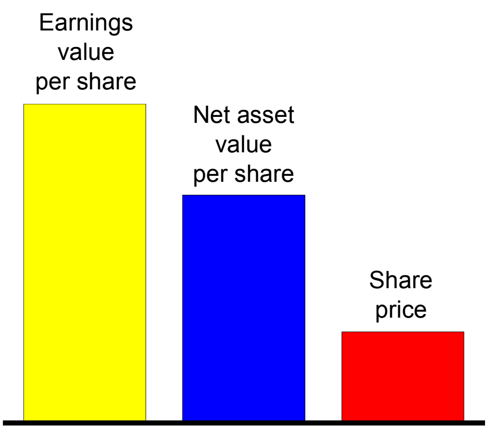
The value investing style

Concentration on heavily undervalued shares

In order to achieve long-term, high growth in value with share investments, and to thus be able to seriously evaluate the associated risks, it is necessary to know the companies concerned and their managements as precisely as possible. The value approach is therefore based on a thorough, disciplined and long-term analysis, in which companies are specially sought out whose shares

- ➪ are undervalued in relation to their intrinsic, effective value and
- ➪ with which the risk of an enduring loss is low.

An undervalued situation



Undervaluing is usually a case that the current stock exchange valuation underestimates the assets, the earnings power and the prospective growth of a company. Security in the sense of avoiding enduring losses is just as important here as making profits. The risk of loss can be considerably reduced by evaluating the company conservatively. However, as even the most critical evaluation still contains uncertainties, K&N Value Select Corp. only acquires papers whose stock market rate lies at least 40 per cent below their estimated, effective value. This procedure creates a margin of safety and that is the core element of the classic value investing style.

Strict assessment criteria for selecting shares

The earnings value, the net asset value and indebtedness are the most important figures used to evaluate the intrinsic value of a company. There are various methods of analysis which serve to determine these figures: Profit discount models, sum of the parts valuation, private market value, relative value within a sector, an so forth.

Earnings value approach

- ➪ The earnings value depends upon the profit made by a company, its cash flow and the expected development of both variables in the future (estimates). An earnings value conform to market is calculated on a basis of earnings figures (price earnings ratio, price cash flow ratio) using comparisons with other firms in the same sector and with other investment alternatives (e.g. bonds or real estate).
- ➪ The majority of financial analysts restrict their assessment of companies to the earnings value because this is the easiest figure to calculate. However, it is precisely the earnings which is most liable to fluctuations and offers the lowest reliability of forecasting.

Net asset value approach

➩ The interest is focussed on the monetary sum which would be paid out in case the company were to be liquidated (liquidation value). For this purpose the current market value of its assets is determined and after subtracting all debts, this is divided amongst the outstanding shares. Such a market-conform evaluation is based on an adjustment for special factors (e.g. goodwill items declared on the balance sheet). In addition, hidden reserves are of particular significance (e.g. under-valuation of real estate due to too high depreciation).

➩ The net asset value is subject to lower fluctuations because it is primarily based on hard assets. The net asset value approach is suited to identifying special factors which put the company in a better light than it really is. Some firms, for example, are under-balanced without knowing it due to inflated goodwill items.

Indebtedness

➩ Viewing a company's debts in ratio to its total assets (debt ratio) shows whether the firm can indeed finance any further growth. Indebtedness of 85 or 90 per cent of the total assets allows no elbow room for any further credit-financed growth. Such firms first need to shrink themselves back to health in the future.

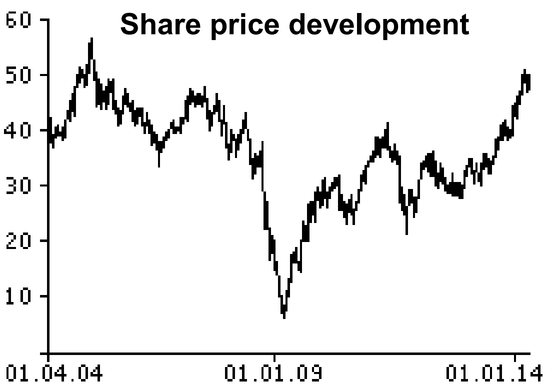
Example of a massive under-valuation – Dow Chemical in March 2009

Earnings value approach

Earnings / share (in 2008):	USD 0.63
Price earnings ratio (PER):	9.5
Market-conform PER:	approx. 14 to 16
Earnings value at PER=15:	**USD 9.45**
Share price (March 2009):	**USD 6.00**

Net asset value approach

Book value per share:	USD 14.60
+ Hidden reserves / share:	USD 9.16
– Goodwill per share:	USD 4.53
= **Net asset value** / share:	**USD 19.23**
Debt ratio:	**64 per cent**



The price earnings ratio of the Dow Chemical share of 9.5 in March 2009 corresponded to a yield of 10.5 per cent (interest rate = 1 / PER). For purposes of comparison: Bonds yielded in 2009 around 2.5 per cent. On the basis of a long-term, market-conform PER of 15 (average of the last 10 years), a clear under-valuation resulted even at a profit of USD 0.63 per share. Assuming a good economic climate and an estimated profit per share of USD 2.40 (potential), the earnings value would then be at USD 36.00 per share. The debt ratio of 64 per cent is relatively modest for the sector and therefore poses no barrier to growth for Dow Chemical in the foreseeable future. Dow Chemical shares were massively undervalued in March 2009, both from the net asset value and the earnings value viewpoints.