February 01, 2018

How to Take Notes on a Company’s Balance Sheet

by Geoff Gannon

The important lines on a balance sheet are: cash, securities, receivables, land and any sort of tax related assets. Liabilities to look out for are pensions and environmental clean-ups

Someone emailed me a question about how to take notes when reading a 10-K:

Geoff,

When you're reading a 10-K, how do you initially read the balance sheet, the income statement and the cash flow statement? I'm thinking about the balance sheet in general.

Is it cluttered with notes and calculations from your part, and if so, what are you usually writing? Do you look for something in particular?

Since you asked specifically about the balance sheet, let’s tackle that statement in this article. For most stocks I am looking at buying these days – the balance sheet isn’t terribly important. Most of the stocks I’ve bought recently get most of their appraisal value (my best guess as to “intrinsic value”) from my expectation of future free cash flows. So, asset values aren’t as important. The balance sheet isn’t as important.

What am I taking notes on even in those cases?

My notes are almost always simplifications. So, I'm crossing out lines that don't matter using little "cheats" to focus on what does matter.

What's an example of a balance sheet "cheat"?

Well, there's checking the level of total liabilities against the levels of cash specifically and current assets generally.

Total liabilities may understate a company's liabilities if there are post-retirement obligations or something like that with incorrect assumptions being made. But, generally, you aren't going to go wrong by assuming a stock is safe if:

- It's profitable. (This is a given. I almost never look at stocks that are either net income negative or free cash flow negative in the past year.)
- It has liquid assets greater than total liabilities.

What's a liquid asset?

Cash, marketable securities and receivables all qualify.

There are other assets – not all liquid – worth considering though. So, let's go through all of the asset lines that you might want to care about. If I don't mention it here – for example, "other current assets & prepaid expenses" – it's usually safe to completely ignore it. You don't need to know what's in that line.

There are usually five sorts of assets worth caring about at almost any company. Let's start with the No. 1 most predictable and most "valuable" in the sense that it's a "definitely telling you something useful right now" kind of asset.

It's cash.

Actual cash is the easiest asset to value. It's the single most important line on the balance sheet. So, if we look at "cash & cash equivalents" and see it's $101 million while total liabilities are $100 million – that's all we need to know. The stock is safe. Later, we can come back and check for more "hidden" assets with extra value. But, just knowing cash is greater than total liabilities would immediately put this stock in the "safe" category. I can now focus on the business.

The No. 2 most important asset line is "securities" of some kind. These might appear in "cash & equivalents" if they are very short-term U.S. Treasury Bills or something like that. They could – if they are mutual funds, individual stocks, etc. – appear on a line called "marketable securities." Or the accounting could get a little complicated. If you're in another country – like Japan – these securities might not show up where you expect. And you might need to do some digging to try to figure out exactly what these assets consist of. In the U.S., if you are looking at a 10-K, it'll be pretty simple. They will go into detail in the footnotes somewhere discussing whether these are bonds, equities, mutual funds and so forth. What was their original cost? What is their fair value? How did the company estimate fair value (for example, did it check the last market price)? If you see any marketable securities listed on the balance sheet, you want to go to the section discussing these marketable securities and read it and take notes very carefully. Do your best to reconstruct a sort of table of the company's holdings.

Sometimes, there will be marketable securities held at odd values. This is most likely to happen in the U.S. where a company owns a large percentage of the outstanding shares of another company. So, if you own like 21-49% of another company, that would potentially cause the accounting for that position to look different than if you owned 19% or 9%. That doesn't make a ton of sense. In many cases, owning even 4% of a publicly traded stock and owning 28% of a publicly traded stock should really be similar economically (the 28% stake is just worth seven times the 4% stake). It's true the 28% stake could be a little harder to sell and could command more of a premium in a block trade But, to me, owning 4% of a company or 28% of a company should be valued the same way. So, if it's a publicly traded company that these shares are in – you can hopefully find that out and do your best to adjust the stake from however it is carried on the books to what it would be worth at today's market value. In other words, you find something valued using the "equity method" and you adjust it to "fair market value" using today's last trade price.

Even bigger (like controlling) stakes are more complicated. If a company owns 51-79% of a stock, this may or may not be so different from owning 4%, 49%, etc. But, it will be accounted for differently. The company's financial results will be adjusted to (most likely, there are exceptions – NACCO, which I own, is an exception) take the subsidiary's results and put it on the parent's books and then back out the minority ownership as a liability. This is quite confusing. You probably want to see if any subsidiary is publicly traded. For example, in a report on my member site (Focused Compounding), I wrote about a stock called Grainger (GWW). It has a majority stake in a Japanese company called MonotaRO. MonotaRO is actually publicly traded in Japan and quite an expensive stock. So, you could look at the value of Grainger excluding MonotaRO as being Grainger's market cap less Grainger's share of MonotaRO's market cap. We made that calculation. We took notes on that point. However, we ultimately did a sum of the parts analysis where we looked more at how we'd value MonotaRO than how the Japanese investing public was valuing MonotaRO. Other investors, however, would probably just use the market value of Grainger's stake in MonotaRO. In all these cases, you need to adjust reported results at the parent to avoid double counting.

