Financial Statement Analysis

Brian Nelson, CFA
President, Equity Research & ETF Analysis

Kris Rosemann
Head of Data, Associate Analyst

www.valuentum.com

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About the Speaker

Brian Nelson is the President of Equity Research and ETF Analysis at Valuentum Securities. Before founding Valuentum in early 2011, Mr. Nelson worked as a director at Morningstar, where he was responsible for training and methodology development within the firm's equity and credit research department. Prior to that position, he served as a senior industrials securities analyst, covering aerospace, airlines, construction and environmental services companies. Before joining Morningstar in February 2006, Mr. Nelson worked for a small capitalization fund covering a variety of sectors for an aggressive growth investment management firm in Chicago. He holds a Bachelor's degree in finance and a minor in mathematics, magna cum laude, from Benedictine University. Mr. Nelson has an MBA from the University of Chicago Booth School of Business and also holds the Chartered Financial Analyst (CFA) designation.

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Agenda

- How to assess the operating strength and earnings power of a company (income statement)
- How to assess the financial health and leverage of a company (balance sheet)
- How to assess the cash flow generating capacity and capital intensity of a company (cash flow statement)
- How financial statement analysis fits into valuation (a walk through of the discounted cash flow modeling process)
- How the Valuentum team predicts dividend cuts and assesses long-term dividend safety
- How to assess earnings quality and common financial warning signs

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Why Study Financial Statements

- To evaluate the progress of companies against their stated goals and objectives
- Build a foundation for the “science” and “art” behind the valuation process
- To become familiar with key sensitivities behind what drives a company’s intrinsic value
- To learn how to quantify the qualitative – is “it” already included in the price?

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Fundamental Financial Analysis

- Publicly-traded firms are required by the Securities and Exchange Commission (SEC) to release annual (Form 10-K) and quarterly "report cards" (Form 10-Q) of their financial position
- These "report cards," financial statements, are used to assess the company's performance and identify trends, both good and bad.
- The financial statements provide the quantitative story (proof) to support whether the "qualitative" makes any sense.

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Fundamental Financial Analysis, cont.

- Some things to be aware of…
- Past performance is *not* indicative of future performance.
  - The past is a great place to start one's analysis, but it is only the beginning of the research process (not the end).
  - Please never forget that stocks are priced on <u>future</u> expectations.
- In many cases, adjustments to the financial statements must be made.
  - Analysts, for example, have to watch out for special (unusual) charges and business model changes, which could have material changes on the direction of a company's revenue and profits (e.g. owner → franchise).

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Income Statement

- The income statement is often called the P and L, which stands for profit and loss statement.
- It tracks the revenue (top line) and costs (expenses) of the company throughout the *fiscal* reporting period (whether on a quarterly or annual basis).
- At the core, it informs investors about how much money a firm made (net income) or lost (net losses) during the period. A company's earnings per share can be found on this statement.
- The income statement is based on the accrual accounting method, meaning it is *not* a representation of actual cash earnings.
- It is separated into a few sections: operating, non-operating, and irregular items.
- Investors are typically interested in operating, or "above-the-line" concerns (e.g. revenue, COGS, SG&A, R&D through EBIT).

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Balance Sheet

- The balance sheet is a “snap shot” in time of the firm’s assets, liabilities and shareholder equity.
- Key assets include cash, PP&E (property, plant, and equipment), inventories, receivables. Key liabilities include long-term debt and payables.
- The balancing formula is Assets = Liabilities + Owners Equity. The balance sheet must balance.
- It is also based on the accrual accounting method.

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Statement of Cash Flows

- The statement of cash flows is perhaps the most important of all three key financial statements.
- It reconciles the cash activity of a firm with its accrual based income statement and balance sheet.
- The statement of cash flows is broken down into three sections: Operating, Investing, Financing.
- It is where traditional free cash flow (FCF) is calculated: cash from operations ("Operating") less capital expenditures (an item in the "Investing" section).
- Because the cash flow statement is based on *actual* cash flow, results can be very lumpy.

