Advanced Judgment

Warning Signs on the SSG

Created by Gretchen Hurt

Welcome

- NAIC is a non-profit organization that sponsors programs and provides information through their local volunteer chapters for the education and use of individual investors and investment club members. NAIC neither recommends nor endorses specific securities.

- Our instructors and assistants are all volunteers.

- Questions are always welcome.

What We Will Cover

- **Places on the Stock Selection Guide where we should slow down and take a closer look at the company**
  - **Debt**
  - **Recent news**
  - **Graph**
  - **Management numbers are trending down**

Taking a Closer Look at Capitalization

Capitalization

- Three ways a company can get money to grow
  - Retained earnings
  - Sell additional shares of stock
  - Leverage (debt)
- Leverage should be used to acquire assets that generate earnings that are greater than the cost of the borrowing.

Capitalization

- **Different industries have different standards of what is an acceptable debt level.**
  - **Compare a companies debt level with its competitors.**
  - **As a general rule, for manufacturing and retail, 33% is about the maximum debt to capitalization rate.**

Capitalizing by Debt

- **There are other ways a company can borrow, or raise money without calling it debt.**
  - **Deferred Taxes**
  - **Minority Interest**
  - **Preferred Stock (only one shown on SSG)**
  - **Off Balance Sheet Items**
  - **Warrants and debentures**
  - **Under funded pensions**

Capitalizing by Debt

- **If a company's debt level is high, check the financial footnotes for any of the previous items.**

- **Then proceed with extreme caution or look for a new company.**

BetterInvesting
The Leader In Investment Education

L-3 Communications

Great SSG!

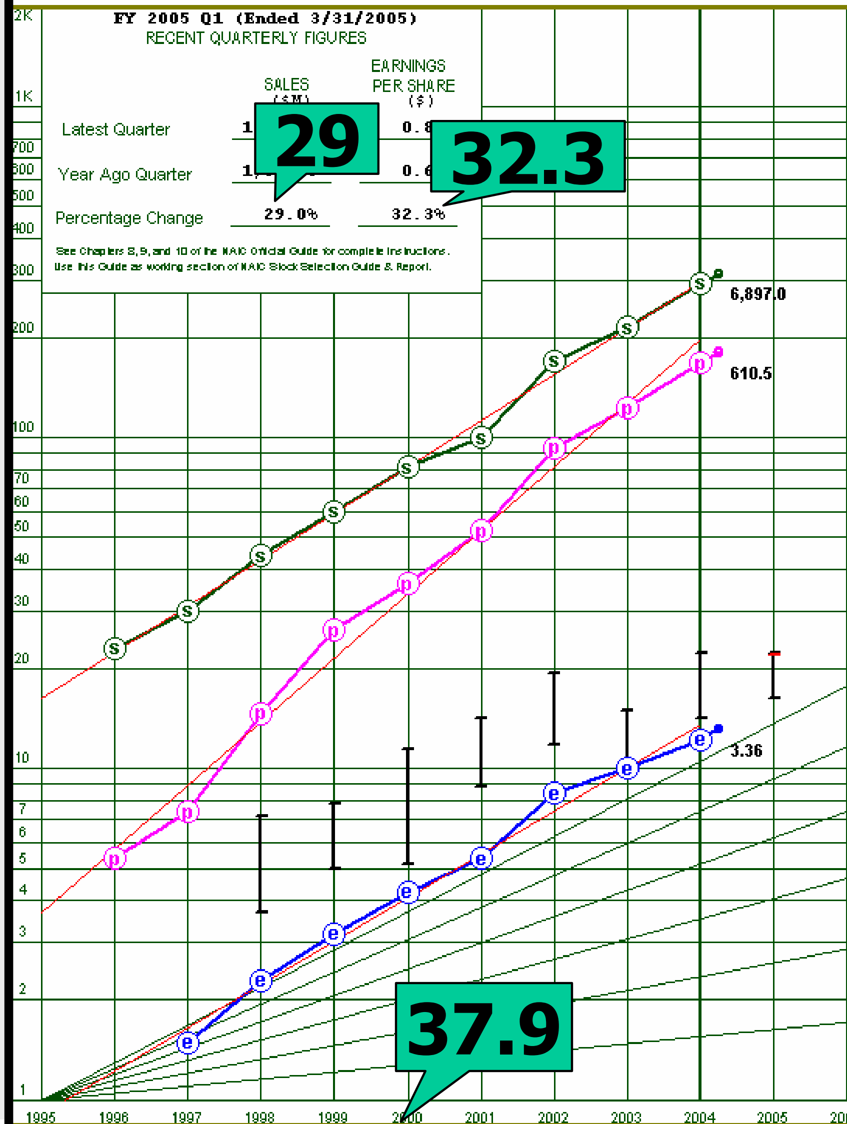
NATIONAL ASSOCIATION OF INVESTORS CORPORATION NAIC

