Screening for Balance Sheet Strength

"It sounds extraordinary but it's a fact that balance sheets can make fascinating reading"

Mary Archer

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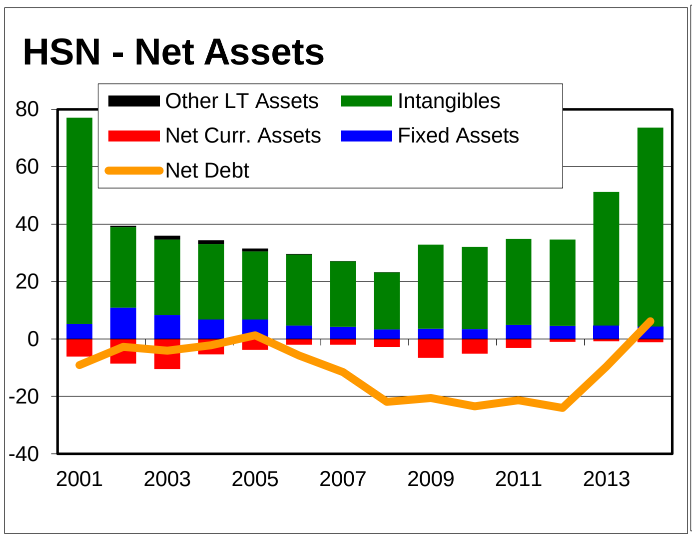
Balance Sheet Analysis – Why?

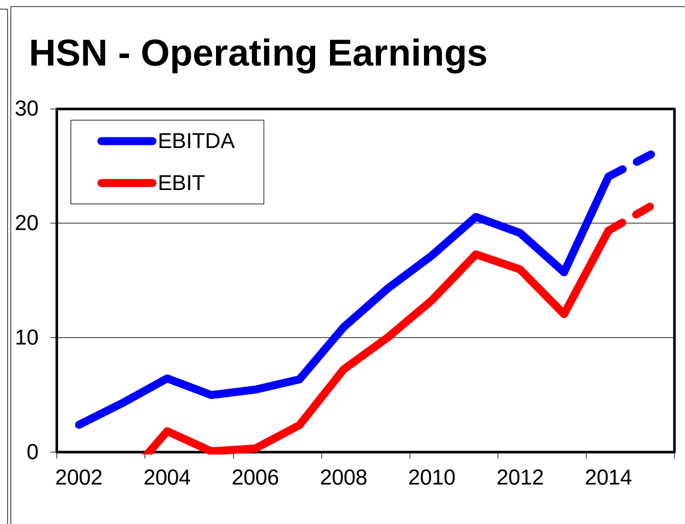
- Analysis of the balance sheet is important for many reasons:
  - Understanding earnings quality (The Balance Sheet is the Residual for Accruals)
  - Understanding returns (The Balance Sheet represents a measure of the investment in the business)
  - Understanding deep value opportunities (Discount to NTA opportunities).
- The Balance Sheet also is important in its own right as a driver of the risk/reward equation:
  - As a source of **optional** value (positive or negative): Opportunity to deploy cheap capital (or requirement to raise expensive capital/forced divestments);
  - As a source of **liquidity/solvency** risk.

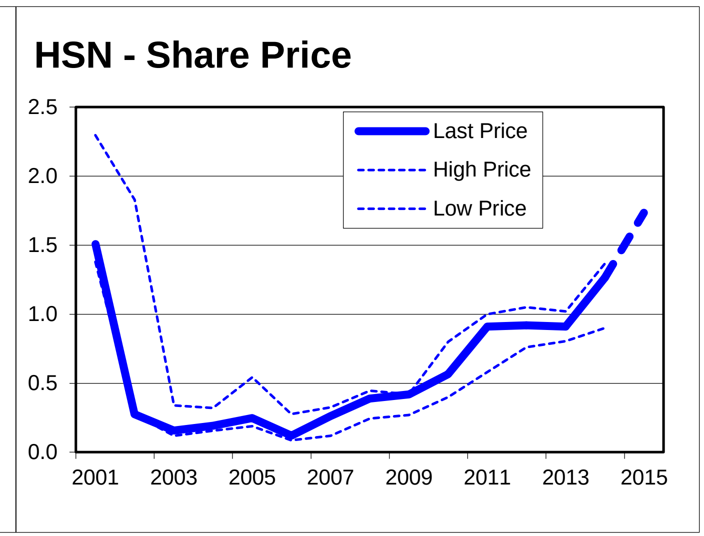
Balance Sheet as a Source of Positive Optional Value

- A strong balance sheet not only reduces risk, it offers the potential to create value:
- This can be either via acquisitions. Eg. Hansen:

- Surplus cash…
- … deployed into accretive acquisitions…
- … drives share price re-rating.



