Stocks to watch

Print page

This article appeared in the July 2011 ASX Investor Update email newsletter. To subscribe to this newsletter please register with the MyASX section or visit the About MyASX page for past editions and more details.

There's a window of opportunity in this reporting season if you know where to look.

By Roger Montgomery, Value.Able

It is almost reporting season, the time of year companies report their annual and, for some, half-yearly results. To make it a little easier, here is a *Value.able* tool to help you discern the very best companies during this year's reporting avalanche - and, later, a list of seven companies worth watching closely.

There is a window of profit opportunity during reporting season. The reason is that larger companies flag or 'leak' their earnings because the rules about earnings guidance are fairly straightforward. According to the ASX's Guidance Note No.8 on Listing Rule 3.1: "*... the way to manage earnings expectations is by using the continuous disclosure regime to establish a range within which earnings are likely to fall*".

It goes on: "*As a general policy, a variation in excess of 10 per cent to 15 per cent may be considered material, and should be announced by the entity as soon as the entity becomes aware of the variation. If the entity has not made a forecast, a similar variation from the previous corresponding period will need to be disclosed.*"

Therefore, large companies disclose material variations from analysts' consensus forecasts and expectations, although there is a grey area when the variation is 10-15%. But the boards of large companies whose profits change by less than 15%, may elect not warn the market.

Then there are the smaller companies. They may not have any analysts covering them, let alone enough coverage to provide anything resembling a 'consensus' estimate of earnings.

This all gives rise to frenetic activity by analysts around reporting season, and you might think that as a private investor you are at an immediate disadvantage. You are not. The billionaire short-seller James Chanos has not had a meeting with a corporate CEO in 25 years.

There is a reason you might actually be better off. Those analysts are so busy running around visiting everyone that they have not got the time or energy to actually update any of their models in a timely fashion. So a window of market inefficiency opens up and some companies with terrific results might be available at very cheap prices.

Your task is to find the companies reporting terrific results, and then find those that are cheap.

Taking account of airlines

On the first score, I'll show you how to go about finding the real cash profit of a company. When a company reports its profit, it may have used a whole range of accounting rules for establishing that figure. The result can be a figure that bears little resemblance to the actual cash profit.

With all the news about Qantas at the moment, it is worth using airlines as an example of this. In 1945 the major US airlines flew 3.3 billion revenue passenger miles (RPMs). By the mid-1970s, the major airlines flew 130 billion RPMs. By 1988, a decade after deregulation, the figure had reached 330 billion, and in the 12 months to February 2011, 802 billion RPMs had been flown. In other words, growth in the number of people flying - something analysts and commentators love to write and think about - has been extraordinary.

Yet by the end of the three-year period 1989-1992, the US airline industry had lost about US$10 billion - more than had been made since its inception.

US airlines Pan American and Eastern disappeared, and TWA and Continental Airlines sought shelter by going into Chapter 11 bankruptcy protection. One in every four jobs in US passenger airlines was lost between 2000 and 2010, dropping from 523,208 to 390,053 jobs over that time.

To top it off, the US airline industry has lost $59 billion in domestic markets since deregulation in 1976, according to a January 2011 paper by University of California (Berkeley) Professor Severin Borenstein, published by the National Bureau of Economic Research.

Globally, the industry is in no better shape, having lost $23 billion in the past decade (provided it makes a forecast $9 billion in 2011).

Accounting fiction

You would think this is appalling, but it is not the profit figures being used that you should be concerned about; how they are created is the real concern. Those profits are an accounting construct, an artifice, an invention, created by accounting rules attempting to estimate the cost of running the business.

For global airlines, the difference between reality and fiction is caused by an item called 'depreciation'. Airlines are fond of using something called straight-line historical cost accounting. This means an airline that owns a plane with a useful life of 20 years may depreciate the cost of the plane, by equal amounts, over 20 years.

But when a new plane is purchased to replace the 20-year-old one, it will be a lot more expensive. The company's accounts, however, do not reflect any money put aside to pay for the new, much more expensive plane. The accounts only show a portion of the cost of the plane that was purchased maybe 19 years ago.