Stock Selection Guide

Company L-3 COMMUNICATIONS HLDGS INC Date 06/29/05
Prepared by G H Data taken from NAIC Data
Where traded NYSE Major product/service Aerospace &

Debt ($M)	2,199.9	% to Tot.Cap.	36.1

VISUAL ANALYSIS of Sales, Earnings and Price LLL



(1) Historical Sales Growth 37.9 %
(2) Estimated Future Sales Growth %
(3) Historical Earnings Per Share Growth 35.1 %
(4) Estimated Future Earnings Per Share Growth %

2 EVALUATING MANAGEMENT

	2000	2001	2002	2003	2004	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	6.9	8.1	8.5	8.8	8.9	8.2	UP	
B % Earned on Equity (E/S ÷ Book Value)	11.3	9.5	9.9	10.4	10.2	10.3	EVEN	EVEN

3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

PRESENT PRICE 76.760 HIGH THIS YEAR 77.260 LOW THIS YEAR 56.200

	Year	A PRICE HIGH	B PRICE LOW	C Earnings Per Share	D Price Earnings Ratio HIGH A÷C	E Price Earnings Ratio LOW B÷C	F Dividend Per Share	G % Payout F÷C X 100	H % High Yield F÷B X 100
1	2000	39.7	17.8	1.17	34.0	15.3	0.000	0.0	0.0
2	2001	49.0	30.4	1.47	33.4	20.6	0.000	0.0	0.0
3	2002	66.8	40.6	2.31	28.9	17.6	0.000	0.0	0.0
4	2003	51.8	34.2	2.76	18.8	12.4	0.000	0.0	0.0
5	2004	77.3	49.3	3.36	23.0	14.7	0.400	11.9	0.8
6	TOTAL		172.3		138.1	80.6		11.9	
7	AVERAGE		34.5		27.6	16.1		11.9	

8 AVERAGE PRICE EARNINGS RATIO 21.9 9 CURRENT PRICE EARNINGS RATIO 21.1

Proj. P/E [0.00] Based on Next 4 qtr. EPS [0.00] Current P/E Based on Last 4 qtr. EPS [3.64]

4 EVALUATING RISK and REWARD over the next 5 years

Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell. The upside-downside ratio is the key to evaluating risk and reward.

A HIGH PRICE — NEXT 5 YEARS
Avg. High P/E ____ X Estimate High Earnings/Share ____ = Forecast High Price $ 0.0

B LOW PRICE — NEXT 5 YEARS
(a) Avg. Low P/E ____ X Estimated Low Earnings/Share 3.36 = $ 0.0
(b) Avg. Low Price of Last 5 Years = 34.5

How much debt is too much?

Debt ($M)	2,199.9	% to Tot.Cap.	36.1

Valuation of Deferred Income Tax Assets and Liabilities. At December 31, 2004, we had net deferred tax assets of $119.1 million, including $3.8 million for loss carryforwards and $18.5 million for tax credit carryforwards which are subject to various limitations and will expire if unused within their

Off Balance Sheet Arrangements

On December 31, 2002, we entered into two real estate lease agreements, as lessee, with a third-party lessor, which expire on December 31, 2005 and are accounted for as operating leases. On or before the lease expiration date, we can exercise options under the lease agreements to either renew the leases, purchase both properties for $28.0 million, or sell both properties on behalf of the lessor (the "Sale