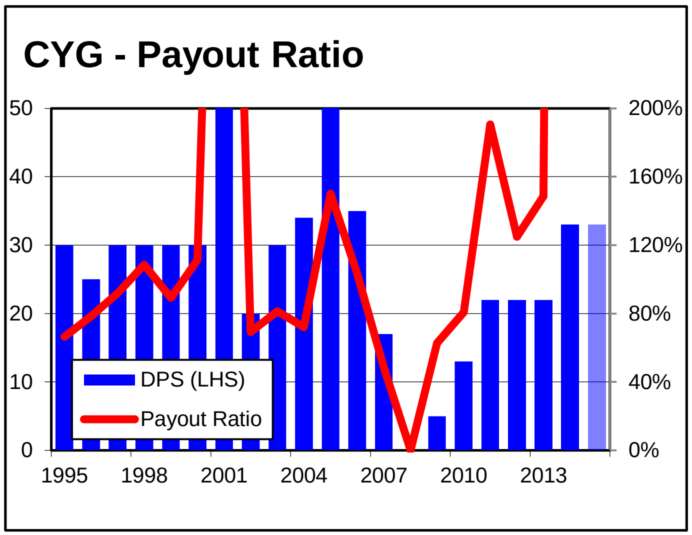


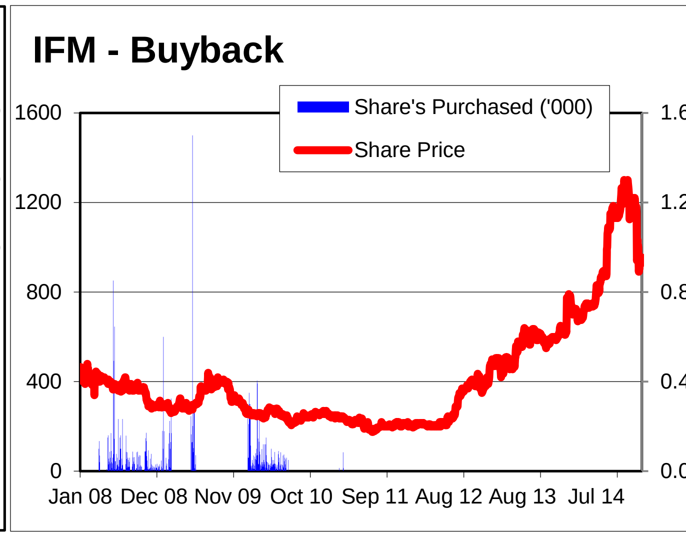


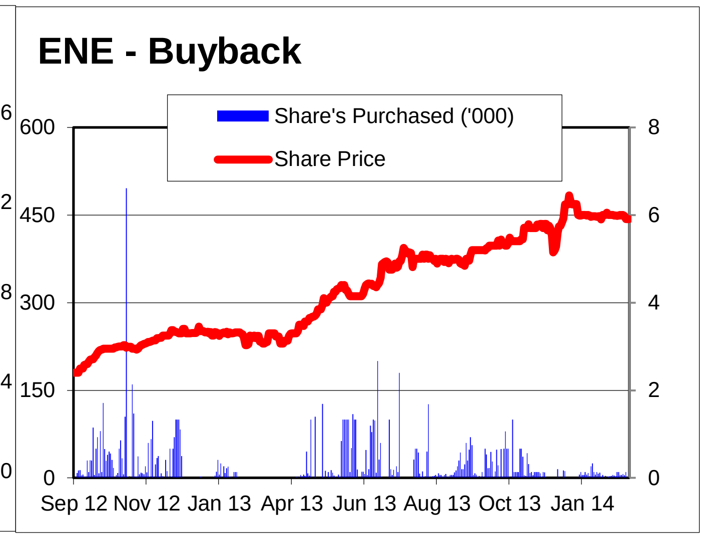
Balance Sheet as a Source of Positive Optional Value

- Or via various forms of capital management:

- Distribution of excess franking credits.
- Buy-back cheap stock.
- … or to support the share price ahead of capital management!





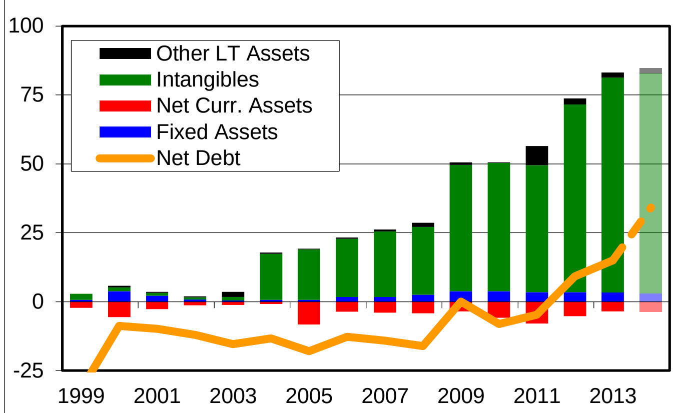


Balance Sheet as a Source of Positive Optional Value

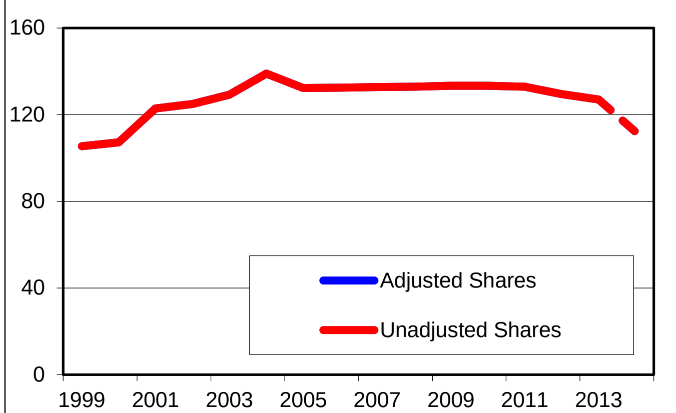
- Note that sometimes the balance sheet is not necessarily creating value, but offers an offset to deterioration in the underlying performance of the business. For example, Reckon:

- Use of under-geared balance sheet…
- … to make acquisitions and buyback stock….
- Propped up shareholder returns in the face of underlying deterioration. At a minimum, this buys time for shareholders to exit.

