Business Perspective Investing

And Why Financial Numbers Are Not Important When Picking Shares

Sample Chapter – Chapter 1

Chapter 1

Why Accounts Don't Matter

"The difficulty lies not so much in developing new ideas, but escaping from old ones"........ John Maynard Keynes.

Financial accounts don't matter for several reasons:

1. They cannot be relied upon.
2. They only represent a snapshot of the business at one point in time.
3. They may tell you little about the future.
4. They don't tell you whether the management are competent and trustworthy.

Point # 1

Accounts cannot be relied upon.

The Annual Report of a company is well worth reading, but even for large FTSE companies where their business strategy should be described, they hide a lot of very important information.

The number of cases where investors have discovered that the accounts of a company were misleading, or even a total work of fiction are numerous. For example in the UK: **Connaught, NCC Group, Autonomy, Cedar Group, iSoft, Utilitywise, Quindell, Mitie, Conviviality, Amey, Capita, Carillion, Cattles, Healthcare Locums, Erinaceous, Findel, Northern Rock, HBOS, Royal Bank of Scotland (RBS), Torex Retail, Silverdell, Globo, Patisserie, Polly Peck, Maxwell Communications** many more which are too numerous to mention. That's apart from major US cases such as **Enron** and **Worldcom**. The above examples include both small and large companies and although smaller companies can be perceived as being riskier, in reality even the largest companies can collapse at short notice. Some of the above were FTSE-100 companies.

Not all of these companies were the victims of deliberate fraud. Many were simply examples of management's proclivity to present optimistic figures to investors. Or at least ones that met analysts' forecasts and enabled them to achieve their bonus targets.

Accrual Accounting Can Mislead

Accrual accounting is the basis for IFRS and other accounting standards. It attempts to match future revenue and costs. Future costs may already be incurred, and future revenues already contracted for and billed, but the cash movements may differ very considerably. The cash movements may not reflect the underlying position of the business. Therefore it is widely accepted that accrual accounts provide a more accurate and consistent view.

But accrual accounting requires estimates by management. On revenues it enables recognition of revenues that are not yet invoiced – for example on long term contracts. Whether the future cash flows will match is often a difficult question to answer.

Accounts Don't Tell You About The Future

Why do people invest in the shares of public companies? In essence, and ignoring the speculators, they do so because they expect to receive more in the future by investing now – it's gratification postponed. That means more in terms of capital appreciation and dividends, i.e. total return, in future time periods from their initial investment than originally invested. The value of a business is dependent on future cash flows.

Point # 2

The value of a business depends on future cash flows.

Investors should preferably be doing a discounted cash flow calculation, either directly or implicitly, on the future cash flows from owning the company. That includes the dividends receivable and the likely cash they can realize from selling the shares in the future. Estimating the future values requires estimation of future earnings and future asset valuations of a business. But typical ratios used by investors to evaluate and compare companies tell you almost nothing about the future.

The commonest ratio used is the price/earnings ratio (P/E) which tells you how much you are paying for the current profits of a company. This is typically based on the historic profits (one year in the past), or one year in the future based on analysts' estimates for the current year.

But what are the profits? Pre-tax, or post-tax? Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA), or "reported" earnings? Underlying profits or not? See Chapter 8 for a discussion of the confusing complexity that has crept in to accounting statements.

Alternative valuation measures are the dividend yield, which is totally at management's discretion even if it does tell you how much cash you may receive in the short term from an ordinary share investment in the company, or measures of the assets held by the company.

Assets used to be a very good measure of the current and potential future value of a company as they can represent productive earnings capability. For example, machinery installed or property owned. But many companies in the modern era rely for their earnings potential on intangible property that may be inadequately valued by conventional accounting. For example, software IP or brands. Or the earnings may be a reflection of the employees' revenue generating capability through the provision of services, or the contracts the company has with third parties. For that reason assets tend not to be used to value companies in modern times unless they are property companies or are suffering financial distress (e.g. are no longer a "going concern" when people start looking at how much the assets could be sold for in a fire sale).

Assets are valued only at a single point in time, and forecasting their future value is often problematic. Indeed in the case of banks, where loans may be anticipated to likely default in future, IFRS does not permit the prudent recognition of that fact. Only actual losses can be reflected in the accounts. This was one cause of the excessively optimistic view of the financial position of banks prior to the financial crisis in 2008.

Accounts Mainly Tell You About the Past

Financial accounts reflect how good the business model of the company has been in the past in generating profits and cash.

A company's business model describes how the organization creates, delivers, and captures value via its adopted business processes. The accounts are only a good pointer to the future if the world, and the markets in which the company operates, are in stasis, i.e. nothing about the market and the company is going to change. That's a very big assumption in the modern world!

Management Competent and Trustworthy?

One of the key factors that affect the outcome of any investment is the competence of the management and how much they can be trusted to look after your interests rather than their own. That is particularly so when investing in smaller or unlisted companies.

Incompetent or inexperienced management can screw up a good business in no time at all, although the bigger the company, the less likely it is that one person will have an immediate impact. But Fred Goodwin allegedly managed to turn the **Royal Bank of Scotland (RBS)**, at one time the largest bank in the world, into a basket case that required a major Government bail-out in just a few years. It's possible that he might claim there were other causes or contributors to the debacle. But few people would argue that Goodwin's aggressive personality did not affect the outcome. Many shareholders, including former employees of the bank, were impoverished and some made bankrupt due to the share price collapse.