	Pension Plans	
	2004	2003
Change in benefit obligation:		
Benefit obligation at the beginning of the year	$ 902,132	$ 713,925
Service cost	54,957	45,901
Interest cost	55,127	49,789
Participants' contributions	1,075	246
Amendments	4,851	9,657
Actuarial loss	62,183	76,863
Actuarial gain due to medicare subsidy	—	—
Obligations assumed in connection with business acquisitions	92,845	25,754
Settlement	(16,938)	—
Foreign currency exchange rate changes	6,102	8,452
Benefits paid	(30,757)	(28,455)
Benefit obligation at end of the year	$1,131,577	$ 902,132

Deferred taxes, off balance sheet arrangements, and under funded pension- is that too much debt?

Taking a Closer Look at the Quarterly Numbers

FY 2005 Q1 (Ended 3/31/2005)

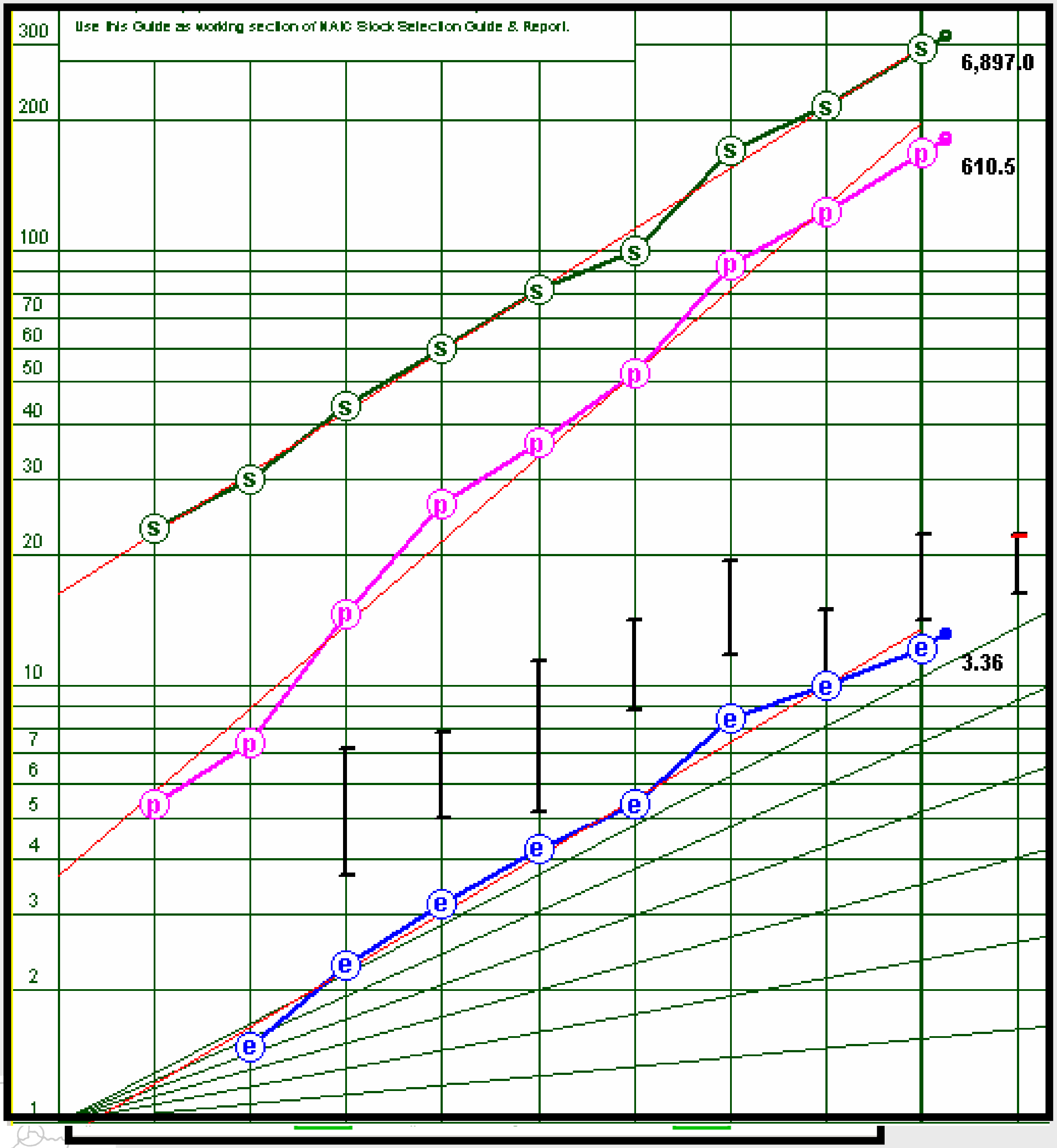
RECENT QUARTERLY FIGURES

	SALES ($M)	EARNINGS PER SHARE ($)
Latest Quarter	1,962.5	0.86
Year Ago Quarter	1,521.6	0.65
Percentage Change	29.0%	32.3%

See Chapters 8, 9, and 10 of the NAIC Official Guide for complete instructions.
Use this Guide as working section of NAIC Stock Selection Guide & Report.

200
100
90
80
70
60
50

L-3 Communications



The data on the SSG graph is annual data for the growth rate of sales, earnings, and pre-tax profit.

If a problem develops during the year, it will not show up on the graph until three months after the end of the fiscal year.

Quarterly Numbers

- It is important to analyze problems when they develop.

200
100
90
80
70
60
50

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Use this Guide as working section of NAIC Stock Selection Guide & Report.

- By themselves these numbers tell only a limited story.

Quarterly Numbers

- Quarterly numbers on the SSG do not tell us if the growth rate is trending up or down.
  - Analyze the numbers over several quarters.
  - Check the PERT A and PERT Graph.

- If the growth rate is slowing, people will pay less for the stock

PERT A Quarterly Numbers

03/02	0.36
06/02	0.48
09/02	0.62
12/02	0.79
03/03	0.50
06/03	0.60
09/03	0.71
12/03	0.95
03/04	0.65
06/04	0.81
09/04	0.93
12/04	1.04
03/05	0.86

- **If you compare quarter to previous quarter you see that the first quarter is always weak.**
- **If you compare quarter to year ago quarter, earnings are always rising.**

