



# FELLOWSHIP PROGRAM ASSIGNMENT COVER SHEET

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<b>CANDIDATE NUMBER:</b>  XXXXXX	<b>COURSE:</b>  INV - Investment
<b>DATE DUE:</b> Monday 16 August 2021 at 9.00am (AEDT)	

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## 1. Introduction

The Investment Analyst team at Pragmatic Investment ('we') have been engaged by the Portfolio Management team, to prepare a report in relation to the value of Clime Investment Management Limited ('CIW') ordinary shares as at 30 June 2021. The valuation results provided are expected to be used in the decisioning process of purchasing CIW shares with the intention of holding them for at least five years.

This report details the modelling approach taken and attempts to justify the assumptions adopted in the valuation process. Furthermore, sensitivity and scenario tests have been performed to provide the Portfolio Manager an understanding of the expected movement in the value of CIW shares during benign and/or turbulent economic conditions. Finally, we opine on the maximum price at which CIW shares should be bought and the minimum price at which they should be sold for as at 30 June 2021.

## 2. Modelling Approach

### 2.1 Valuation Methodology (Q1)

There are two main discounted cash flow models that could be used to value the CIW shares, being a Dividend Discount Model ('DDM') and a Free Cash Flow ('FCF') valuation approach. The DDM values a company as the present value of future dividends paid to shareholders with the discount rate set to be the cost of equity (' $k$ '), designed to represent the required return of investors. The FCF model values a company as the present value of future free cash flow to the company discounted at the weighted average cost of capital (' $wacc$ ').

We have chosen to value the CIW shares with the DDM as opposed to the FCF model as neither CIW's capital structure nor are their FCFs constant and/or stable. CIW's capital structure continues to fluctuate and change over time, especially with their recent acquisition of Madison Financial Group ('MFG'). The FCF model requires a relatively constant or stable capital structure for the purpose of calculating  $wacc$ . Furthermore, CIW is an investment management company whose revenue is highly dependent on their fund management fees. Therefore, the FCFs are highly dependent on the business cycle, where an expansion will result in high revenue and vice versa for contractionary periods. The FCF model calculates the present value of forecasted FCFs and therefore it is difficult to ascertain the revenue of a company whose profits are sensitive to the business cycle.

There are several variations of the DDM model. Generally, the DDM can be used to calculate the value of a single CIW share today using the formula below.

#### Equation 1: General equation of the DDM

$$V_0 = \sum_{t=0}^{\infty} \frac{E(D_t)}{(1 + k_t)^t}$$

Where  $E(D_t)$  is the expected dividend at time  $t$  and  
 $k_t$  is the discount rate at time  $t$

From Equation 1 above, the value of a single CIW share is calculated as the present value of all cashflows paid to shareholders (i.e. dividends). Given the difficulty in forecasting dividends for infinite time periods, if we assume that the next dividend,  $D$ , will be paid in a year's time, and that dividends are paid annually, grow at a constant rate of  $g$  and are discounted at the cost of equity,  $k$ , then we arrive at the Gordon Growth Model ('GGM'). The formula for the GGM is provided below.



Equation 2: Gordon Growth Model ('GGM')

$$V_0 = \sum_{t=1}^{\infty} \frac{D(1+g)^{t-1}}{(1+k)^t} = \frac{D}{k-g}$$

This model is particularly sensitive to assumptions made surrounding the expected dividend, growth rate and discount rate. We have used the GGM to check our valuation results using a multi-period dividend discount model described in the equation below.

Equation 3: Multi-period DDM

$$V_0 = \left( \sum_{t=1}^5 \frac{E(D_t)}{(1+k)^t} \right) + \frac{E(D_6)}{(k-g)(1+k)^5}$$

The value of a CIW share is the expected dividends paid over the next 6 years where we assume the dividend from the 6<sup>th</sup> year onwards is paid annually and grows at a constant growth rate. Furthermore, a constant discount rate is adopted for discounting all future cash flows. The multi-period DDM gives us greater flexibility to make qualitative and quantitative adjustments to the expected dividends in the immediate future and therefore is a more suitable model than the GGM.

## 2.2 Model Assumptions & Data Considerations (Q2 – Q6)

The data provided in the spreadsheet has long term data from FY2012 to HY2021, being a period of 9.5 years. We have only used the data from FY2015 to HY2021 for our valuation purposes as this data is more recent and provides a more accurate representation of CIW's financial health today.