Always use the approach that makes the most sense to you. Keep it simple. But, most importantly: Make sure you never double count. You can either count the earnings of a subsidiary as belonging to the parent – or, you can treat the value of the subsidiary (like its fair market value) as belonging to the parent. But you can't count both. If a subsidiary is appraised by you at 10 times EBIT, you can either make a note that the parent owns something worth $1 billion or that it makes another $100 million in EBIT. You can't do both. If you value the stake in the subsidiary at $1 billion – you have to adjust EBIT down by $100 million. You can never count the earnings from something and count that same something as an asset at the same time. You either take the earnings stream or you value it as an asset. Don't do both.

The No. 3 most interesting asset is receivables. Receivables are usually – especially under GAAP (U.S.) accounting – close to being as good as cash except they're "restricted." Cash is surplus. You don't need to keep cash in a business to run it day-to-day. Receivables are something you can borrow against. But, you can't take the receivables themselves out of the business. However, for purposes of safety receivables can be included in the current assets versus total liabilities type safety calculation. If you are looking at a company where cash plus marketable securities plus receivables is greater than total liabilities – it's a safe stock. What I mean is: If it's consistently profitable – it's a safe stock. The balance sheet is solid. There's no need to keep digging. Economically, receivables are bad insofar as they are a use of cash. It's an asset that ties up owner's capital in the business. But, you can safely borrow against receivables. So, they are another "quick" asset that adds to a stock's safety.

Inventory I mostly ignore. Theoretically, people would rank this as the No. 4 most interesting asset. I don't. I mostly consider inventory a cost of doing business and don't expect it to protect my investment in a doomsday scenario. After all, if a company has solvency troubles – it usually has sales trouble. And if a business is having trouble selling its inventory – what would that inventory fetch in a sudden fire sale?

Not much.

So, I mostly ignore inventory except insofar as it is one of items that adds to net tangible assets. We'll discuss NTA in a second.

It's worth noting inventory has some features that might make it interesting. One, if the company is using something like "LIFO" (last-in, first out) accounting. Two, if the inventory is mostly a commodity. This means either that inventory is something like a raw material: steel, leather, etc., that hasn't been "finished" yet, or the company actually sells a product that is mostly just a commodity like gold jewelry or diamond engagement rings. These considerations are irrelevant in today's low inflation environment. But, if you had high inflation, quickly rising commodity prices and so forth, there would be a big disconnect from the carrying value of inventory and its market value in some cases. I think almost all investors can almost always ignore the inventory line of the balance sheet. But it is something I look at checking for things like LIFO whether it is a commodity. You don't have to do that. So, don't worry about inventory.

And then, if you want to get super technical: Under non-GAAP accounting systems there are some complexities especially having to do with biological assets. This is a very obscure point. You'll rarely run across it. But it is going to be important in the few cases where you encounter it. So, it you're analyzing a French vineyard or something – the accounting would matter versus analyzing a vineyard in California.

The second to last balance sheet item I care about as a plus is land. Buildings and land both have value. Land – again, going by U.S. GAAP for this article – can be an especially good source of hidden value. Land is recorded at cost and then it is not depreciated, but neither is the value adjusted upwards. I try to always figure out what the original cost of the land was and when it was bought. You can then use a site like "Measuring Worth" to do a quick inflation adjustment. This is a conservative way of valuing the land.

So, if a company is carrying $1 million of land on the books bought in 1950, we can assume that is worth no less than $10 million (I just used the CPI for that one). Land is useful mostly as a sort of potential source of hidden value. Be careful though if the company really needs this land for day-to-day operations.

Let me give you two examples. Copart (NASDAQ:CPRT) owns land as part of its business. The company's business is running auctions of totaled cars at salvage yards. It needs these junkyards and it needs to site the junkyards in or around major cities. We know from some digging – you can use the 10-K as a starting point to look up the oldest 10-Ks or to check property records online – that some of the junkyards Copart runs (like in its original home of California) are carried on the books at well below what these properties could be sold for today.

Does that matter?

I don't think so. Copart has a high return on capital. The highest and best use much of the property could be put to is being a Copart junkyard.

The situation is different with something like Ingles Market (IMKTA). That company owns a lot of property. It is worth more than what it is carried for on the company's books. And, in some cases, I suspect the company may not be putting the property to its highest and best use. We can see this in the low return on assets at the company. So, that's a stock where you want to look carefully at the footnotes on land and other property.

There is a section of the 10-K (quite early on) called "properties." Always read that. And, also, always read the footnotes on depreciation of property, plant and equipment.