L-3 Communications Quarterly Earnings

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PERT Worksheet-A

Quarterly Data

Last 12 Month Data

PERIOD	EPS		PRE-TAX PROFIT			SALES		INCOME TAX RATE	EPS $	PRE-TAX PROFIT		SALES MIL	INCOME TAX		% CHANGE		
	$	% CHANGE	$ MIL	% SALES	% CHANGE	$ MIL	% CHANGE			$ MIL	% SALES		$ MIL	% RATE	EPS	PRE-TAX PROFIT	SALES
03/00								38.1						38.5			
06/00	0.23		25.37	5.5		460.98		38.2						38.4			
09/00	0.34		38.29	7.4		514.42		37.5						38.1			
12/00	0.45		50.60	9.1		557.62		38.1						38.0			
03/01	0.20		22.95	5.0		461.90		37.7	1.21	137.21	6.9	1,994.9	52.0	37.9			
06/01	0.30	31.1	38.78	6.9	52.9	561.56	21.8	40.7	1.28	150.62	7.2	2,095.5	58.0	38.5			
09/01	0.41	20.6	56.56	9.1	47.7	618.16	20.2	35.9	1.35	168.89	7.7	2,199.2	64.3	38.1			
12/01	0.53	19.1	71.77	10.2	41.8	705.80	26.6	34.3	1.44	190.05	8.1	2,347.4	70.5	37.1			
03/02	0.36	77.5	46.24	6.6	101.5	696.84	50.9	36.8	1.59	213.35	8.3	2,582.4	78.7	36.9	31.4	55.5	29.4
06/02	0.48	62.7	68.92	7.2	77.7	955.19	70.1	36.8	1.78	243.48	8.2	2,976.0	87.5	35.9	38.7	61.7	42.0
09/02	0.62	51.2	97.77	9.3	72.9	1,053.61	70.4	33.7	1.99	284.69	8.3	3,411.4	100.8	35.4	47.0	68.6	55.1
12/02	0.79	49.1	126.48	9.7	76.2	1,305.59	85.0	34.7	2.25	339.41	8.5	4,011.2	120.5	35.5	56.4	78.6	70.9
03/03	0.50	40.8	78.00	7.2	68.7	1,089.05	56.3	32.7	2.39	371.17	8.4	4,403.4	128.0	34.5	50.3	74.0	70.5
06/03	0.60	25.0	95.03	7.7	37.9	1,226.88	28.4	33.3	2.51	397.28	8.5	4,675.1	133.5	33.6	41.4	63.2	57.1
09/03	0.71	14.5	116.78	9.2	19.4	1,264.61	20.0	35.2	2.60	416.29	8.5	4,886.1	141.4	34.0	31.0	46.2	43.2
12/03	0.95	20.3	156.94	10.6	24.1	1,481.06	13.4	35.3	2.76	446.75	8.8	5,061.6	152.5	34.1	22.9	31.6	26.2
03/04	0.65	30.0	114.01	7.5	46.2	1,521.64	39.7	33.9	2.91	482.77	8.8	5,494.2	166.3	34.4	21.8	30.1	24.8
06/04	0.81	35.0	140.37	8.4	47.7	1,679.99	36.9	37.0	3.12	528.10	8.9	5,947.3	186.7	35.4	24.3	32.9	27.2
09/04	0.93	31.0	166.19	9.3	42.3	1,784.13	41.1	38.4	3.34	577.52	8.9	6,466.8	208.9	36.2	28.5	38.7	32.4
12/04	1.04	9.5	189.95	9.9	21.0	1,911.24	29.0	35.1	3.43	610.52	8.9	6,897.0	220.5	36.1	24.3	36.7	36.3
03/05	0.86	32.3	163.79	8.3	43.7	1,962.54	29.0	37.2	3.64	660.30	9.0	7,337.9	243.9	36.9	25.1	36.8	33.6
06/05								35.4						36.5			
09/05								35.4						35.8			
12/05								35.4						35.9			