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Let’s open up a few financial statements…

- Apple
- Microsoft
- Energy Transfer Partners
- Realty Income
- JP Morgan

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Efficiency Ratios

- Efficiency ratios show analysts how efficiently a firm is utilizing its capital base.
- They blend income statement and balance sheet accounts and are great for comparing the performance between two or more firms.
- Most efficiency ratios are generally expressed in days turnover or days outstanding.
- Examples:
  - Days Receivables (Accounts Receivable /Revenue) x 365
  - Days Inventory (Inventory/COGS) x 365
  - Days Payables (Accounts Payable/Revenue) x 365
  - Cash Conversion Cycle (Days Receivable + Days Inventory – Days Payable)

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Credit Ratios

- Credit ratios help the analyst frame a company's debt position, allowing the comparison of creditworthiness across firms (and even across industries).
- Leverage ratios
  - Debt to Capital Ratio (Debt / (Shareholder's Equity + Debt))
  - Debt to EBITDA (expressed as turns of leverage)
- Coverage ratios
  - EBIT / Interest Expense
  - EBITDA / Interest Expense

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Return Ratios

- Return ratios inform investors how much earnings a firm is generating on its relative capital base.
- These are generally expressed as percentages and are great for comparing the performance of firms.
- Examples:
  - Return on Assets (Net Income / Average Assets)
  - Return on Equity (Net Income / Average Shareholder's Equity)
  - Return on Invested Capital (Earnings before Interest / Average Invested Capital)
  - DuPont Equation
    - (Net Income/Sales) * (Sales/Assets) * (Assets/Equity) or Profit Margin * Asset Return * Financial Leverage

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Ratio Concerns

- Be aware of the impact of non-operating cash on ROA. Firms with large cash balances may have an artificially low ROA. This isn't necessarily bad.
- Watch out for the impact of financial leverage on ratios, especially with respect ROE. The third component of ROE, as expressed in the DuPont equation, is leverage, and firms can take on more debt to improve ROE. This isn't always a good thing.
- Analysts also have to keep a watchful eye on firms that use different accounting treatments or other financial tricks:
  - Lease versus owning
  - Joint-ventures
  - Capitalized versus expensed

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The Holy Grail: Return on Invested Capital!

- Return on Invested Capital (ROIC) gives the clearest insight to the returns generated on a firm's assets.
- We like ROIC as a measure of economic return because it is not exposed to the same pitfalls as ROA or ROE.
- ROIC is calculated as Earnings before Interest / Average Invested Capital.
- There are many different ways to arrive at both EBI and Invested Capital. Here are the traditional definitions:
  - Tax-affected operating profit [EBIT x (1-tax rate)]
  - Average Invested Capital (operating assets less operating liabilities)

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Let’s now open up a DCF model…

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Question: What Makes an Ideal Dividend Growth Stock?

A) The company has a sufficient dividend yield, not one that implies risk to the payout (i.e. financially-engineered), but one that is supported organically.
B) A strong company with solid fundamentals (an attractive Economic Castle rating – it generates outsize economic profits).
C) The share price is going up (i.e. the market has conviction in the idea).
D) The company covers its dividend payment with copious amounts of free cash flow, as measured by cash flow from operations (CFO) less *all* capital spending.
E) It has a large amount of *net* cash on the balance sheet that can be used as reserves in case it encounters trouble.

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Wait… There's more!

F) The company is undervalued on the basis of a discounted cash flow process (and a relative valuation process, too!).

G) The firm's management has a strong willingness to keep paying an increasing dividend, as measured by its dividend track record.

H) The idea has a solid Dividend Cushion ratio (a measure of the safety and growth potential of the dividend).

I) Only some of the above… which ones?

J) All of the above (A though H).

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Introducing: The Valuentum Dividend Cushion Ratio™

- An objective, cash-flow based fundamental ratio that gauges a company's ability to *continue raising* its dividend long **into the future**.
- Adds five-year forecast of free cash flow (CFO less capital expenditures) to net balance sheet (cash less long-term debt) and divides that sum by five-year forecast of expected cash dividends paid.
- It is pure cash-flow dividend coverage ratio that considers the health of a firm's balance sheet, which is a key funding source for dividend expansion.
- **The bigger the positive number above 1 the better**. Anything less than 0 (a negative number) signals trouble.
- A more comprehensive measure of growth and safety than the payout ratio (dividends per share divided by earnings per share).

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The Valuentum Dividend Cushion™ Helps Dividend Growth Investors Avoid Dividend Cuts

- The Valuentum Dividend Cushion measure has predicted, in *real-time*, the dividend cuts, of SuperValu (SVU), Roundy's (RNDY), Dover Downs (DDE), Strayer (STRA), Exelon (EXC), Cliffs Natural (CLF), Pitney Bowes (PBI), CenturyLink (CTL) and JC Penney (JCP)…and more.

