https://www.theglobeandmail.com/globe-investor/investment-ideas/sanofi-is-a-truly-global-stock-that-offers-good-value/article4369650/

WATCHLIST THE GLOBE AND MAIL

Sanofi is a truly global stock that offers good value

MICHAEL MCCLOSKEY
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED JUNE 25, 2012

Sanofi is one of the largest pharmaceutical companies in the world and a leading manufacturer of vaccines.ANTOINE ANTONIOL/BLOOMBERG

As a value investor I often hunt for value in the strangest places. Superbowl champions may head to Disney World, but I much prefer the European Union (EU) and the euro zone at the moment. Financial calamity and market panic always draw me in for a closer look.

The EU and the entire construct of the euro currency are being challenged. I wouldn't touch a European bank stock or a European government bond with a 10-foot pole. I also avoid many European companies that have significant funding risks or are exposed to credit risk with suspect European counterparties. However, Europe is home to many of the world's great companies – ones that export their products and services around the globe. As exporters, they are also beneficiaries of a declining euro exchange rate relative to countries outside the euro zone.

As a consumer, you're familiar with many Europe-based companies: AstraZenica, Diageo, Nestlé, SAP, Unilever. What you may not appreciate is that each sells a material percentage of its products or services outside of the EU. These are truly global companies. In addition, they possess wide competitive "moats," generate high returns on equity and invested capital, and have balance sheets that will allow them to survive the current crisis even if the euro and the EU do not.

The key additional questions that I ask are about their future prospects, whether management is shareholder-friendly, and whether the shares are trading at a sufficient discount to my estimate of their value to make them attractive. The stocks mentioned above did not meet all of my criteria – at least not yet. But one stock not mentioned did manage to make the cut. I own Sanofi S.A.

Sanofi, headquartered in Paris, is one of the largest pharmaceutical companies in the world. The company also possesses a sizable consumer healthcare division and is a leader in the manufacture of vaccines. Geographically, its sales are equally spread out amongst Europe, North America and the rest of the world, including some fast-growing economies.

Many of the big pharma names are trading at low P/E multiples due to "patent cliffs" – their biggest selling blockbuster drugs are coming off patent. Sanofi has managed to deal with this through acquisitions. They also have a pipeline of drugs in Phase II and III clinical trials. At current prices I believe that the stock is attractively priced even factoring in some inevitable pipeline failures.

At first glance Sanofi may not look that cheap. Under international accounting standards the company earned €4.29 ($5.52) a share in 2011. However as my accounting professors in business school taught me, accounting standards doesn't always tell the full story.

When valuing companies I prefer to use what Warren Buffett calls "owner earnings." This is essentially how much cash the shareholders of a business can extract from the business without eroding its competitive position. Calculating it requires judgment. Analysts often use similar but not identical numbers called "cash earnings" or "free cash flow."

Sanofi's income statement deducts from income significant amortization and depreciation charges that are non-cash in nature. Yet the business does require certain capital expenditures to be made in order to continue to thrive. The concept of owner earnings takes all of this into account.

Based on my review of Sanofi's cash flow statement, I believe that Sanofi's reported earnings understated the company's cash generating ability by about a third last year. I believe that Sanofi earned at least €5.70 in owner earnings in 2011. Analysts expect that number to decline in 2012 but then grow considerably in the coming years. At its current share price Sanofi trades at less than 10 times owner earnings. The company has raised its dividend in each of the last seven years and 2012 was no exception. In May the company declared and paid a dividend of €2.65. At current prices SNY has a dividend yield of over 4.6 per cent with a conservative 40-per-cent payout ratio.

Europe will eventually sort itself out and great companies will continue to thrive. For those who think that Europe's problems are permanent I am reminded of a postcard that one of my former colleagues kept on his desk: "In the end everything will be fine. If it isn't fine, it just isn't the end."

It reminds me to remain optimistic about the future but realistic about the present.