Royal Bank of Scotland remained a bank and many of its operations remained the same, but the strategy adopted of taking on more risk, not just by reducing capital adequacy but my pursuing risky acquisitions, undermined the business and brought its downfall.

The moral is that one cannot assume that what makes a company profitable in the past will continue to do so in the future if management changes strategy or makes poor operational decisions.

Examples of How Accounts May Mislead

Financial accounts and conventional valuation metrics used by many investors are particularly misleading when valuing early stage companies, or those rapidly growing. A conventional p/e ratio ignores the future growth in earnings that on a discounted cash flow basis will add substantial value.

Jim Slater attempted to tackle that issue by inventing the Price Earnings Growth Ratio (PEG) that adjusts for the rate of growth in earnings. But that is a rather simplistic approach and cannot be applied if the company has no current earnings.

For example, **Amazon** apparently took a strategic decision to grow the company some years ago as opposed to maximizing short term profits. As a result it reported losses in 2014 and prior years and was still valued at $150 billion at the 2014 year end! The company has subsequently continued to grow and is reporting profits at the time of writing but is on the sky-high p/e of 95. Needless to point out perhaps that it is not paying a dividend. So investors clearly have taken a view on the future ability of the company's business model to continue to be successful in terms of gaining market share with the prospect of market dominance and future profits.

Or take that other big internet success story, **Facebook**. It was founded in 2003 and grew to 1 billion users by 2012. Initially there seemed to be little attention to how the users could be "monetized" but an advertising model was soon adopted. The year 2012 was the year when it did an IPO, but it still lost $59 million in that year. The IPO valued the company at over $100 billion! That made it the third largest IPO in American history. Like Amazon, investors were obviously forecasting that the company would continue to grow both its users and that profits would subsequently appear, as they have done. Users are now over 2 billion, at the time of writing.

The same can be true of many relatively new smaller companies, and not just technology or internet-based ones. A good example is **Purplebricks**, an on-line estate agency. It currently has a market cap of £500 million but has never made a profit. Losses are actually increasing and the share price has been falling in the last year as doubts are raised about its business model.

But still some investors are clearly willing to invest in it, or continue to hold the shares in anticipation of future profits. Such investors are rather like those who invest in new gold mines on the principle that it might make them as rich as Croesus. It rarely does of course but hope springs eternal. Perhaps Purplebricks is an extreme case, but there are many similar examples.

Investors hope that on-line estate agents will mainly replace traditional ones with new low-cost operating structures and lower customer fees, and that Purplebricks will become the dominant player or "gorilla" in its marketplace. I would not like to predict whether that will be the case or not but clearly there are competitors in that space and low barriers to entry so they are in a market share "land grab" as it is called so as to establish a dominant position while it is still possible to do so.

An alternative shorthand approach to valuing such companies as opposed to doing a full analysis is to use a revenue multiple (market cap divided by historic or future revenue). On that basis Purplebricks is valued at 5.5 times last year's revenue. If it was not making big losses, the multiple would likely be higher.

You could of course do a full cash flow analysis based on forecasting future revenues and operating costs, but such forecasts can be wildly inaccurate more than a year or two hence. And what discount rate do you apply anyway?

Now you might say that valuing unprofitable companies is a mug's game and that you will never invest in such companies. But by doing so you are likely to miss out on substantial portfolio returns. The key point being made here is that the market has no problem with valuing such companies.

A share price of any company, whether it is listed or unlisted, is determined by what a willing buyer is willing to pay a willing seller, and in every stock market trade, for every buyer there is a seller.

John Maynard Keynes pointed out that stock markets are more like a beauty parade than a rational valuation process. To quote: “It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be."

Point # 3

The stock market is a beauty parade.

Better Measures of the Quality of a Business

If you look at the financial accounts of a company alone, then you are missing out on those aspects of the business that show you how it generates profits and cash. Such measures can tell you more about the likely future success of the business and the risks that it will face. In other words, alternative measures tell you much more about the “quality” of a business and its attractiveness to investors, which are important in the beauty parade of the stock market.

The “quality” of the business, and the capabilities of the management, are the biggest influence on the future profits and return on capital of a company. Actually determining the quality of a business and its earning potential is not easy. But there are many pointers that can help you decide.

Another factor that needs to be taken into account is how risky is the business, i.e. how volatile the future profits might be, and whether they face risks that might fatality undermine the company. It is the “risk adjusted returns” that matter to investors. There are some fairly simple things you can look at to see whether a business is risky or not.

SWOT Analysis

One useful technique to use when looking at a business is a SWOT analysis where SWOT stands for strengths, weaknesses, opportunities and threats. This is a technique invented in the 1960s which became a favourite of MBAs and management consultants. It is a good way to identify and highlight in a one-page quadrangle the key strategic and operational issues that a company faces. It can be a useful approach to identifying some of the non-financial aspects of a company that are worth looking at. Many of the aspects to be examined will be covered in later chapters of this book.

Quality is the Key

This book will attempt to cover what investors should look at when valuing companies, in additional to conventional financial metrics. The key to successful investment is to identify those aspects of a company that make it a high quality business and which will enable it to generate a superior return on capital in the long term.

There are thousands of listed companies you can invest in, so why bother with those that are low quality or high risk? Let the speculators and those with short term horizons waste their money on bad investment choices.

Note: There is a checklist at the end of each chapter after this one, and a summary at the end of the book, so that you can easily rate prospective investments on the perspective of quality.