The Valuentum Dividend Cushion Caught These Dividend Cuts in Advance

A Valuentum Dividend Cushion Score Below 1 Indicates a Firm's Dividend is At Risk in the Years Ahead

Dividend Cutter	Cut Date	Dividend Cushion (Before Cut)	Reason for Dividend Cut
Avery Dennison (AVY)	31-Jul-09	0.66	Reduced dividend to support debt-reduction efforts.
ConAgra Foods (CAG)	16-Mar-06	-0.59 (1)	Restructuring, divestitures.
Constellation (CEG)	18-Feb-09	-4.36	Refocus on core business of generating and selling power.
DR Horton (DHI)	6-May-08	-0.03	Housing turmoil.
Gannett Co. (GCI)	25-Feb-09	-0.06	Excessive debt; preserve cash amid downturn of newspaper industry.
La-Z-Boy (LZB)	17-Feb-09	0.89	Suspended dividend to preserve cash amid downturn in home furnishings.
Marriott Intl (MAR)	1-May-09	2.18 (2)	Suspended dividend in the wake of weak business travel, but dividend achieved record highs again, May 6, 2011.
Masco Corp (MAS)	11-Feb-09	-0.74	Cut dividend to ensure ability to fund operations and service debt coming due.
New York Times (NYT)	20-Nov-08	0.04	Effort to preserve cash. Downturn in newspaper industry. Loss of investment-grade credit rating.
Pfizer (PFE)	26-Jan-09	0.54	Bought Wyeth to diversify revenue base. Raised $22 billion+ in debt.
Sara Lee Corp (SLE)	8-Aug-06	0.70	Streamlining operations, business unit divestitures to raise cash.
Sunoco Inc. (SUN)	6-Oct-09	-0.85 (3)	Poor margins, overseas competition.
SuperValu (SVU)	20-Oct-09	-5.78	Rising unemployment, competition from Wal-Mart, etc.
Valero Energy (VLO)	27-Jan-10	0.15	Lower demand for gas and diesel.
Vulcan Materials (VMC)	14-Oct-11	-1.42	Free up much-needed cash amid downturn in aggregate demand.

(1) Forecast period for ConAgra, 2007 through 2011.

(2) Marriott is an instance where management prematurely cut its dividend, in our opinion. The Cushion reflected little risk at the time of cut, and sure enough Marriott restored its payout to record high

(3) Forecasts adjusted to reflect Sunoco's poor free cash flow trends beyond last reported year.

Backtesting Methodology: Net balance sheet (year prior to dividend cut). Free cash flow for years beginning in year of dividend cut through reported years. If reported years do not total five, last reported year is extrapolated for remainder of forecast period. Dividends paid reflects what the dividends would be ex dividend cut.

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The Valuentum Dividend Cushion™ Helps Identify Stocks with Long-term Dividend Growth Potential

- The Dividend Cushion ratio highlights stocks with:
  - Substantial *future* free cash flow generation in excess of cash dividends paid
  - Fantastic balance sheets with solid net cash positions (i.e. total cash less total debt is significantly positive)
  - Little financial leverage or debt refinancing risk (emphasis is placed on *true* balance sheet cash-rich entities)

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The Dividend Cushion: Some Finance Definitions

- Cash flow from operations (CFO)
  - Found on the cash flow statement
  - A good measure of cash earnings
  - Takes into consideration changes in working capital (inventory, accounts receivable, accounts payable)
- Capital expenditures (capex)
  - Found on the cash flow statement
  - Growth and maintenance spending necessary to continue growing cash from operations
- Traditional free cash flow (FCF)
  - Derived by analyst
  - Cash from operations less capital expenditures
- Long-term debt
  - Found on the balance sheet
  - Debt due after one-year
- Total cash and cash equivalents
  - Found on the balance sheet
  - Cash that can generally be used for dividends, share repurchases, and/or acquisitions
- Cash dividends paid
  - Found on the cash flow statement
  - The actual cash going out the door in the form of cash dividend payments

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Microsoft: By the Numbers (FYE June 2014)

Cumulative 5-year Forecasted Cash from Operations	190,536
Culumative 5-year Forecasted Capital Expenditures	-34,344
Cumulative 5-year Forecasted Free Cash Flow (CFO - capex)	156,192
Total Cash - Last Fiscal Year	85,709
Total Long-term Debt - Last Fiscal Year	20,645
Net Cash (total cash less total long-term debt)	65,064
Cumulative 5-year Forecasted Dividends Paid (from CF statement)	67,015
Valuentum Dividend Cushion Score (greater than 1.25 = good)	3.30