### 2.2.1 Derivation of cash flows (Q2 – Q5)

The multi-period DDM requires us to forecast future dividends and make assumptions about the growth in these dividends. From Equation 4 below, we note that when forecasting dividends, we need to forecast the individual components of NPAT, the number of shares outstanding and the expected payout ratio.

Equation 4: Dividend formula

$$\text{Dividend} = \frac{\text{NPAT}}{\text{number of shares outstanding}} * \text{payout ratio}$$

The table below shows the historical data used with calculations performed in blue. Given the relatively strong performance of equities in the half-year prior to 30 June 2021, we have assumed that the cashflow data for the year ending 30 June 2021 will be double that of the HY ending 31 December 2020.

Table 1: Historical financial data used

Historical Data (\$000s)	Year Ending 30 June						HY ending 31 December 2020	Year ending 30 June 2021
	2015	2016	2017	2018	2019	2020		
Revenue	11,360	9,785	8,359	10,768	13,220	11,151	7,973	15,947
NPAT	3,289	1,065	621 <sup>1</sup>	1,064	1,461	397	865	1,730
NPAT/Revenue	29.0%	10.9%	7.4%	9.9%	11.1%	3.6%	10.8%	10.8%
Number of shareholders	55,279	56,508	48,574	54,933	54,738	64,658	65,759	65,759
EPS (c/s)	5.95	1.88	1.28	1.94	2.67	0.61	1.32	2.63
Payout Ratio	88%	276%	141% <sup>2</sup>	155%	87%	352%	76%	76%
DPS (c/s)	5.21	5.21	1.80	3.00	2.33	2.17	1.00	2.00

<sup>1</sup> NPAT for FY17 adjusted from \$2,561 to \$621 after a one-off tax benefit of \$1940

<sup>2</sup> Assumed a long-term average payout ratio from FY12 to HY21 excluding FY17



We note that CIW's funds under management ('FUM') were heavily impacted in February to April 2020 due to investor uncertainty pertaining to the impacts of Covid-19 (see Figure 1 below). Since then there has been strong recovery in equity markets and therefore it is reasonable to base the growth rate assumptions on the forecasted values for the year ending 30 June 2021 as opposed to the historical values for the year ending 30 June 2020.

Figure 1: CIW gross funds under management (\$m)



Table 2: Calculation of growth in revenue and number of shareholders

Data (\$000s)	Year ending 30 June 2015	Half year ending 31 December 2021	Year ending 30 June 2021	Growth (% p.a.)
Revenue	11,360	7,973	15,947	5.8%
NPAT	3,289	865	1,730	n/a
NPAT/Revenue	29.0%	11%	11%	n/a
Number of shareholders	55,279	65,759	65,759	2.9%
EPS (c/s)	5.95	1.32	2.63	n/a
Payout Ratio	88%	76%	76%	n/a
DPS (c/s)	0.88	1.00	2.00	n/a

The calculations for the forecasted dividends are provided in Table 3 below, where assumptions are coloured red. A full explanation of the assumptions adopted is provided in Table 4 below.

Table 3: Derivation of forecasted dividends

Forecast (\$000s)	Year ending 30 June					
	2021	2022	2023	2024	2025	2026
Revenue growth rate	5.8%	6.2%	5.8%	5.8%	5.8%	5.8%
Revenue	15,947	16,935	17,917	18,957	20,056	21,219
NPAT/Revenue	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%
NPAT	1,515	1,609	1,702	1,801	1,905	2,016
Growth rate in shares outstanding	n/a	2.0%	2.0%	2.0%	2.0%	2.0%
Number of shareholders	65,759	67,074	68,416	69,784	71,180	72,603
EPS (c/s)	2.30	2.40	2.49	2.58	2.68	2.78
Payout Ratio	76%	76%	76%	76%	76%	76%
DPS (c/s)	1.75	1.82	1.89	1.96	2.03	2.11



The assumptions involved in forecasting future dividends, as provided in Equation 4 above, are listed in the table below.