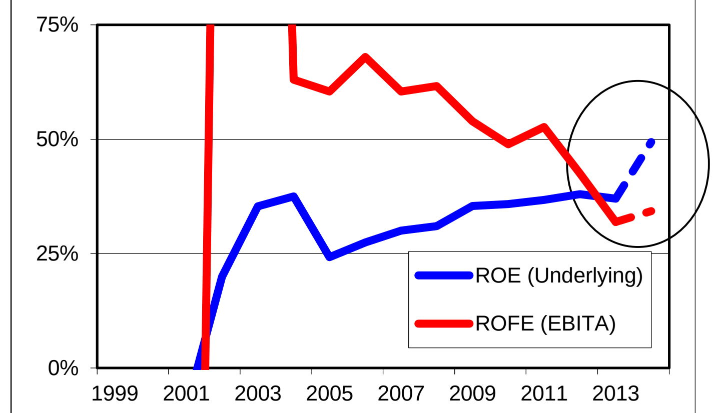
RKN - Net Assets



RKN - Share Base



RKN - ROE



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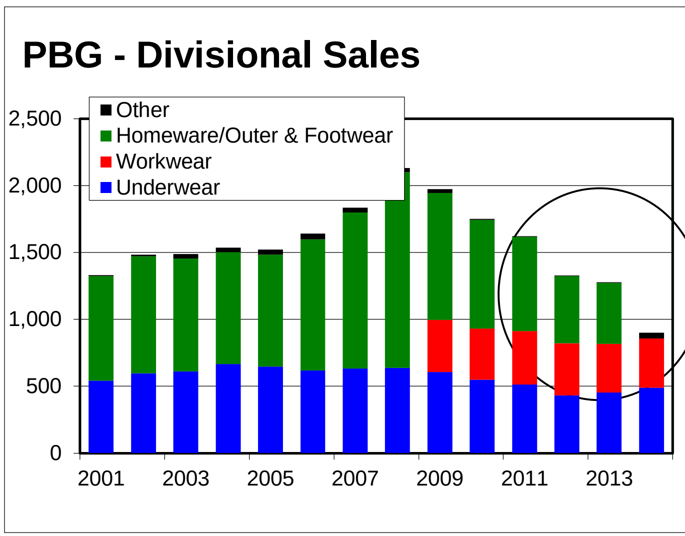
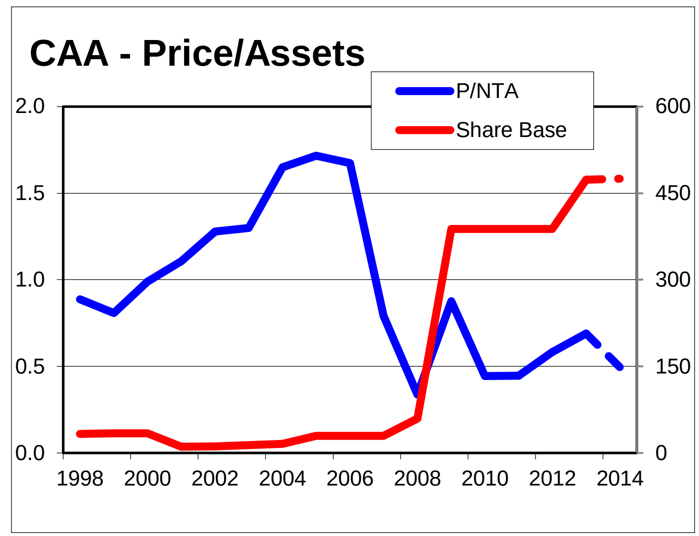
Balance Sheet as a Source of Negative Optional Value

- This process works in reverse, where excess gearing destroys value:

  - Forcing companies to sell their best businesses…

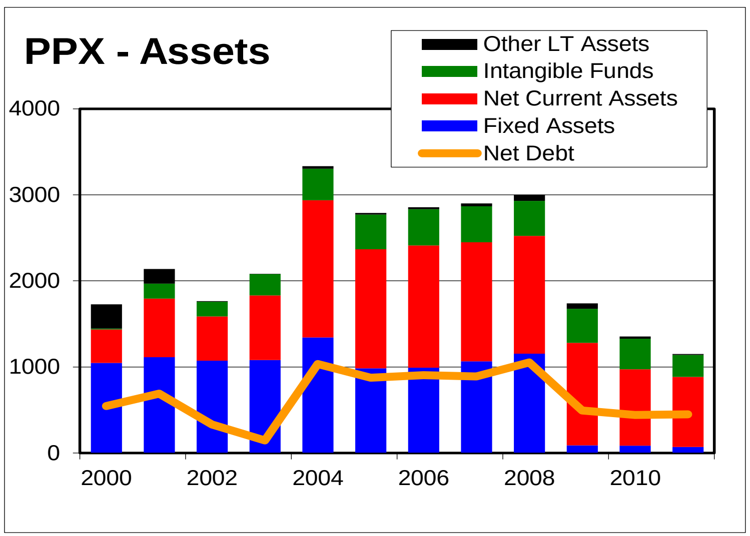


  - … or to raise capital at prices highly dilutive to returns.



Balance Sheet as a Source of Negative Option Value

- And note that once the banks take control, they transfer significant value from shareholders, to themselves…
  - E.g. Breach of bank covenants crystallised large step up in financing costs.
  - + asset sales and dilutive capital raisings.



	CONSOLIDATED 2009 $m	CONSOLIDATED 2008 $m
Note 8. Financing costs		
(a) Net financing costs from continuing operations		
Financial income:		
• Interest income	3.4	5.4
• Net foreign exchange gains	–	21.6
Total financial income	3.4	27.0
Financial expenses:		
• Interest expense [1]	(90.6)	(84.2)
• Less capitalised interest expense on qualifying capital expenditure	11.3	18.8
	(79.3)	(65.4)
• Net foreign exchange losses	(33.1)	–
• Individually significant items – Note 10	(37.2)	–
• Other borrowing costs [2]	(31.6)	(4.1)
Total financial expenses	(181.2)	(69.5)
Total net financing costs	(177.8)	(42.5)
(b) Net interest from continuing operations:		
• Interest income	3.4	5.4
• Interest expense	(90.6)	(84.2)
• Less capitalised interest expense on qualifying capital expenditure	11.3	18.8
	(79.3)	(65.4)
Total net interest	(75.9)	(60.0)

(1) Current year includes default interest associated with breach of bank covenants.
(2) Borrowing costs in the current year include waiver fees and adviser fees incurred due to breach of bank covenants. Refer

Liquidity and Solvency

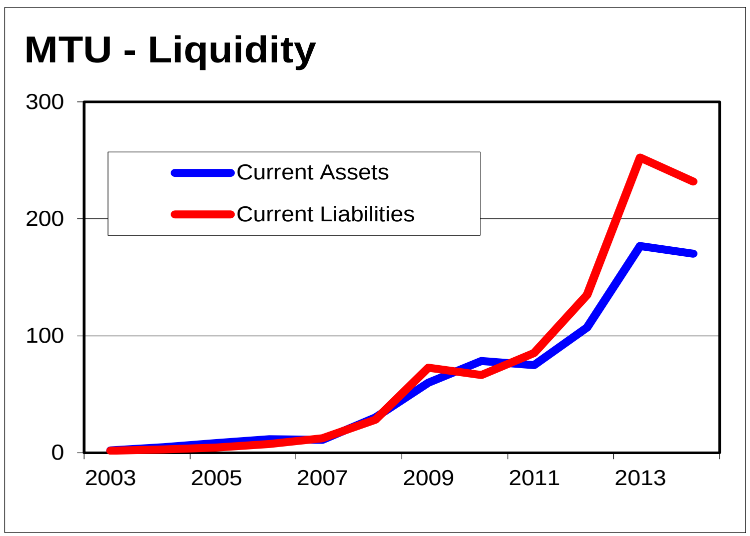
- Balance sheet strength is traditionally measured with respect to liquidity and solvency:
  - Solvency: Ability of a company to meet long term financial obligations
  - Liquidity: Ability of a company to meet short term financial obligations.
- Both of these issues can destroy long term equity value. This process is:
  - Part of a Continuum – not just solvent or insolvent
  - Movement along this continuum is dynamic;
  - This creates Inter-dependence – Liquidity impacts solvency, solvency impacts liquidity; and
  - Non-linearities in impact due to asymmetry and feedback.