The quarterly numbers for earnings, sales, pre-tax profit and income tax rate are shown along with the percent change for the first three items.

PERT Worksheet A

PERT Worksheet-A

Company L-3 COMMUNICATIONS HLDGS INC (LLL)

	LAST 12 MONTHS DATA								
	EPS $	PRE-TAX PROFIT $MIL	PRE-TAX PROFIT % SALES	SALES MIL	INCOME TAX $MIL	INCOME TAX % RATE	% CHANGE EPS	% CHANGE PRE-TAX PROFIT	% CHANGE SALES
1						38.5			
2						38.4			
5						38.1			
1						38.0			
7	1.21	137.21	6.9	1,994.9	52.0	37.9			
7	1.28	150.62	7.2	2,095.5	58.0	38.5			
9	1.35	168.89	7.7	2,199.2	64.3	38.1			
3	1.44	190.05	8.1	2,347.4	70.5	37.1			
8	1.59	213.35	8.3	2,582.4	78.7	36.9	31.4	55.5	29.4
8	1.78	243.48	8.2	2,976.0	87.5	35.9	38.7	61.7	42.0
7	1.99	284.69	8.3	3,411.4	100.8	35.4	47.0	68.6	55.1
7	2.25	339.41	8.5	4,011.2	120.5	35.5	56.4	78.6	70.9
7	2.39	371.17	8.4	4,403.4	128.0	34.5	50.3	74.0	70.5
3	2.51	397.28	8.5	4,675.1	133.5	33.6	41.4	63.2	57.1
2	2.60	416.29	8.5	4,886.1	141.4	34.0	31.0	46.2	43.2
3	2.76	446.75	8.8	5,061.6	152.5	34.1	22.9	31.6	26.2
9	2.91	482.77	8.8	5,494.2	166.3	34.4	21.8	30.1	24.8
0	3.12	528.10	8.9	5,947.3	186.7	35.4	24.3	32.9	27.2
4	3.34	577.52	8.9	6,466.8	208.9	36.2	28.5	38.7	32.4
1	3.43	610.52	8.9	6,897.0	220.5	36.1	24.3	36.7	36.3
2	3.64	660.30	9.0	7,337.9	243.9	36.9	25.1	36.8	33.6
4						36.5			
4						35.8			
4						35.9			

The last three columns give the trailing 12 month percent change for sales, pre-tax profit and earnings per share.