**Table 4: Assumptions for forecasting dividend payments**

Item	Assumption	Rationale/Calculation	Qualitative adjustments
Revenue	Growth in revenue	Historical revenue growth of 5.8% p.a. from FY15 to FY21 (see Table 2).	Revenue growth for FY21 and FY22 is assumed to remain high at 5.8% p.a. and 6.2% p.a. respectively as revenue is increased due to the merger with the integration and synergies from merging with MFG are realized <sup>1</sup> . Growth returns to a relatively high 5.8% p.a. after the increased growth from the merger as management's focus is on organic growth in operating earnings, business simplification and efficiency and further mergers and acquisitions. <sup>2</sup>
NPAT	NPAT is calculated as a percentage of revenue	NPAT/revenue is relatively constant (see Table 1), albeit for 2020, and therefore we have assumed this remains constant in the future at 9.5%.	The historical average of NPAT/revenue is 11.8%, which includes the high NPAT in FY15 of 29.0% and the low NPAT of 3.6% in FY20 due to Covid-19 <sup>3</sup> . The average excluding both FY15 and FY20 is 10.0%. Given the ongoing impacts of Covid-19 and the potential for future impacts to profitability during stressed periods, we have assumed a slightly lower NPAT/revenue of 9.5%. CIW have consistently announced profits in recent periods <sup>4</sup> and therefore a relatively high NPAT/revenue of 9.5% is relatively conservative.
Number of shares outstanding	Growth in the number of shares outstanding	Number of shares outstanding has fluctuated, peaking in 2020/2021. The historical growth rate in the number of shares outstanding is 2.9% p.a. (see Table 1). The growth rate in the number of shares outstanding is assumed to be 2.0% p.a. for forecasting the dividend payments.	Management focus is on mergers and acquisitions <sup>2</sup> which will likely increase the number of shares outstanding as more capital may be required. However, CIW have announced a share buyback scheme <sup>5</sup> which is likely to continue and therefore the growth rate in the number of shares outstanding has been decreased from 2.9% to 2.0% p.a. for forecasting the dividend payments.
Payout ratio	Constant payout ratio, subject to any statements about payout ratio changes from the Board	Historical payout ratios have fluctuated dramatically with historical payout ratios greater than 100% (see Table 1), suggesting dividends are paid out of cash and earnings. Given the unsustainable nature of payout ratios greater than 100%, we assume that the most recent payout ratio is held constant at 76%.	No dividend policy has been historically announced for CIW and therefore there is relatively high uncertainty regarding this assumption. Assuming a constant payout ratio based on the most recent financial data assumes that CIW's current propensity to pass profits onto shareholders is held into the future. Given managements growth prospects in operational earnings <sup>2</sup> , this appears reasonable to remain at a lower payout ratio in comparison to the average payout ratio.

<sup>1</sup> CIW half year results and dividend announcement (23 February 2021) noted the full integration and synergies (which result in revenue increases) of MFG would be realised over the next 12 months

<sup>2</sup> Management focus stated in Investor Presentation FY20 (2 September 2020)

<sup>3</sup> Decreased profitability stated in Investor Presentation (3 June 2020) with FUM down from \$1,097m to \$874m

<sup>4</sup> Increases in profit and/or revenue announced in half-year report (31 December 2020), half-year results and dividend announcement (23 February 2021) and quarterly update for the quarter ending 31 March 2021

<sup>5</sup> Share buybacks announced in 2020 Annual Report



CIW typically pay semi-annual dividends and therefore are expected to pay a dividend in September 2021. To simplify the calculation process, we assume dividends are paid annually at 30 June thereafter. The forecasted dividends are summarized in the table below.

Table 5: Forecasted dividends for CIW

Date	Forecasted Dividend
30/09/2021 *	\$0.75
30/06/2022	\$1.82
30/06/2023	\$1.89
30/06/2024	\$1.96
30/06/2025	\$2.03
30/06/2026	\$2.11
Growth Rate	3.17%

\* Final dividend from FY21 is to be paid in September 2021

The DDM also assumes that dividends are paid into perpetuity and grow at a constant growth rate,  $g$ . Implicitly, the growth rate cannot be greater than the discount rate applied due to the nature of the perpetuity calculation. The growth in forecasted dividends is 3.17%, however, we expect the long-term growth rate to be considerably lower. Therefore, we have considered the long-term forecasts in GDP, where we assume that long-term dividends grow at the long-term GDP growth rate. The growth rate in GDP is given in the table below.

Table 6: Long-term GDP growth rate

Year	USD (\$m)	Source
2021	1,617,540	Statistia
2060	3,515,286	OECD
Growth Rate (% p.a.)	2.01%	

We have used a growth rate of 2.01% when calculating the terminal value of CIW's dividend payments.

### 2.2.2 Discount rate (Q2 – Q4, Q6)

We have used the capital asset pricing model ('CAPM') to present value future dividend payments. The formula for the cost of capital at time  $t$  is provided below.