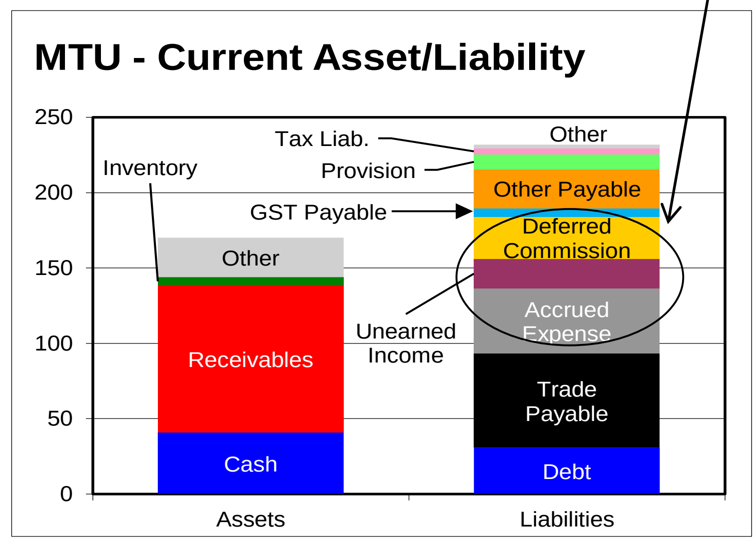
Liquidity

- Liquidity is usually considered relative to the maturity of debt facilities. However, this can be misleading as if covenants are breached, debt is usually immediately payable.

- May also measure liquidity via:
  - Current Ratio = Current Assets/Current Liabilities
  - Acid Test = (Cash + Receivables)/Current Liabilities

- Composition of assets/liabilities important in this case. i.e. some liabilities do not reflect cash outflow (but rather a lack of future inflow)





Solvency

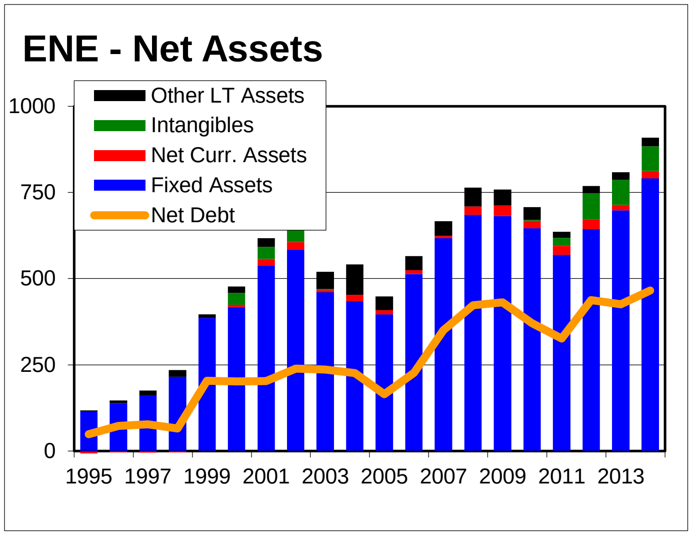
- We traditionally measure Solvency in two ways:
  - Relative to Assets (Gearing)
  - Relative to Income (Coverage)

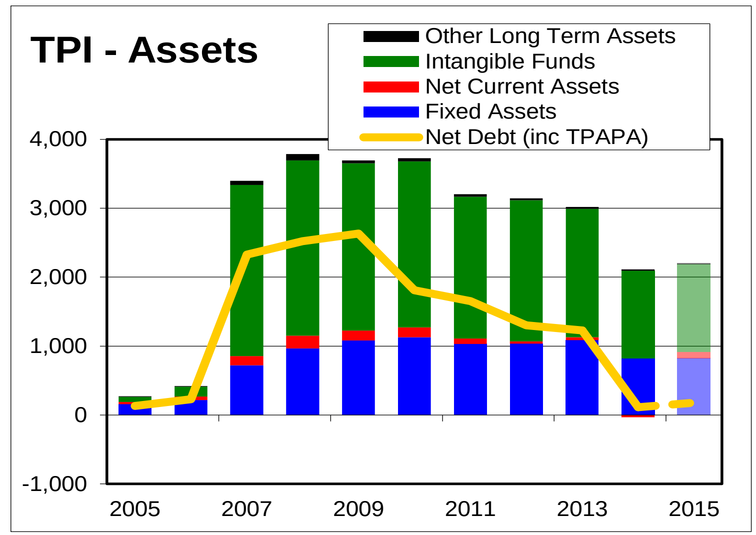
Gearing Ratios (Examples)	**Coverage Ratios (Examples)**
Net Debt/Equity	Interest Cover (EBIT/Net Int)
Net Debt/(D+E)	Interest Cover (EBITDA/Net Int)
Net Debt/Tangible Funds Employed	Fixed Charges (EBITR/Net Int. + Leases)
Liabilities/Equity	EBITDA Cover (Net Debt/EBITDA)

- However, simplistic application of these formulas can be dangerous without consideration of:
  - What is the nature of the assets or liabilities you are leveraging against?
  - What is the nature of the income you are leveraging against?

Gearing – Points to Note

- Some assets are better at supporting debt than others



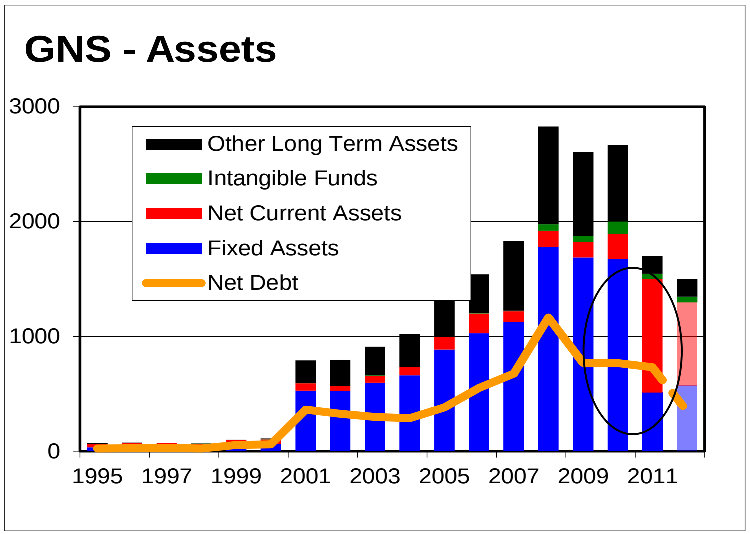


- This is a function both of the realisable value of the assets…

- … and their earnings power. i.e. May be hard to earn economic profits on intangibles.