If the accounts revealed the running costs of an airline, they would include the costs of buying new planes.

Becoming a cash flow expert in minutes

Thankfully, you do not have to be an airline industry expert to find out what the real profit of an airline is. Indeed, with a short and simple set of steps, you can work out the cash profit of just about any company.

Think about it this way, if you and I had a business that started the year with $100,000 in its bank account and we ended the year with $200,000 after paying all expenses and tax, we could say we made a $100,000 profit.

But what if, during the year, we also borrowed $200,000? That $100,000 increase in the bank account is at least partly explained by the increase in the borrowings. In fact, when the bank gave us the $200,000 it transferred the funds into our bank account. So we need to reduce the bank account by the amount the bank gave us.

What if we also raised some money from friends and family during the year? Any capital we raised that was put into the business needs to be treated the same way as the money lent by the bank. If family and friends have given us $150,000, we need to reduce the bank account by this amount too.

So starting with cash in the bank rising by $100,000, we subtract the extra $200,000 borrowings and the additional equity of $200,000, and we arrive at a cash loss of $300,000.

Finally, what if the business also paid a dividend during the year of $200,000? We would have to reverse the effect of the cash leaving the business and add this back.

Our business in this example lost money. But what if accounting rules allowed this particular business to book a profit? As an investor, you might be none the wiser.

Let's look at just such an example from a listed company.

For the 2008 financial year, Clive Peter's reported a profit of $10.3 million. As **Table 1** below shows, during the year to June 30, 2008, cash in the bank rose by $5.9 million, from $11.2 million to $17.1 million. Total borrowings, which includes current and non-current borrowings, also rose, by a total of $19.3 million. No new equity capital was raised so issued capital remained unchanged. Dividends of $7.6 million were paid.

Starting with $5.9 million, subtracting $19.3 million and adding back $7.6 million produces a cash 'outflow' of $5.8 million, compared to a reported profit of $10.3 million. Another simple way of doing this is to list the items, as I have done in Table 1, by their year. Put a negative sign in front of 'cash' and then add up everything. Next, subtract the most recent year's results from the previous years. Then add back the dividend.

Figure 1.
Clive Peter's cash profit estimate 2008

$'000	2008	2007	Note
Cash and Cash equivalents	-17,083	-11,212	*From 2008 Balance Sheet*
Current borrowings	16,742	27,179	*From 2008 Balance Sheet*
Non-current borrowings	30,066	308	*From 2008 Balance Sheet*
Issued capital	54,578	54,578	*From 2008 Balance Sheet*
Total	84,303	70,853	*Statement of Changes in Equity*
Dividend Paid	7,620		
Cash flow (outflow)	**-5,830**		

Source: Roger Montgomery

The company did not have the money to do all the things it was trying to, while also paying a dividend. Trying to sustain such behaviour can result in worsening economics, which will result in worsening share prices.

If you have reached this point, consider yourself value able and a graduate of this year's reporting season.

You are now better prepared to read annual reports with an eye for those businesses that are generating real excess cash. For those interested in applying this method of analysing cash flow, be sure to look out for the following companies' 2011 annual results: *(Editor's note: do not read the ideas below as recommendations. Do further research of your own, or talk to your financial adviser before acting on themes in this story.)*

- The Reject Shop
- JB Hi-Fi
- M2 Telecommunications
- Woolworths
- Forge Group
- Breville Group
- Asciano.

Not every one of these companies is extraordinary quality, but all can teach you something about the importance of cash flow.

So grab the balance sheet of an industrial company, pull out four items - cash, current borrowings, non-current borrowings, and issued capital - and measure their net change, then add back the dividend. You are ready to see the reported profit figure in a new light. You will also be able to quickly take advantage of a very inefficient period in the market when extraordinary businesses can be overlooked.

About the author

Roger Montgomery is the Chief Investment Officer at Montgomery Investment Management and author of the best-selling stock market guide book Value.able. Exclusively for ASX Investor Update subscribers, Roger will personally sign your copy.