Equation 5: Capital asset pricing model

$$k_t = r_{f,t} + \beta_t(r_{m,t} - r_{f,t})$$

Where  $r_f$  is the risk-free rate,  $\beta$  represents the volatility of CIW to the market and  $r_m$  refers to the market risk premium

The annual cashflows are discounted using different discount rates with a terminal discount rate used for the last payment. We assume that  $\beta$  and  $r_m$  remain constant for each time  $t$ . We have used a  $\beta$  of 0.88 provided in the dataset. The  $\beta$  provided is calculated based on the returns of the ASX200 and therefore we have sourced  $r_m$  to be the average market returns from the ASX200 over the past 5 years, being 7.0%.

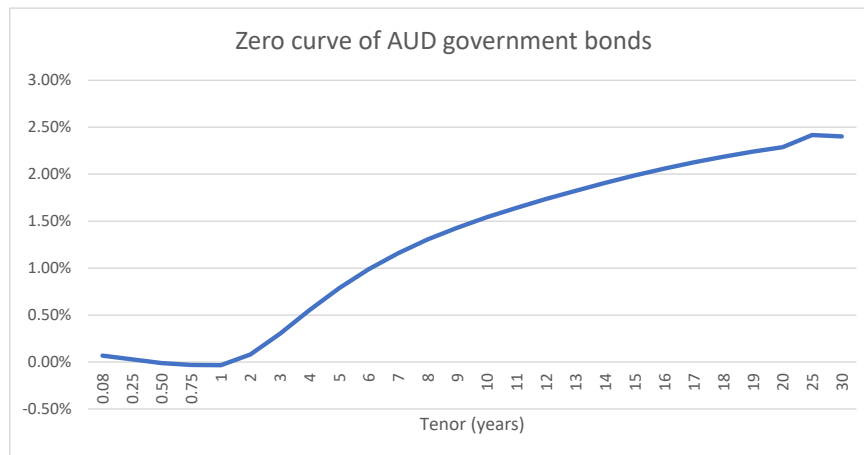


Table 7: Returns (% p.a.) for ASX200 - sourced from Yahoo Finance

Date	Adjusted Close Price (\$)
30/06/2016	5223
30/06/2021	7313
Return (% p.a.)	7.0%

We have set  $r_f$  to be the zero curve as at 30 June 2021 of AUD government bonds which capture the term premium involved with holding an asset for longer periods of time. We note the upward sloping nature of the curve after 1 year captures the desired term premium for holding bonds.

Figure 2: Zero curve of AUD government bonds sourced from Thomson Reuters



From the 2020 AGM, CIW elected new directors and on 26 April 2021, a new CEO was appointed. Both events were positively received by investors evidenced through an immediate rise in the share price. CIW's management appears capable of meeting objectives, such as growing operational earnings and therefore little to no qualitative adjustment for management is required. However, as at 29 June 2021, an announcement was released calling for the immediate removal of a director, suggesting that there may be some internal conflict within upper management and an overall lack of confidence in the directors chosen. As a result, we have incorporated a 40bps spread to the discount rate which tapers to 20bps after FY22. The full calculation of the discount rates is provided in the table below.

Table 8: Derivation of discount rates

Cashflow date	30/09/2021	30/06/2022	30/06/2023	30/06/2024	30/06/2025	30/06/2026
Time from valuation (yrs)	0.25	1.00	2.00	3.00	4.00	5.00
Risk-free rate	0.03%	-0.03%	0.08%	0.30%	0.55%	0.79%
Beta	0.88	0.88	0.88	0.88	0.88	0.88
Market rate of return	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Qualitative adjustment	0.40%	0.40%	0.20%	0.20%	0.20%	0.20%
Discount rate	6.56%	6.56%	6.37%	6.40%	6.43%	6.45%



### 3. Valuation Results (Q5 – Q7)

Using the historical data and assumptions described in Section 2 above, we have valued a single CIW ordinary share. The full valuation can be found in the 'Valuation' tab in the attached spreadsheet.