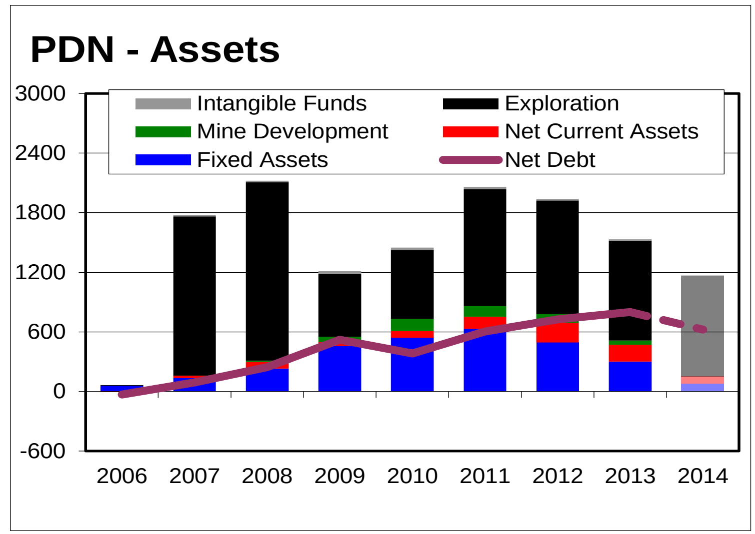
Gearing – Points to Note

- But need to understand reliability of tangible asset valuations.



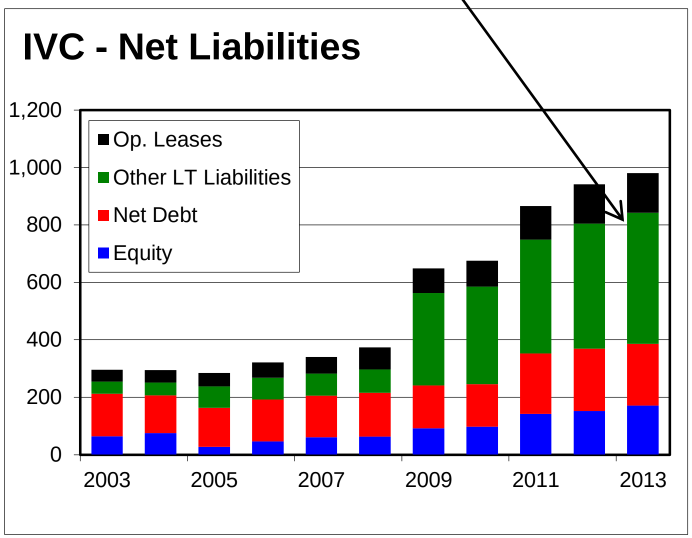
- Potential sometimes for book value to understate true value.

- .. Or other imaginary balance sheet creations.

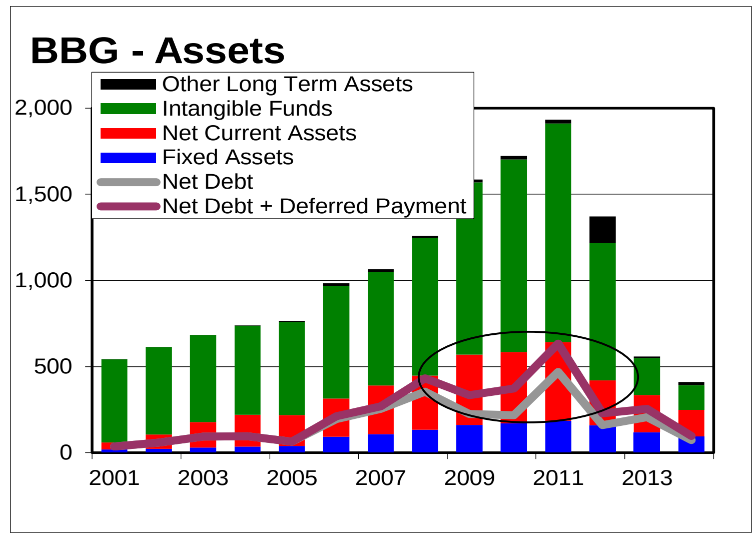


Gearing - Liabilities

- We tend to focus on net debt, but other liabilities are real.
  - For example – prepaid contract liabilities:



