Chapter 8

Case on “To buy, or not to buy”

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Joy is a fresh graduate employed at a local bank. As a commerce graduate he was quite interested in the financial markets of the country. He came from a middle income family and had set big dreams on his professional and personal life. He was certain that it would be difficult to achieve greater heights by solely depending on the salary. So, he had picked up the habit of closely observing the stock prices of potential companies and invested in those stocks if the financials were good.

Presently, he was keenly monitoring the stock prices of Mass* Ltd., a company that manufactured dental products in Malaysia. The stock prices showed a steady increase over the last four years. However, he wanted to ascertain that the company rested on strong fundamentals and was not just a stock market performer; he believed in long-term investments. He started researching on the company and managed to collect a treasure trove of information from the secondary sources and his friend Aman who worked for the company.

About Mass Ltd.

Mass Ltd., turned out to be one among the very few dental product manufacturers in Malaysia. It specialised in manufacture of dental braces, titanium implants and dental equipment. Apart from manufacturing it also provided training to the dentists on usage of their products and equipment. The promoters being dentists themselves were actively involved in training, research and development, and management.

The government actively supported biotech companies as a part of its efforts in developing medical tourism (Wong et al, 2014). Various subsidies and tax incentives were available to the companies involved in medical tourism (Ormond et al. 2014 and Chee, 2007). Consequently, Mass was entitled enjoy tax benefits for six more years. The situation appeared to be promising and Joy started sieving through the financials of Mass Ltd. (Table 1).

Table 1: Financials of Mass Ltd.

Particulars / Year	**2012**	**2013**	**2014**	**2015**
Sales	270,000	520,000	620,000	980,000
EBIT	150,000	240,000	500,000	800,000
Interest expense	0	0	0	-3,000
Tax expense	-3,000	-21,000	-1,700	3,000
Net income	147,000	219,000	498,000	800,000
Assets	1,700,000	1,400,000	1,600,000	2,000,000
Equity	240,000	450,000	960,000	1,400,000

Figures in RM

Industry situation

The company appeared to exist in an ideal environment and Joy called Aman to discuss the prospect of investing in the stock. Aman gave a hint on the cost implications of dental procedures involving the company's products. Most of the products were very expensive by inherent nature and also due to industry practices. Similar to the pharmaceutical companies most of the medical equipment companies spent substantial amount of money on product promotion. This was incurred in terms of information dissemination, training and educating the dentists on contemporary practices and technological advancements.

Joy was disappointed to know that not more than five percent of the dentists were willing to perform intricate procedures such as root canal and titanium implants. Most of them shied away from performing these procedures due to concerns on costs, medico-legal issues, insurance coverage and motivational aspects (Jagyasi, 2016). The Ministry of Health had prescribed strict guidelines on product and procedural requirements. Aman revealed that this was not the case in all the Asian countries. Due to higher volume of patients, the cost and medico-legal concerns were less in the neighbouring countries.

Future plans of Mass Ltd.

Nevertheless, the local market didn't seem to be very promising from the company's perspective due to the above complexities. Hence, the company contemplated the idea of exporting to other Asian countries. Mass Ltd. moved quickly and started discussions with prospective partners in Brunei, Thailand and India. It believed that exporting would reduce over-dependence on the local market and subsequently help to overcome the business risks and financial risks.

Aman also emphasized that the Malaysian currency was weakening and hence it would be an added advantage to all the exporters and medical tourists would also increase in number ((Khoo, 2015)). Joy was not a fan of short-term investments and gave more importance to capital appreciation than dividend payments. His assessment of the company now seemed to be less encouraging. It seemed that the company had managed to grow and earn profits due to government support and incentives to the industry.

Long-term prospects

He started doubting if it was worthy to invest his hard earned money in a company that seemed to exist on external support than inherent strength. In addition, the local market was not promising and exporting was still in the discussion stage. He was also puzzled how the currency deprecation would affect the long-term prospects of Mass Ltd. He needed answers and he was not sure how to analyse and interpret the available information.

Joy had come across some of his friends who used the DuPont system to better understand the position of client companies. As he had never done this analysis earlier he decided to seek the help of his colleagues before buying the stocks of Mass Ltd.

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Teaching Note

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The basic measurement of a company's performance is profit (returns). However, profit in itself is insufficient to decide on the performance of any company and it needs to be compared with the assets and equity. This simple computation of Net Income / Assets or Net Income / Equity was made more comprehensive by DuPont when they included operating efficiency, total asset turnover and financial leverage.

For example, the three-step DuPont Analysis is done as follows:

$$\text{ROE} = \underbrace{\frac{\text{Net Income}}{\text{Sales}}}_{\textit{Net Profit Margin}} \times \underbrace{\frac{\text{Sales}}{\text{Assets}}}_{\textit{Total asset turnover}} \times \underbrace{\frac{\text{Assets}}{\text{Equity}}}_{\textit{Equity multiplier}}$$

Table 1: Three-step DuPont Analysis of Mass Ltd.

Particulars / Year	**2012**	**2013**	**2014**	**2015**
Net Profit Margin	54.44	42.12	80.37	81.63
Asset Turnover	15.88	37.14	38.75	49.00
Equity Multiplier	708.33	311.11	166.67	142.86
Return on Equity	57.14	51.91	48.67	61.25

Figures in percentage

Five-step analysis

ROE =	Net Income / Pretax Income	x	Pretax Income / EBIT	x	EBIT / Sales	x	Sales / Assets	x	Assets / Equity
	Tax burden		*Interest burden*		*Operating Income Margin*		*Asset turnover*		*Equity multiplier*

Table 2: Five-step DuPont Analysis of Mass Ltd.

Particulars / Year	**2012**	**2013**	**2014**	**2015**
Pre-interest pre-tax margin	55.56	46.15	80.65	81.63
Asset Turnover	15.88	37.14	38.75	49.00
Interest Burden	100.00	100.00	100.00	100.38
Tax efficiency	102.00	108.75	100.34	99.63
Equity Multiplier	708.33	311.11	166.67	142.86
Return on Equity	63.75	58.00	52.26	57.14

Figures in percentage

Suggested Answer:

The Return on Equity has been quite high over the last few years. Though the equity multiplier (Assets/Equity) has shown an increasing trend it could be attributed higher level of assets. However, the increase in assets doesn't seem to be matched by a proportionate increase in the sales (Sales / Assets). The Asset Turnover could be a cause for concern. This could also be related to lesser number of dentists who offer complex services and also higher cost of services.

The interest burden is 100% which indicates that the company has not borrowed and doesn't incur interest expenditure. Though this is generally good, optimal amount of borrowing is essential for expansion. Consequently, the company cannot fully utilize the tax benefits.

However, in consideration of the fact that tax benefits are provided for 10 years and that dentistry is undergoing phenomenal changes this company's stock could be bought. Increase in aging population would also provide additional business opportunities.

The next best available option involves Stem Cell therapy and that is unlikely to happen in the near future. The impetus provided by the government to medical and particularly dental tourism would also be an added advantage. Hence, it is suggested that Mass's stocks could be bought by Joy.