Table 9: Derivation of valuation result

Cashflow date	30/09/2021	30/06/2022	30/06/2023	30/06/2024	30/06/2025	30/06/2026
Time from valuation (yrs)	0.25	1.00	2.00	3.00	4.00	5.00
DPS (c/s)	0.75	1.82	1.89	1.96	2.03	2.11
Discount rate	6.56%	6.56%	6.37%	6.40%	6.43%	6.45%
Discount factor	0.98	0.94	0.88	0.83	0.78	0.73
PV(cashflow)	0.74	1.71	1.67	1.63	1.59	60.92
Proportion of value	1.1%	2.5%	2.4%	2.4%	2.3%	89.3%
PV (\$)	\$0.68					

#### 3.1 Allowance for uncertainty in deriving cash flows (Q5)

Forecasting dividends inherently involves uncertainty and the valuation results are reliant on the best-estimate assumptions described in Table 4 above, aimed to represent the current and expected financial situation of CIW. These assumptions are made with consideration for quantitative factors (e.g. historical growth rates and long-term averages) which are then adjusted for qualitative factors specific to CIW, resulting in a valuation result of \$0.68.

The revenue growth rate assumptions and the constant payout ratio assumptions heavily impact the valuation outcome. We have assumed that revenue grows at the historical growth rate of 5.8% to 6.2% in FY21 and FY22 respectively due to the integration and synergies realized from the merger with MFG. The growth rate of 5.8% p.a. is inclusive of the additional revenue resulting from the merger of MFG in FY20/FY21 and therefore by holding this assumption constant at 5.8% from FY23 onwards, we expect CIW to continue to have strong operational earnings. Furthermore, a revenue growth rate of 5.8% makes an allowance for any potential mergers or acquisitions that may occur. Consequently, the expected earnings and thus cashflows will increase. If no allowance is made for future mergers and acquisitions, a lower revenue growth rate of 4% may be appropriate.

The valuation result under such a scenario, ceteris paribus, is presented in the table below where the lower growth rate has decreased the expected dividends from FY23 to FY26 with a lower terminal value in 2026. The overall impact is a 4% decrease in the value of CIW.

Table 10: Valuation result when revenue growth rate is set to 4%

Forecast (\$000s)	Year ending 30 June					
	2021	2022	2023	2024	2025	2026
Revenue growth rate	5.8%	6.2%	4.0%	4.0%	4.0%	4.0%
DPS (c/s)	1.03	1.82	1.86	1.90	1.93	1.97
PV(cashflow)	2.00	1.71	1.64	1.57	1.51	56.88
Proportion of value	3.1%	2.6%	2.5%	2.4%	2.3%	87.1%
PV of scenario with reduced revenue growth rate (\$)	\$0.65					
PV of base scenario (\$)	\$0.68					
Percentage difference	-4%					

Given CIW's historical payout ratio has fluctuated from 76% to over 200%, there is a high degree of uncertainty in determining the expected future payout ratio. A lower payout ratio will result in a lower value and a high payout ratio will result in larger cashflows being discounted, particularly the terminal value. Over the past 5 years, except for FY20, the payout ratio has been trending downwards and therefore given the long-term unsustainability of paying dividends greater than earnings, we have assumed the payout ratio is kept constant at 76% for our valuation purposes. Given the subjective nature of the assumption, we have performed a scenario whereby the payout ratio is set to 100%. As shown in the table below, we have checked the impact of altering this assumption by setting the payout ratio to 100%, being the maximum sustainable long-term dividend payout ratio. The value of



this scenario, ceteris paribus, is \$0.91, being a 33% increase in value. Given our payout ratio assumption of 76% is conservative, we are not over-valuing CIW and therefore the subjective nature of selecting a suitable payout ratio has been considered in our valuation approach.

**Table 11: Valuation result when payout ratio is set to 100%**

Forecast (\$000s)	Year ending 30 June					
	2021	2022	2023	2024	2025	2026
Revenue growth rate	5.8%	6.2%	5.8%	5.8%	5.8%	5.8%
Payout Ratio	100%	100%	100%	100%	100%	100%
DPS (c/s)	1.30	2.40	2.49	2.58	2.68	2.78
PV(cashflow)	2.27	2.25	2.20	2.14	2.09	80.16
Proportion of value	2.5%	2.5%	2.4%	2.4%	2.3%	88.0%
PV of scenario with higher payout ratio (\$)	\$0.91					
PV of base scenario (\$)	\$0.68					
Percentage difference	33%					

### 3.2 Sensitivity to discount rate (Q6)

The derivation of the discount rate has been described in Section 2.2.2. For the purposes of testing the sensitivity of the model to changes in the discount rate, we have tested flat movements in the discount rate. The table below shows the valuation results when the discount rate is altered by -2%, -1%, 1% and 2%.