- Deferred acquisition consideration

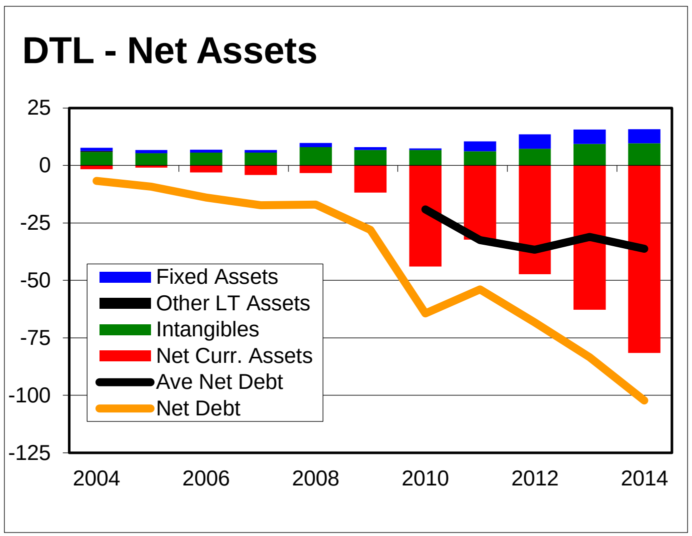


- Note implications of this for calculation of Enterprise Value

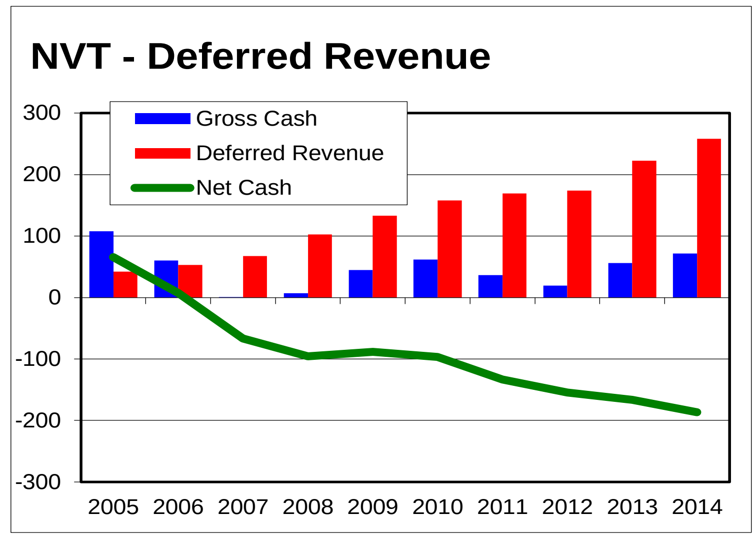
Gearing - Liabilities

- We tend to focus on net debt, but this is not the only consideration.

- Working capital can be negative, or year end balances not predictive of average balances.…



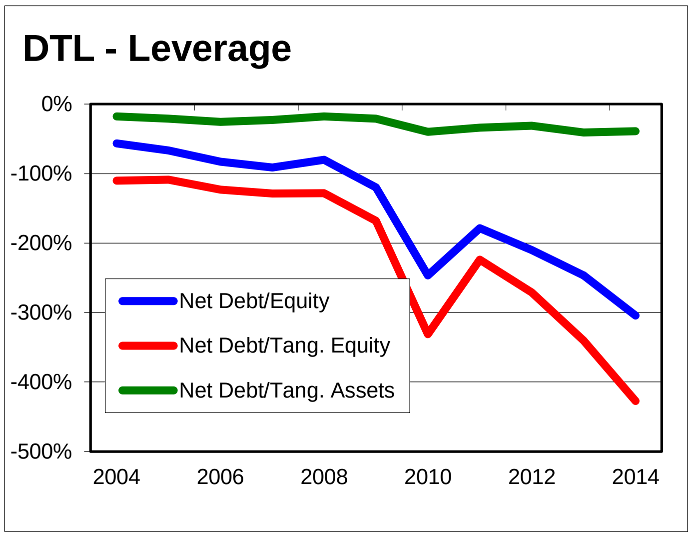
- … so not all the cash that is on balance sheet is really surplus cash available to shareholders.

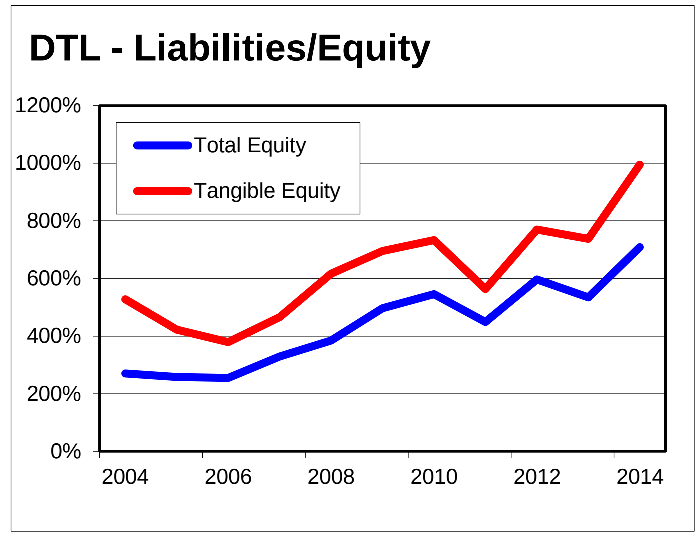


- … again note implications for calculating EV.

Gearing - Liabilities

- Often we have a variety of these effects, so we need to understand total balance sheet leverage, not just debt/equity

