Tim du Toit
Presents...

"How to decrease the time you research investments, make less mistakes and increase your returns in any type market"

31 Proven checklist items, questions and ratios that will increase your returns and virtually eliminate investment mistakes in recessions, depressions and booms.

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Introduction

What does your investment decision check-list look like? Do you even have one?

Check-lists have been used with great success in the aviation industry since their introduction in the Second World War by the U.S. Army Air Corps after a star aviator crashed a B-17 bomber during its demonstration flight.

Check-lists work best in a complex environment where the performing of certain steps is critical. In flying it is taken as a given that highly trained pilots work through check-list for virtually every eventuality.

An aeroplane is a complex entity, and I want to argue, so is investing!

When evaluating a company there are so many factors that are beyond our control. However, through empirical research, we know what increases the probability of us making profitable investment decisions.

What is important is that we focus on what we can control in our research and analysis.

As part of my evaluation process, I work through the following check-list. It forces me to be methodical, and to evaluate and analyse all items on the list.

I have put this check-list together over a period of more than 20 years and often make changes to it as I gain new insight or learn something valuable.

However, I do not have a formula that if a company fails in terms of various points on the check-list I do not consider it worthwhile investment.

The check-list just gives me an indication of what problem areas are in the company that may require further research and analysis.

I urge you to spend a few minutes to read through the list and then formulate your own check-list. It will definitely make you a better investor.

Also please let me know if you have any additional points I should add to the list by sending me an e-mail at tdutoit@eurosharelab.com

Yours in investing

Tim du Toit

GENERAL

Is the dilution lower than 3%?

((Diluted number of shares in issue – actual shares in issue) / actual number of shares in issue)

Some companies hand out really excessive amount of options to management and that dilutes the returns of existing shareholders. The optimal situation is where management spends its own money to buy shares in the company as that would align their interests perfectly with shareholders, but that is unfortunately very seldom the case.

I look at this number just to get an idea of what the dilutions in the company are, but there is really no hard or fast rule here. If it is more than 3% I usually investigate further.

Is management's shareholding > 10%?

I like to see a substantial commitment by management in terms of shareholding when I invest. Should management not have a substantial percentage shareholding, or at least a substantial amount of money invested in the company, it will make me think twice before investing.

Does the company have an enormous moat?

This is another question can only have come about as a result of reading the writings of Warren Buffet. Should a business not have a moat, or the moat is deteriorating, as in the case of newspaper companies at the moment, I will be careful before investing.

Is the stock screaming “cheap”?

This is usually an easy question to answer because there are a few basic valuation measures that I look at, including the following:

- price to earnings ratio
- price to book ratio
- dividend yield
- price to free cash flow
- price to sales ratio

Just by examining these indicators you can usually quickly decide if the companies are screaming “cheap”. Should this be the case I usually overlook a few other things such as lower management percentage shareholding and one-sided compensation arrangements.

Is it a low risk business?

This is just a question I ask myself to determine the nature of the business of the company. Obviously if it is a high risk business I will invest less than, for

example, a utility where the business is very stable and low risk. This may also be one of the reasons why the company's share price is inexpensive, but at least asking the question makes me more aware of the company's business risk.

Is there high uncertainty?

This item can relate either to the company or the industry it operates in. It's a similar question to the one before and it may seem completely redundant but it definitely is not. Usually higher uncertainty means the company will be inexpensive.

An example of a high uncertainty situation was the home building companies in America shortly after the property bubble burst. The companies all appeared cheap compared with past earnings but if you consider the uncertainty around the number of houses to be built in the next few years it would probably not be a wise investment.

What are the future growth prospects of the business?

I ask this question to give me an idea of where the company, as well as its industry, is moving. If it's a low or no growth industry, I am not averse to buying but I usually have a look to make sure that no growth projections are included in my investment decision.

Is it in my circle of competence?

This question could only have come from Warren Buffet. I use it to determine if I really know enough about the business the company is in so that I have a reasonable possibility of analysing the company and making a sound investment decision.

If my answer to that question is no, I may use this opportunity to get to know a new industry in order be able to invest in it in future.

Is it a good business?

I use this question to make a quick judgement as to whether it is a highly profitable business with low amounts of debt and high margins. Should this not be the case I have to make a decision if I am going to invest based on other metrics, such as a low price to book value.

Is the company in a bubble industry or has there been a huge industry tailwind?

