

# Financial Statement Analysis

Session 2

The Balance Sheet

# Introduction to your speaker

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    - Exempt Fund Manager under the MAS regime
  - 10 years of investment experience
    - Singapore and Hong Kong

# The Balance Sheet

- Snapshot / “Picture” concept
  - At a particular point in time
- Assets
  - Non-Current (>1 year) vs. Current (1 year or less)
- Liabilities
  - Non-Current (>1 year) vs. Current (1 year or less)
- Minority Interests
- Shareholders’ Equity
- Capital and Reserves
- Working Capital
- Cash Conversion Cycle
- Off-Balance Sheet Items

# Non-Current Assets

- Plant, Property and Equipment
  - Land, Buildings, Machinery, Cars, Furniture etc
  - For manufacturing companies, PPE correlates with sales
- Investments in Associates and Joint Ventures
  - Single-line item
  - Notes to the Accounts often contain more details e.g. revenue, profit, assets, liabilities etc.
- Long-Term Investments
  - Passive Financial Investments held >1 year

# Current Assets

- Trade / Account Receivables (AR)
  - Sales recognized but cash not collected
  - AR Days measures speed of cash collection
    - Defined as  $AR / Sales * 365$
- Inventories (Inv)
  - Raw Materials, Work In Progress, Finished Goods
  - Inventory Days measures speed of inventory sales
    - Defined as  $Inv / COGS * 365$
- Cash and Cash Equivalents
  - Cash, Fixed Deposits
- Short-Term Investments
  - Stocks, Bonds, Hybrid Securities, Structured Products etc.

# Non-Current Liabilities

- Long-Term Loans
  - Notes to the Accounts often have more details
    - Repayment Schedule
      - Amortizing or Bullet
    - Interest Rate and Currency
    - Special terms and conditions
      - Controlling shareholder stake
      - Restrictions on dividends
- Deferred Taxes
  - Usually booked on unrealized fair value gains

# Current Liabilities

- Short-Term Loans
  - See Notes to the Accounts for details
- Trade / Account Payables (AP)
  - Payments owed to suppliers
  - AP Days measures speed of payment
    - Defined as  $AP / COGS * 365$
- Accrued Payables
  - Payroll, Rent, Utilities etc.
- Accrued Taxes
  - Income Tax, VAT etc.

# Minority Interest

- Non-100% subsidiaries
  - Adjustment of balance sheet
    - Can cause massive distortion if minority interest is large  
e.g. Hong Leong Asia's special share in China Yuchai confers control despite 34.9% stake
  - Dividends are reduced proportionately
    - Shown in cash flow statement as “dividends paid to minority shareholders”

# Shareholders' Equity

- The net assets that shareholders actually own
  - Total Assets minus Total Liabilities minus Minority Interest
- Also known as “Book Value”
  - Theoretical “liquidation value” i.e. sell everything, pay all liabilities
- Not always representative of realizable value
  - Assets usually carried at historical cost, not market value
    - Operating Assets: Hotels, Factories, Vessels
    - Intangible Assets: Brands, Patents, Trademarks
  - Equipment often worth much less than book value
    - Cost of shutdown, cleaning, testing, moving etc.
    - Obsolete equipment has value only in use
  - Inventory has to be discounted heavily in closing-down sales
  - Liquidation Rule of Thumb: Liabilities at par, Assets at discount

# Capital and Reserves

- Paid-Up Capital
  - Initial Capital
  - May include in-kind contributions
- Accumulated Profits / Retained Earnings
  - Cumulative
  - Can be paid out as dividends
  - Accumulated losses usually means dividends not possible
- Reserves
  - May be created by regulations
  - May be created by fair value gains

# Working Capital

- Money that is “locked up” in the business
  - Defined as  $AR + INV - AP$
  - Scales up/down with the volume of business
- Adapting to working capital requirements
  - Usually correlate with margins, to compensate for use of capital
    - Jewellery (high capital needs, high margins)
    - Supermarkets (low capital needs, low margins)
  - Positive exceptions (low capital needs, high margins)
    - Franchisors (McDonald’s, Subway, Ya Kun)
    - Professional Services (KPMG, McKinsey)
  - Negative exceptions (high capital needs, low margins)
    - Shipping (NOL)
    - Wafer Foundries (CSM)

# Cash Conversion Cycle

- Measures the speed of cash generation
  - How long does it take for \$1 of working capital to convert to cash?
- Cash Conversion Days = AR Days + Inv Days – AP Days
- Can be negative i.e. using Other People's Money (OPM)
  - Walmart / NTUC / Dairy Farm
    - Customers pay cash (immediate) or via credit card (within 28 days)
    - Suppliers are paid on credit (90 days)
    - Fast Moving Consumer Goods (FMCG) means low Inventory Days
- AR Days trend can point to bad debt problems
  - Ezra, CH Offshore
- AP Days can be distorted by advance payments to suppliers
  - Adjust by netting off against AP

# Off-Balance Sheet Items

- Sale-Leaseback Transactions
  - Financial Engineering
    - Asset+Loan removed from balance sheet, replaced with off-balance sheet long-term lease
    - Apparent gearing improves (no loan), actual gearing worsens (rental exceeds loan payments)
    - Typical Buyer is an investment fund e.g. Shipping trusts, REITs
    - Typical Assets are Vessels (Swiber, Ezra), Buildings (Osim, CWT) or Aircraft (MAS)
  - Portrayed as Win-Win
    - Seller gets cash, buyer gets rental income
  - Actually Lose-Lose
    - Seller pays high rent, buyer overpays
    - In a downturn: seller defaults on rent, and buyer suffers impairment on asset value
- Contingent Liabilities
  - 3<sup>rd</sup> party guarantees
  - Contracted expenditures
  - Minimum lease payments