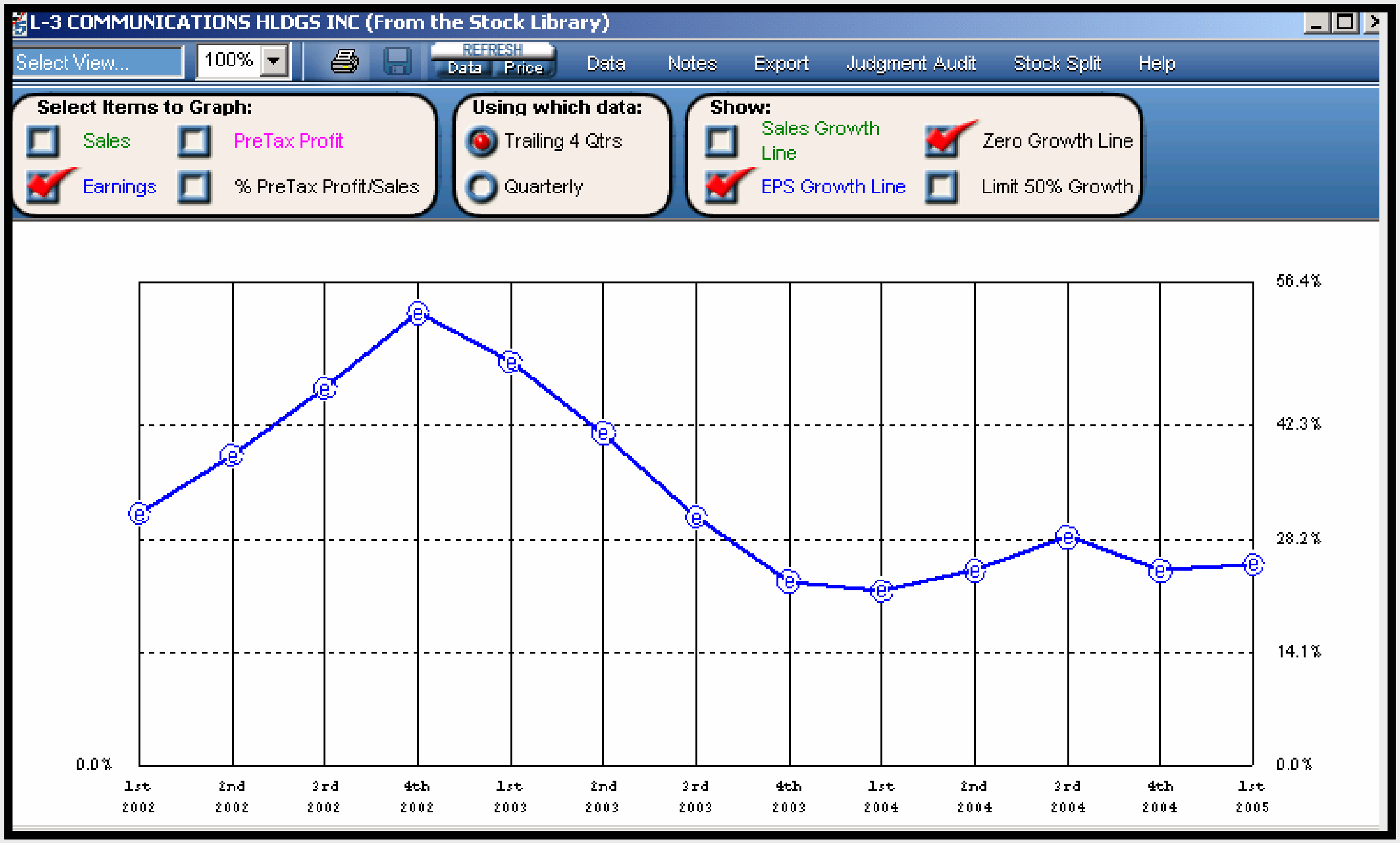
L-3 Quarterly Earnings

03/02	0.36	31.4
06/02	0.48	38.7
09/02	0.62	47.0
12/02	0.79	56.4
03/03	0.50	50.3
06/03	0.60	41.4
09/03	0.71	31.0
12/03	0.95	22.9
03/04	0.65	21.8
06/04	0.81	24.3
09/04	0.93	28.5
12/04	1.04	24.3
03/05	0.86	25.1

