Financial filings and Annual reports: Separating the wheat from the chaff

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Data versus Information

- In the interests of providing more information to investors, the SEC and the accounting standards boards (GAAP, IFRS) have required companies to reveal more and more about themselves.
- That is good news, but it is also bad news. Financial disclosures from firms have become “data dumps”, stretching to hundreds of pages and several GB of downloads.
- The key to using these financial disclosures in valuation and investing has become separating the “stuff that matters” from the ‘stuff that is noise”

The key to making the distinction between information & noise

1. Be focused: Reading financial statements cover to cover, looking for "interesting" and "important" stuff almost never works. Instead, start with focus, by defining the items that you want information on, at least in broad terms, and then classifying what you find along those categories.
2. Tie the information to your valuation model/metrics: Broadly speaking, you can value a company in one of three ways:
   - Intrinsic or DCF valuation, where the value of a company is estimated by forecasting out expected cash flows and discounting them.
   - Relative valuation, where you are using a multiple and comparable firms, to make a judgment on value.
   - Contingent claim valuation, where you value a business as an option.

The information that you will get out of the financials will vary, depending on the approach you use.

The drivers of value

Determinants of Value

Growth from new investments
Growth created by making new investments; function of amount and quality of investments

Efficiency Growth
Growth generated by using existing assets better

Terminal Value of firm (equity)

Current Cashflows
These are the cash flows from existing investment,s, net of any reinvestment needed to sustain future growth. They can be computed before debt cashflows (to the firm) or after debt cashflows (to equity investors).

Expected Growth during high growth period

Stable growth firm, with no or very limited excess returns

Length of the high growth period
Since value creating growth requires excess returns, this is a function of
- Magnitude of competitive advantages
- Sustainability of competitive advantages

Cost of financing (debt or capital) to apply to discounting cashflows
Determined by
- Operating risk of the company
- Default risk of the company
- Mix of debt and equity used in financing

The key valuation questions that you are trying to answer…

Item	Key questions	Key inputs
Cash flows from existing investments	1. How much capital is invested in existing assets? 2. How much did the firm earn on these assets?	1. Current revenues 2. Current earnings 3. Current capital invested (Debt + Equity – Cash)
Future growth	1. How much growth from new investments? 2. How much growth from improved efficiency?	1. Revenue growth 2. Operating margin
Quality of growth	1. How much new capital will the firm have to invest to deliver that growth?	1. Reinvestment 2. Return on invested capital
Operating Risk	1. What businesses does the firm operate in? 2. What countries does the firm operate in?	1. Relative risk (Beta) 2. Equity Risk Premium 3. Cost of capital
Financial Risk	1. How much debt does the firm have? 2. Are there any other contractual commitments?	1. Debt ratio 2. Cost of debt
Other assets/ claims	1. Are there any non-operating assets? 2. Are there other claims on the equity?	1. Non-operating assets 2. Minority interests 3. Options outstanding

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A template for reading a “financial” disclosure

Step	Information
Timing & Currency	**General:** Period covered by the financials, Reporting currency
Business mix	**General:** Business segment breakdown (revenues), Geographic breakdown (revenues), Specific risks (not generic)
Base year inputs for valuation	**Income statement:** Revenues, Earnings, Interest exp, Tax rate **Balance sheet:** Book equity, debt outstanding, Cash & Working capital (WC), Cross holdings (minority & majority) **Statement of cash flows:** Change in WC, Capital Expenditures, Depreciation, Debt issued (repaid)
Follow through	**Footnotes to financials:** Operating lease, rental & other commitments, Employee options, Timing of debt due, Under funded obligations (pension & health care)
Units	**Share count:** Number of shares outstanding, Restricted stock units (RSUs), Acquisitions paid for with stock
Corporate governance	**General:** Differences in voting rights across share classes, special rights or privileges given to insiders etc.