This question is used to determine if the current and past few years earnings my not be inflated. Should this be the case, normal profits will be lower and the company will be overvalued in spite of appearing attractive.

A good example will be the steel companies in 2008. Having profited from the resource boom profits may not look the same going forward.

Has the industry profited from a regulatory tailwind?

Be careful of industries that benefited from regulatory protection that may disappear. The best example was the airline industry in the USA that was quite stable and profitable before Open Skies agreements in 1979 or the brokerage business in London before the Big Bang deregulation of financial markets.

MANAGEMENT

What incentives does management have?

This is just to get a feel for how management is most likely to run the company. As human behavior is greatly influenced by incentives this gives me an idea as to how the company will be managed.

For example if management keeps on making acquisitions to make the company as large as possible I'm usually careful as size does not mean a high return to shareholders; it probably means less dividends as more cash will be used for further acquisitions.

How high are the salaries of management?

I usually have a quick look to compare the salaries of management with the size of the company, and with the salaries of peer companies. If salaries are excessive I usually take a hard look at the company as it has to be exceptionally cheap for me to invest in a company where management takes them bulk of the income for themselves in terms of excessively high salaries.

I usually look at this indicator along with the percentage of shareholding management under the company. For example, large cash salaries with a low percentage shareholding in the company would make me very uncomfortable.

Does management make a solid impression?

(Operators, capital allocators, integrity)
This question doesn't really have a definitive answer in terms of the numbers – it is based more on a feeling I get after reading a few year’s annual reports.

What I try to do is get an idea if management follows up on what they promised, or if they just mention a new set of goals in each set of annual reports. This is a subjective impression you get after reading about the company and its management.

Is there heavy insider buying or selling?

This gives me an idea of the amount of insider transactions in the company. Obviously heavy buying at the same time as I'm thinking of investing will be a positive; heavy insider selling will make me more careful of investing.

INCOME STATEMENT

Is free cash flow per share higher than dividends paid?

I use this item to determine if the dividend the company pays is sustainable. Should free cash flow per share be less than the dividend per share, and profits don't recover soon, the company will most likely have to reduce its dividend or eliminate it completely.

Are there net share buybacks?

Net share buybacks mean that a company is buying back more shares than what it is issuing. In other words, the number of shares outstanding is decreasing.

I added this item to my check-list after reading a research study that found that companies that have net share buybacks in one year substantially outperform the market in the following year, and also over two or three years. It's a definite plus in my evaluation.

Does the company generate high returns on capital?

(Pre-tax profits / (total capital + long-term debt)) > 15%

I am attracted to companies that generate a high return on capital.

Should this not be the case I'm usually careful before investing, or the company has to be extremely cheap.

Does the company profitably reinvest retained profits?

This an important question to ask, especially if the company does not return any cash to its shareholders. In order to answer this question I usually look at the amount of profits reinvested in the business by management every year and then compare the yearly operating profit margin and the net profit margin to make sure they are not deteriorating.

Should there be a trend where management keeps on investing in the business but margins continue to go down I'm very careful before investing.

Are pre-tax margins higher than 15%?

(Profits before tax / total sales)
I like buying companies which are highly profitable and this is one of the metrics I use to make sure that this is the case.

Is there growth in earnings per share?

I use this ratio, even though it may sound simplistic, to see if the company's profits are growing year by year on a per share basis.

Should the company grow by acquiring other companies all the time, and especially by issuing shares, but in spite of it getting bigger its earnings per share may actually be decreasing because of the amount of new shares they issue to buy the companies.

CASH FLOW STATEMENT

How capital intensive is the business?

This is a question that comes back to the amount of free cash flow a business generates. The higher the capital intensity of the business the more capital has to be invested as it grows and the lower the amount of free cash flow the company generates. I usually try to find companies that generate a large amount of free cash flow but will occasionally consider buying into a capital intensive industry if it is cheap enough.

Is operating cash flow higher than earnings per share?

This item is to make sure that the company is not just making accounting profits but cash profits. I added this item after the Enron bankruptcy, as it was one of the ways you could determine that something was fishy.

As soon as accounting earnings are substantially higher than cash earnings, especially over multiple financial years, it deserves further investigation.

If a company is growing or investing a substantial amount of money in working capital, cash earnings are often less than accounting earnings. This is, however, not a problem as you can see where the cash flow goes.

Where is free cash flow invested?