In USD millions

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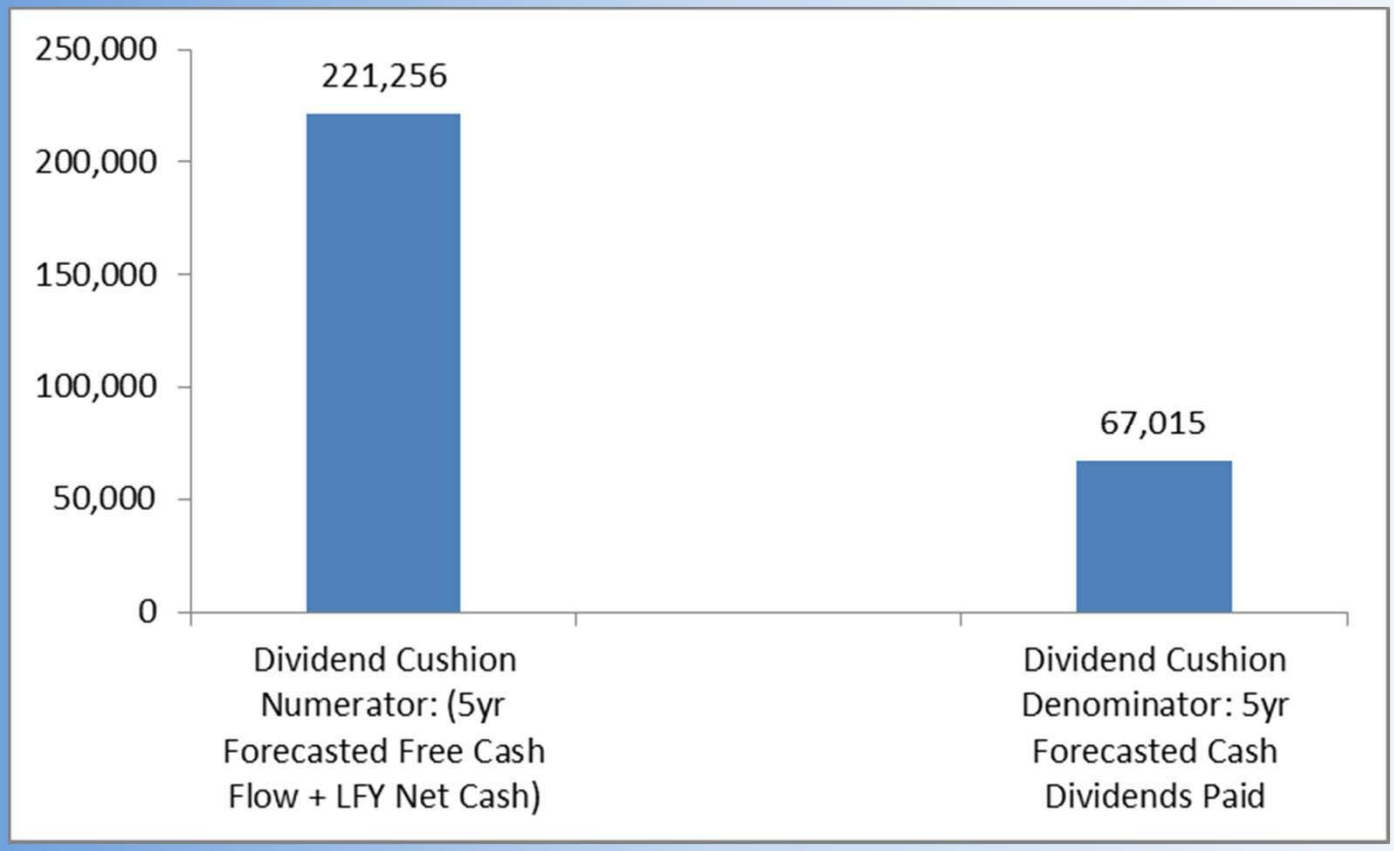
Microsoft: Dividend Cushion Derived