Sometimes the address of the property is a dead giveaway. In a report on my member site (Focused Compounding) I wrote about a stock called Town Sports International (NASDAQ:CLUB). This company runs gyms in places like Manhattan. It leases almost all of its gyms. But it owned the building one gym was in. It didn't need to do this. When I started looking at this stock, I knew only the building was likely valuable (I had the address of the building). Later, the company sold the property for $82 million. That was more than 5% of the company's market cap at the time. That's what you're looking for. You want to find land that is worth 5% or more of the company's market cap/enterprise value and is carried on the books for much less. Other than that, it's not worth spending a lot of time worrying about land.

Finally, there are tax related items. The only one really worth thinking about – because it could really change your appraisal of a company – is net operating loss carryforwards. A good example of this right now is Green Brick Partners (NASDAQ:GRBK). That's a homebuilder that we know has operating loss carryforwards that will reduce taxes and yet we know those tax savings will get used up in full pretty quickly. So, it's valuable. It's valuable to know a stock will pay, say, 0% in taxes instead of around 20% for the next three years versus its peers. Many companies with net operating loss carryforwards are on shakier footing when it comes to being sure they'll have enough profits soon enough to use up the carryforwards. Generally, I only adjust my appraisal value based on tax savings when it's clear the company is making enough money fast enough to definitely use up the tax savings and to do it fairly soon.

While we're on the topic of Green Brick Partners – a homebuilder – we need to make a distinction between the accounting treatment and economic treatment of some item. Homebuilders account for land as "inventory." However, land is land. So, when I say you can "ignore inventory" but "pay attention to land" – I don't mean you can ignore the "inventory" line on a homebuilder's 10-K. Why not?

Because it's land. A homebuilder's inventory is land. You need to always exercise that kind of common sense. Land values matter. Homebuilders use land as inventory. So, you need to pay careful attention to a homebuilders inventory and what you'd appraise it at.

As far as liabilities, I mostly focus on post-retirement obligations (pensions) and environmental liabilities (site clean-ups and so forth). I try to learn about these things and the assumptions the company is making.

In all cases, you only have to worry about asset lines or liability lines that are going to “move the needle.” If the company has a market cap of $500 million and a $50 million pension obligation shown on the balance sheet – pay attention to that. If it has a $1 million pension obligation, just cross it out. Likewise, if land is $25 million – look at it. If it’s $2.5 million – don’t.

Anything that immediately looks like it’s less than around 5% of the value the market is putting on the whole company – just move on from that for now. You only want to start with the items that are 5%, 10%, 20% or more of the value the market is putting on a company.

This is even true of cash. If the market cap is $500 million and there’s a $10 million net cash position – who cares? Just use the market cap in place of enterprise value. There’s no point being so exact you care about a 2% difference in your estimate of the “price” of a company. If a 2% change in a stock’s price would determine whether or not you buy the stock – you aren’t doing appraisals right. If something would change the value of a company by 10% or more – then, you can start caring.

So, mostly you cross things out. You simplify. There is some investigating. Mostly, you want to investigate marketable securities and land on the asset side and environmental and pension obligations on the liabilities side.

Finally, there’s “NTA.” Remember: this stands for “net tangible assets.” I use NTA as an estimate of the amount of owner’s capital needed to run a business. How do I estimate NTA?

I take inventory plus receivables plus property, plant and equipment (PP&E).

Then I subtract accounts payable and accrued expenses from that.

If there’s “deferred revenue” you should also subtract that. But that’s a discussion for another day.

Finally, I take EBIT and divide it by NTA to get a return on capital figure.

Again, it’s not important to be precise.

What’s a good number?

Anything that is clearly 30% or higher passes with flying colors.

Anything that is clearly less than 15% fails.

At least, those are the figures I used when U.S. tax rates were around one-third. Now, they will be around one-fifth. So, I suppose that means you can lower that to around 25% or more being a perfectly good pre-tax return on net tangible assets and 12% or lower being an unacceptable level.

I'd say avoid any business that seems to earns less than 12% pre-tax on its invested capital.

And then don't worry about how high return on capital is once you know it's at least 25% pre-tax.

Any business with an unleveraged ROE below 10% is one to avoid staying in long-term. And any business with an unleveraged ROE above 20% is fine to stay in long-term.

Once you've done these things, move on from the balance sheet. Usually, it's not worth spending a lot of time with the balance sheet. If a stock is trading well above book value – as almost all U.S. stocks are these days – the balance sheet isn't that informative. It's earning power that matters.

So, check to make sure the stock is safe. And check to make sure it's earning definitely more than 10% a year after-tax on owner money and hopefully more like 20% a year.

If it's earning 10%, 20% or more and it's safe – move away from the balance sheet and toward your assessment of the company's competitive position as soon as possible.

You probably want to spend 90% of your time researching a stock thinking about the business model and 10% of your time thinking about the balance sheet.

The exception is Ben Graham-type stocks. But, unless you are looking at stocks trading below book value – you shouldn't fixate on the balance sheet.