**Table 12: Sensitivity analysis for discount rate**

Discount Rate	Valuation Result	Percentage Difference	Terminal Value at Year 6	Terminal Value (portion of valuation result)
-2%	\$1.10	62%	\$1.03	93%
-1%	\$0.83	22%	\$0.76	91%
0%	\$0.68	0%	\$0.61	89%
1%	\$0.59	-14%	\$0.52	88%
2%	\$0.52	-23%	\$0.45	87%

From Table 12 above, we note that the valuation is significantly impacted by changes in the discount rate, where decreases in the discount rate result in higher values and vice versa. Furthermore, decreases in the discount rate impact the value of the stock more than the increases in the discount rate. This is primarily driven by the changes to the terminal value at Year 6. As the discount rate decreases, the value becomes increasingly sensitive to the terminal value at Year 6. Going forward, the discount rate applied when valuing CIW should be closely monitored and updated for any movements.

### 3.3 Scenario Analysis (Q7)

The valuation results were conducted using a 'base' scenario. As part of our scenario analysis, we have performed an 'upside' and 'downside' scenario, where each scenario represents positive and negative outlooks on the economy respectively. The scenario analysis performed can be found in the 'Scenario 4 Upside' and 'Scenario 4 Downside' tabs of the attached spreadsheet. In the table below, we present the changes in assumptions made on top of the base scenario for both the upside and downside scenario.



Table 13: Scenarios and reasoning

Assumption	Upside	Downside	Rationale
Growth in revenue	+1%	-1%	Expect increases in revenue during expansions and decreases in revenue during contractions.
NPAT/Revenue	+1.5%	-1.5%	Expect increases in profitability during expansions and decreases in profitability during contractions.
Growth in number of shares outstanding	+1%	0%	During expansionary periods, more capital is likely to be raised to drive further growth and therefore an increase in the number of shares outstanding is likely. During contractionary periods, the number of shares outstanding is likely to remain relatively stable.
Payout Ratio	0%	-5%	A surplus in earnings during expansions will likely be used to continue to fuel growth through retained earnings. During recessions, companies are likely to be more conservative when releasing profits and therefore we expect the payout ratio to decrease.
Terminal growth rate	+1.5%	-1%	Expect that during expansionary periods, GDP growth rate will increase and vice versa for contractions.
Discount rate	-0.5%	+0.5%	During expansionary periods, discount rates tend to be lower as the demand for liquidity is lower. During periods of contraction, interest rates tend to increase as the demand for liquidity increases but the supply of credit decreases. However, often monetary policy is used to change the interest rates. Therefore, only mild movements in the discount rate have been applied.

The valuation outcomes for each scenario are presented in the table below.

Table 14: Valuation result of scenario analysis

Scenario	Value	Percentage Difference
Upside	\$1.15	68%
Base	\$0.68	0%
Downside	\$0.43	-37%

From the table above, we note that the value of the base scenario is between the upside and downside scenarios as expected. Furthermore, the upside scenario uses favorable assumptions resulting in a higher value and vice versa for the downside scenario. The scenario analysis demonstrates how sensitive the value of CIW is to changes in the business cycle and therefore any future valuations of CIW need to carefully consider the current and future business cycle.



#### **4. Recommendation and Conclusion (Q8)**

As at 30 June 2021, the value of a single ordinary CIW share is \$0.68. In determining the value of the share, we have used assumptions that best reflect our belief of CIW's current financial health and their future prospects, with consideration for the current and future economic environment.

Given there is inherent uncertainty in the assumptions adopted and the valuation methodology used, we believe it is appropriate to adopt buy safety margins and sell safety margins when purchasing or selling the stock. Respectively, these form our maximum price we believe the stock should be bought for and the minimum price we should sell the stock for. Given we currently do not hold the stock, the minimum sell price is for illustrative purposes when considering the potential for the stock to grow in the future. The maximum buy and minimum sell prices are displayed in the table below.

**Table 15: Maximum buy and minimum sell price**

Option	Safety Margin	Adjusted Value
Buy	10%	\$0.63
Sell	-10%	\$0.77

Given the closing price as at 30 June 2021 of CIW is \$0.61, we believe it is appropriate to purchase the share as it is below our maximum buy price and therefore is currently undervalued by the market. If the stock is purchased, we recommend this valuation report be completed every quarter to monitor the performance of CIW shares. If the value is greater than the updated minimum sell price, Pragmatic Investment should consider whether this stock satisfies their risk appetite criterion.