In USD millions

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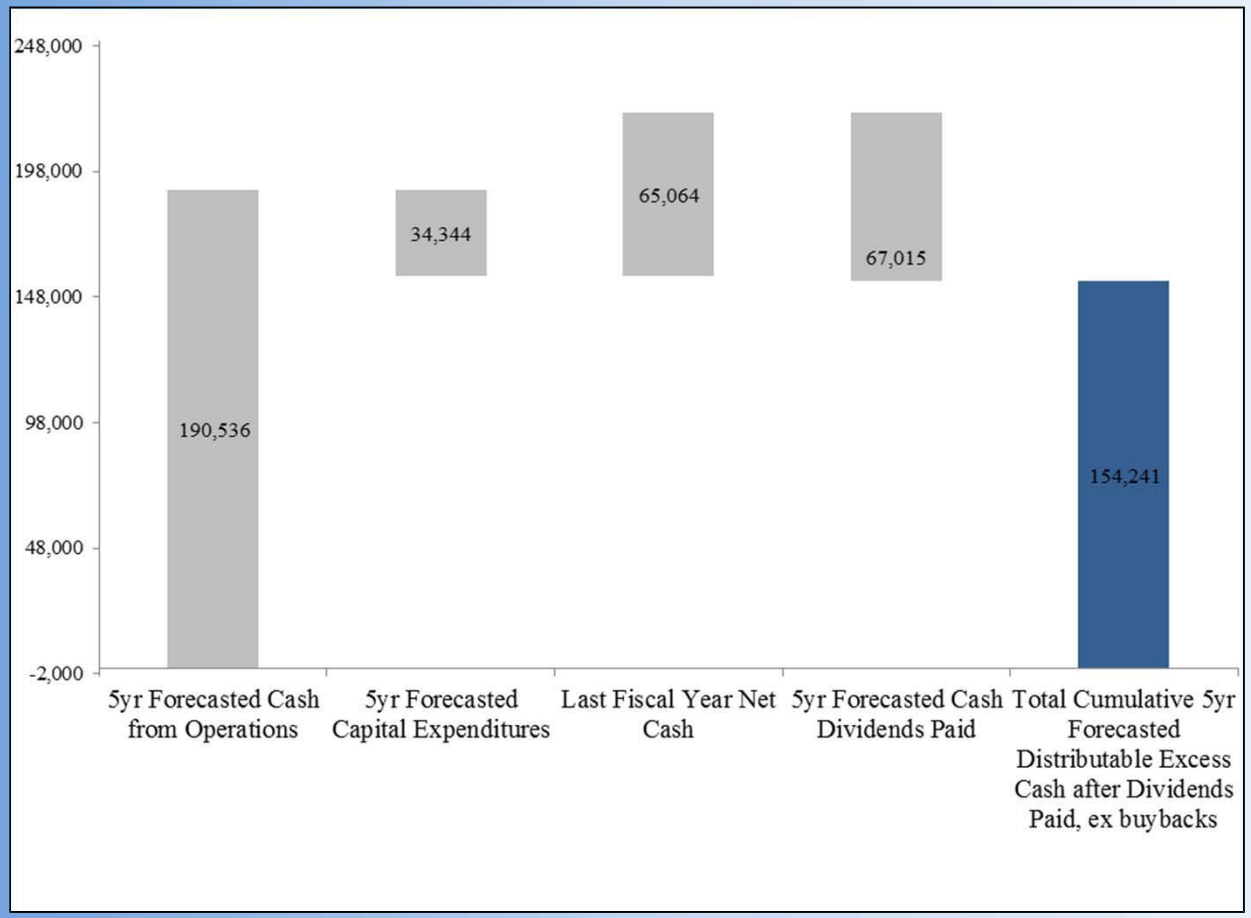
Microsoft Dividend Cushion Cash-Flow Bridge



In USD millions

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What Does This Mean for Microsoft?

- Valuentum Dividend Cushion™ Ratio: **3+** (FYE June 2014)
- Translation: Microsoft could cover its *growing* dividend with expected free cash flow and its net cash position **more than 3 times** over the measurement period!
- Conclusion: The company has fantastic dividend growth prospects on the basis of its free-cash-flow profile and net balance sheet.

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Follow Up: What Do You Think Microsoft Did?

- Microsoft raised its dividend September 2015 by 16%+ (updated Dividend Cushion ratio: **~2.6**).
- Question #1: Why did the ratio fall?
- Question #2: Could Microsoft still *double its dividend* and still have room to grow the payout? *Yes.*
- These are the types of solid, secure dividend growth ideas we seek to deliver to members in the Dividend Growth Newsletter portfolio.
- Not one position in the Dividend Growth Newsletter portfolio has ever experienced a dividend cut!