Valuing Procter & Gamble: September 2012
The timing issue in financial statements

- If you are valuing a company for a transaction (investment, acquisition etc.), you should use the most updated information that you can find on the company. While market numbers (interest rates, stock prices) get updated constantly, accounting numbers get updated at pre-specified intervals (usually) once every quarter.
- To value P&G in September 2012, I started with the most recent 10K. That filing, which was made with the SEC in August 2012, reflects P&G's financial year, which ends June 30, 2012. (See page 3 of the 10K). Since it is the most recent filing, it will be used in the valuation.
- If the year-end in the last 10K had been December 31, 2011, I would have obtained the last 10Q and calculated trailing 12 month numbers for flow numbers (income statement & statement of cash flows) and the balance sheet from the last 10Q for stock numbers (balance sheet).

The pre-read: Browsing the 10K

Page 2: Fiscal year end, Number of shares
Page 3, 21: Business segmentation, and on Page 35: Business segment sales growth
Page 4: Key customers (Risk)
Working capital policy similar to industry
Page 6: Geographical breakdown
Page 7-14: Pablum
Page 15: Key employees
Page 17: Performance against sector
Page 19, 25, 30: Historical comparison
Page 31: Non-operating income/expenses
Page 32: Taxes (27.1%)
Page 34-35: Venezuela current impact: Materiality?
Page 36-43: Profitability by segment
Page 45, 47: Investment cash flows (Cap ex, WC)
Page 47: Financing cash flows (Dividends, stock buybacks, debt cash flows)
Page 46: Free Cash flow (Co's definition)
Page 48: Bond ratings
Page 49: Contractual commitments (Debt, capital leases, operating leases, pension obligations)
Page 51: Rate of return on pension benefit obligations
Page 52: Acquisition accounting
Results of past acquisitions
Page 54: Hedging activities
Page 57: Organic versus Total Sales Growth
Page 65: "Consolidated" Earnings Statements
Page 65-70: Financial Statements
Page 75: Goodwill
Page 82-85: Debt coming due
Page 87: Derivatives exposure
Page 89: Shares outstanding
Page 90: Stock-based compensation
Page 91: Options outstanding
Page 93: Pension plan underfunding
Page 95: Assumptions used to compute pension obligations
Page 103: Operating lease commitments & Purchase obligations
Page 107: More segment details

P&G: The key numbers…

	This year	Last year	10K: Page #	Concerns
Industry	Household Products		3	
Revenues	$ 83,680.00	$ 81,104.00	66	
Operating income or EBIT	$ 13,292.00	$ 15,495.00	66	
Book value of equity	$ 64,035.00	$ 68,001.00	67	
Book value of debt	$ 29,778.00	$ 32,014.00	67	51, 93, 95
Do you have operating lease commitments?	Yes		103	103
Cash and cross holdings	$ 4,436.00	$ 2,768.00	67	
Non-operating assets	$ -	$ -	67	
Minority interests	$ 596.00	$ 361.00	67	
Number of shares outstanding =	2754.28		3 & 68	113
Current stock price =	$ 68.91		Current	
Effective tax rate =	27.10%		32, 66,100	
Marginal tax rate =	35.00%		100	
The value drivers below:				
Compounded annual revenue growth rate over next 5 years =	3.00%		57	
Target pre-tax operating margin (EBIT as % of sales in year 10) =	16.00%		30	
Sales to capital ratio (for computing reinvestment) =	0.94			
Market numbers				
Riskfree rate	1.60%		Current	
Initial cost of capital =	9.47%			4
Other inputs				
Do you have employee options outstanding?	Yes		91	
Number of options outstanding =	353.09			
Average strike price =	$53.83			
Average maturity =	5.00			
Standard deviation on stock price =	20.00%			

Some parting advice (suggestions)…

1. Skip the pablum: Financial filings increasingly use legal boilerplate to protect companies against lawsuits. Thus, much of the risk discussion (P&G: 6-13) either states the obvious ("change in consumer demand") or says nothing of value ("successfully manage organizational change")
2. Don't sweat the small stuff: Significant sections of the financial filing will be dedicated to issues that are immaterial to your valuation or too "small" to make a difference. (See P&G Venezuela 34-35)
3. Cross check across financial statements: To make sure that you are not missing items or to catch inconsistencies, cross check your information. For instance, is the net capital expenditure in your statement of cash flows close to the change in fixed assets on the balance sheet? How about change in non-cash working capital?
4. Fill in the gaps: When you are missing information, make your best judgments based on either the company's past financial statements, industry norms or common sense.