- Share buybacks
- Dividends
- Reinvested
- ROE & ROCE
- Incremental BV growth

Answering this question allows me to clarify where the company invested money. I usually compare this to management’s comments rights in the annual report. Doing so usually quickly allows me to determine if management’s deeds equal their actions.

BALANCE SHEET

Is total debt to equity less than 35%?

I am very conservative in terms of balance sheet risk and do not like total debt to be more than 35% of equity.

I sometime make exceptions when investing in utility type businesses, but normally I look for companies that generate a high amount of free cash flow and therefore, except if they've recently make an acquisition, usually have no or very little debt on the balance sheet.

You can easily increase this number to 50% or even 66%, and that would also be fine; I just prefer a lower number.

Is total debt less than book value?

([Current liabilities + total debt]/total equity)
This is another debt measure I use in conjunction with the one above. This measure also includes current liabilities, and is therefore a wider measure of the company's liabilities.

If the number rises above 1, I have a look at the size of each component. If current liabilities are substantial I look at accounts payable to determine why it forms such a large part of the company's liabilities.

Remember, all creditors have to be paid at some point.

Is long term debt less than 2 x working capital?

(Long term debt/(Current assets – Current liabilities)
This is also a measure of a company's liquidity, which I think comes from Benjamin Graham.

Should long term debt be more than twice working capital, it should warrant some investigating as the company's financial situation may not be very sound.

Is the current asset ratio greater than 1.5?

(Current assets / current liabilities)
This item is used to check if the company has more than short-term assets to cover its short-term liabilities.

Is the quick ratio greater than 1?

([Current assets – inventory] / Current liabilities)
This is also a measurement of the company's liquidity and is more restrictive than the current asset ratio above. This ratio determines if the company has enough short-term assets to meet its short-term liabilities assuming it is unable to sell any of its inventory.

Is the Altman Z Score > 3?

The Altman Z score is a number that is calculated as explained below and is used to determine the likelihood the company will experience financial distress. I like to see a ratio above three for the companies I invest in, as I am conservative - as can also be seen in the low debt to equity ratio mentioned above.

The Z-score is a combination of five weighted business ratios and can also be used to predict bankruptcy. In a series of tests covering three different time periods over 31 years (up until 1999), the model was found to be 80-90% accurate in predicting bankruptcy one year prior to the event, with a error rate of 15-20%.

The z-score is calculated as follows:
Z-score = 1.2T1 + 1.4T2 + 3.3T3 + .6T4 + .999T5.
T1 = Working Capital / Total Assets.
T2 = Retained Earnings / Total Assets.
T3 = Earnings Before Interest and Taxes / Total Assets.
T4 = Market Value of Equity / Book Value of Total Liabilities.
T5 = Sales/ Total Assets.

and is interpreted as follows:
Z-score > 2.99 = Safe
1.8 < Z-score < 2.99 = Middle or grey
Z-score < 1.80 = Distress
Source: Wikipedia

What is the flow ratio (Good < 1.25, Bad > 3)?

(Current Assets - (Cash + Short-term Investments))/(Current Liabilities - Short-term Debt)

This ratio comes from a good friend of mine, Zeke Ashton, who used to write for the fool.com in the US and now has his own fund management company.

The flow ratio can be explained as follows:

Cash and short-term investments are the ultimate good current assets. To isolate the bad current assets, you subtract cash and short-term investments from the total current assets. Bad current assets primarily consist of: accounts receivable and inventory. Accounts receivable represent sales for which the company hasn't received payment. The longer it takes to collect on them, the less valuable those original sales become to the company. Inventory represents goods waiting to be sold, but like accounts receivable, the longer those goods have to wait before they get sold, the less valuable they are to the company.

I do the same with current liabilities. The most common are accounts payable, which are simply goods and services the company has received but hasn't yet paid for. Good current liabilities are those that don't accrue interest. Each day

that the company can put off paying these accounts without being assessed an interest penalty is another day that they can keep that cash earning interest.

Dividing the bad current assets by the good current liabilities gives us the flow ratio. The lower the flow ratio, the better the business is at maximising the value of its cash flow.

A low flow ratio tells us that the company has a light business model and / or excellent financial management. Also, a low ratio means the company may also have powerful financial leverage due to leadership in the industry.

A rising flow ratio shows a deterioration of these qualities. If the flow ratio gets up over 3.0, it's best to avoid the company as far as possible.