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Important Risks for Dividend Growth Investors

- Beware of financially-engineered dividends as in the case of MLPs and some REITs.
- Too many definitions of cash flow – focus on traditional free cash flow (cash flow from operations less *all* capital spending)
- If the dividend yield is too good to be true, it probably is… (8%+ = danger!). Use common sense.
- Rising interest rates could complicate the strategy. Higher rates could cause permanent capital impairment in income-oriented equity holdings, especially ones with financially-engineered payouts.
- Don't fall in love with the past – the future is all that matters. A dividend track record is history.
- The current state of the global economy.

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How to Assess Earnings Quality

- According to the Research Foundation of the CFA Institute:

  Understanding the quality of earnings is an essential part of processing and interpreting information. A high-quality earnings number will (1) reflect current operating performance, (2) be a good indicator of future operating performance, (3) and fairly annuitize the intrinsic value of the company.

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How to Assess Earnings Quality, cont

- At Valuentum, there are five basic areas that we evaluate to assess the quality of a firm's earnings:
  - Is the company's earnings growth driven by higher-quality revenue expansion or lower-quality cost-cutting measures (can the trajectory of earnings be sustained with continued revenue increases because cost-cutting, by definition, is a finite activity?);
  - Has the company benefited from one-time items and/or an abnormally low tax rate to bolster net income (is the company shifting items from one period to the next?);

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How to Assess Earnings Quality, cont

- Has the company engaged in aggressive share buybacks to bolster earnings per share (is management incentivized based on return on invested capital or accounting earnings per share, the latter not always in the best interests of shareholders?);
- Does the company convert 100%+ of its net income into cash flow from operations (are the earnings it generates truly cash earnings or are they more an accounting measure?);
- Was there a large re-classification of costs and/or segments that muddied the performance (is the company trying to hide something?)

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Assessing Cash Burn Scenarios

- A focus on the operations are key, particularly cash flow from operations and capital expenditures.
- Financing activities cannot be depended upon. When companies need the cash the most, banks and the equity markets are the least forgiving.
- Cash flow from operations less capital spending equals free cash flow.
- Summing up future free cash flows is a good proxy for cash build or burn during the measurement period.

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Assessing Cash Burn Scenarios, cont

- Evaluating the firm's future debt maturity schedule and non-cancelable cash commitments are key.
- If future free cash flows do not cover future debt obligations, the company is dependent on refinancing initiatives.
- Should operations falter, the credit markets tighten, or an exogenous event impede results, the probability of a liquidity event increases.

Contractual Obligations and Commitments

Aggregated information about our obligations and commitments to make future contractual payments, such as debt and lease agreements, and contingent commitments as of February 2, 2013 is presented in the following table.

($ in millions)	Total	Less Than 1 Years	1 - 3 Years	3 - 5 Years	More Than 5 Years
Recorded contractual obligations:					
Long-term debt[1]	$ 2,868	$ -	$ 200	$ 485	$ 2,183
Capital leases and note payable	124	30	68	24	2
Merchandise accounts payable	1,162	1,162	-	-	-
Unrecognized tax benefits[2]	76	2	-	-	74
Contributions to non-qualified supplemental retirement and postretirement medical plans[3]	297	53	97	60	87
	$ 4,527	$ 1,247	$ 365	$ 569	$ 2,346
Unrecorded contractual obligations:					
Interest payments on long-term debt	$ 5,096	$ 198 [4]	$ 396	$ 341	$ 4,161
Operating leases[5]	2,876	252	405	282	1,937
Standby and import letters of credit[6]	281	281	-	-	-
Surety bonds[7]	79	79	-	-	-
Contractual obligations[8]	1,796	465	834	338	159
Purchase orders[9]	2,510	2,510	-	-	-
Guarantees[10]	40	5	9	4	22
	$ 12,678	$ 3,790	$ 1,644	$ 965	$ 6,279
Total	$ 17,205	$ 5,037	$ 2,009	$ 1,534	$ 8,625

Equity and credit analysis are inseparable. During liquidity squeezes, the equity market factors in a probability of an adverse event into the share price..

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Common Financial Warning Signs

- Unexpected large asset write-offs
- Large fourth-quarter adjustments
- Unexplained changes in accounting methods
- Unusual transactions that bolster profits
- Concerning inventory build relation to sales
- Changes in the auditor and related party transactions
- Very important: Net income increasing but cash flow from operations falling (big red flag)

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Competitive Advantages of Valuentum's Approach

- Independent
- Integrity and systematic application of analytical process
- Comprehensive equity research provider – from value through momentum investing
- Breadth and depth of coverage
- Commitment to expanding coverage
- Strong performance track record
- Fair value estimates for all firms under coverage
- Unique cash-flow based dividend growth process
- Valuation expertise

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