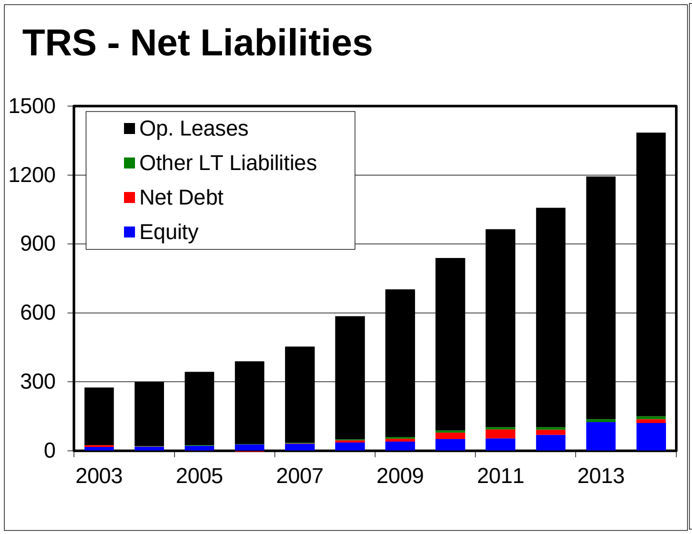


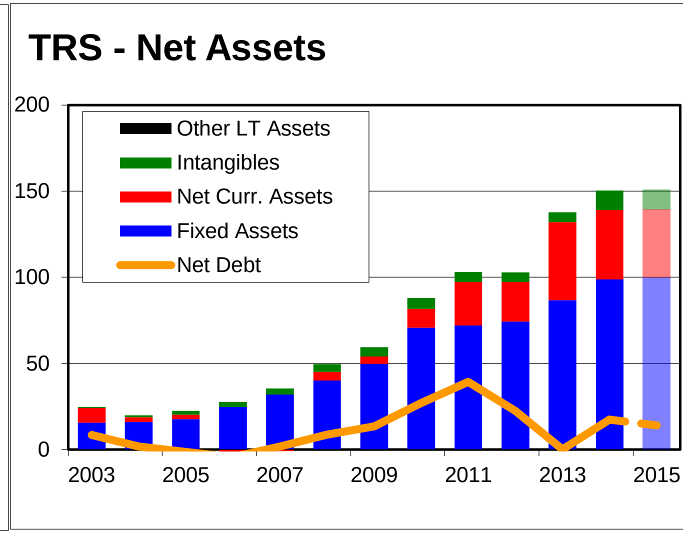


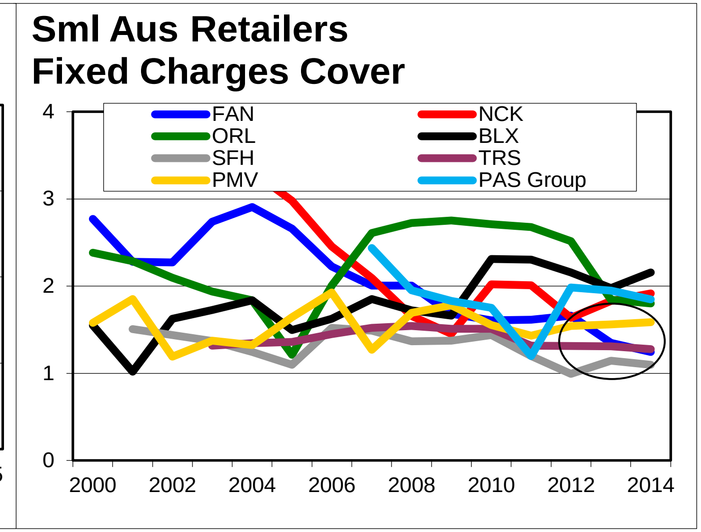
- E.g. Has net cash position, but still quite leveraged given gross levels of working capital.

Gearing – Off Balance Sheet Liabilities

- Operating leases are often the major source of leverage.
  - Whilst this is often standard industry practice, it is often possible to distinguish between companies (in this case via fixed charges cover).





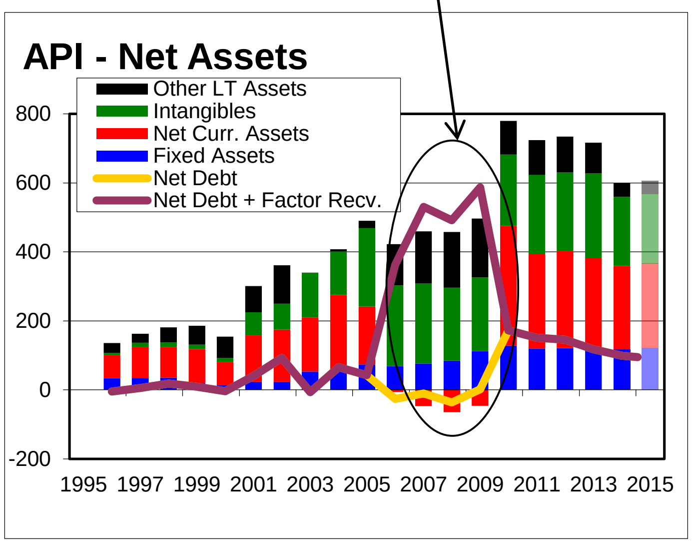


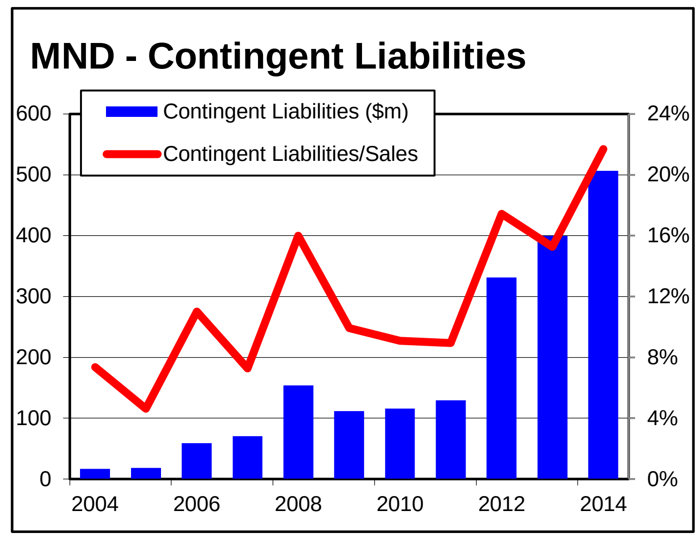
Gearing – Off Balance Sheet Liabilities

- Many other forms of off balance sheet financing.

- Factoring of receivables: Can be material for appearance of balance sheet – but no economic change.

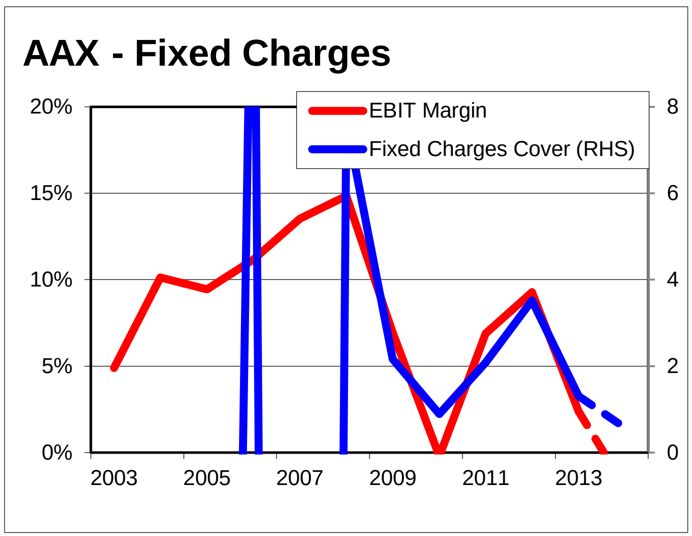
- And especially contingent liabilities in various forms

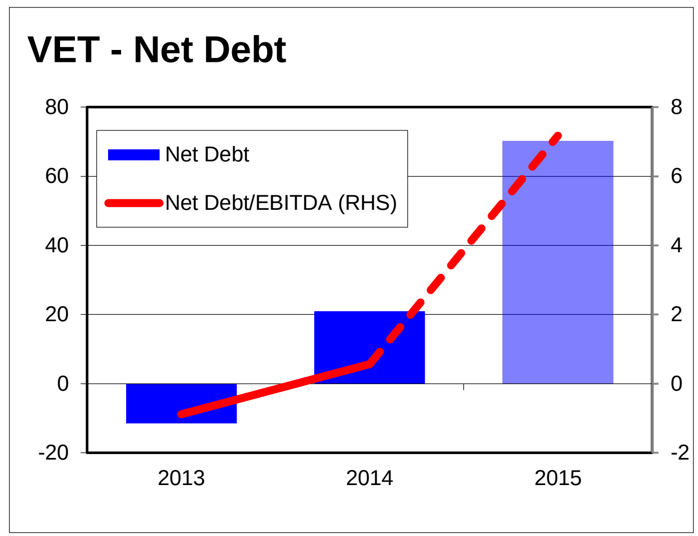




Coverage – Points to Note

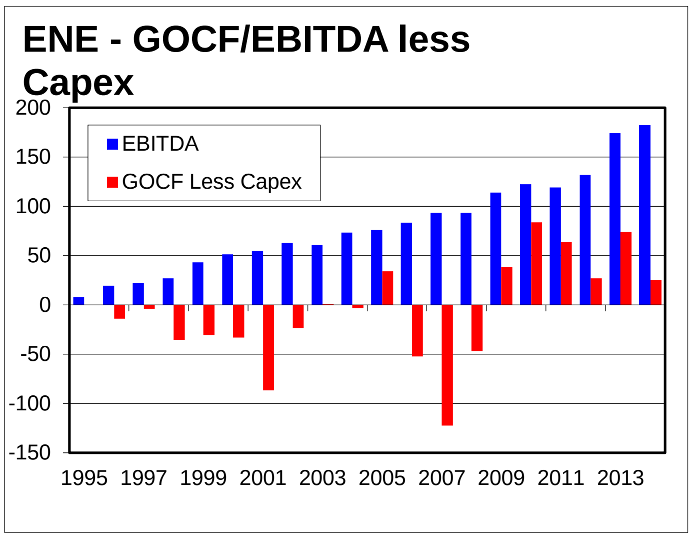
- The other way to measure gearing is relative to income, usually via some form of coverage ratio.
- It is important when doing this to consider the reliability of the earnings:
  - How cyclical…
  - … or subject to structural threats.

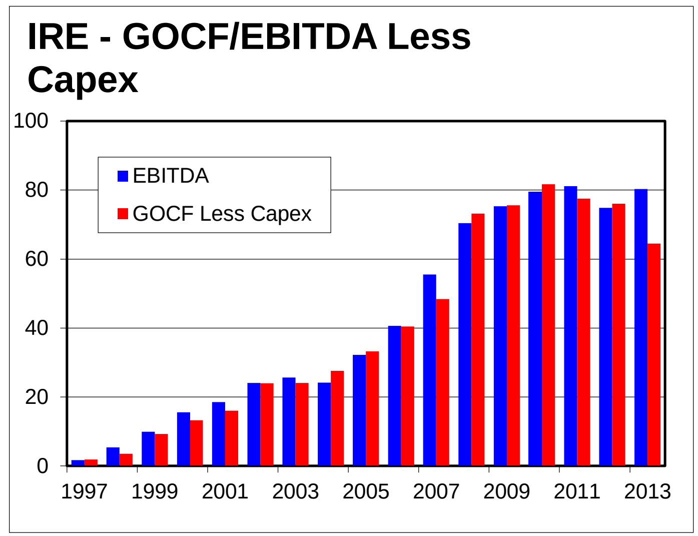




Coverage – Points to Note

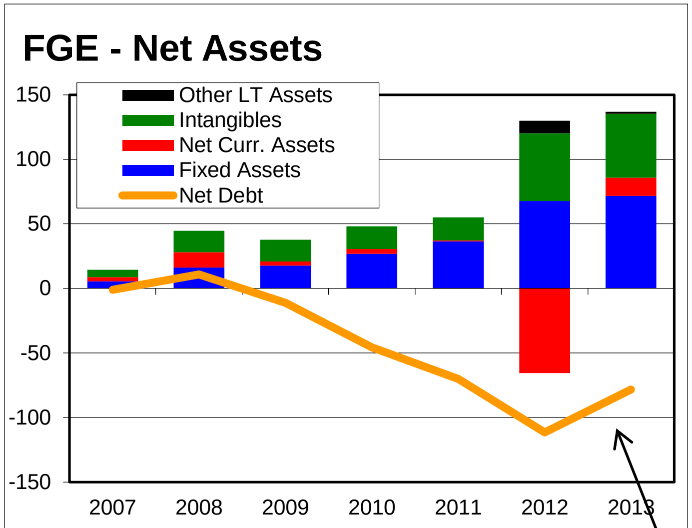
- What are the earnings you are testing coverage against?
  - Eg. EBITDA vs EBIT

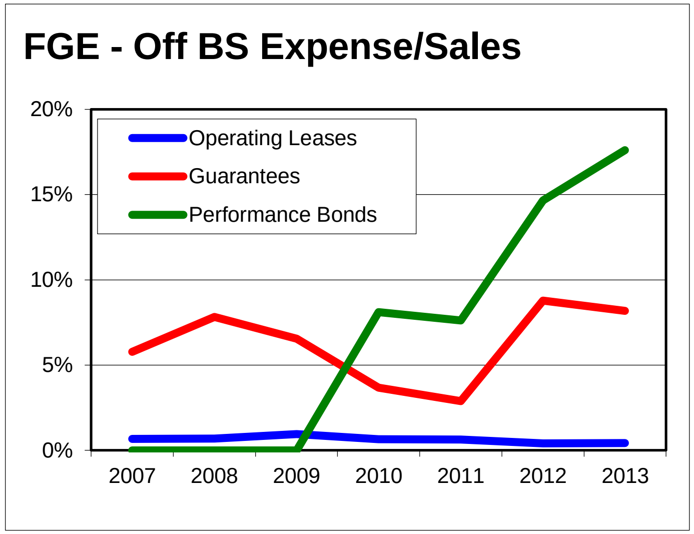




Balance Sheet – Conclusion

- We need to consider the entirety of a companies assets, liabilities and earnings to make a conclusion on balance sheet strength. Simple assessments of net debt position are insufficient.
- For example, a company with net cash of >$100m…
- … can still go bankrupt within two years!





"The financial covenants were tested for the quarter ended 30 June 2012… this testing resulted in … a technical breach of financial covenants"

Forge FY 12 Annual Report Note 19.

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