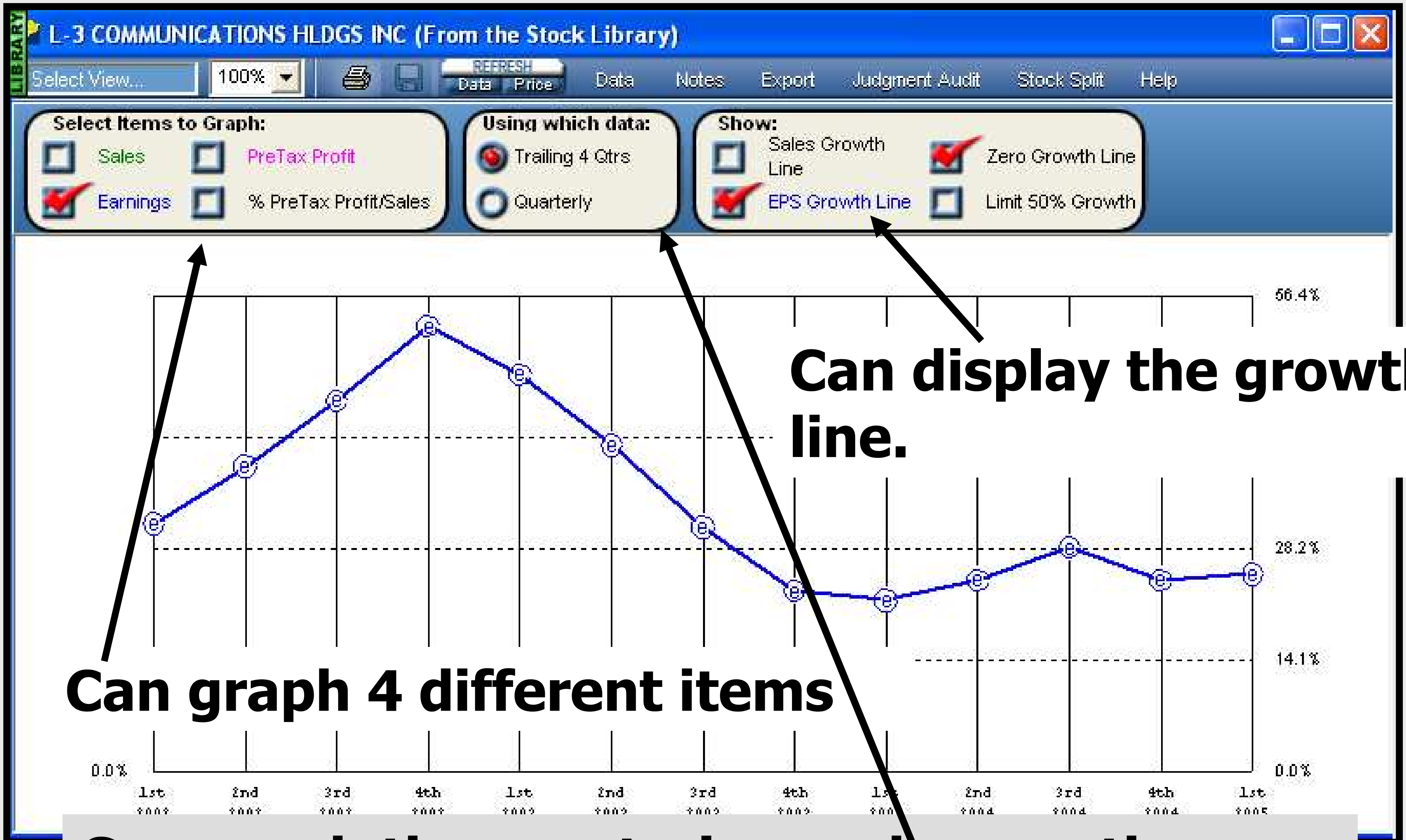
- The rolling trailing four quarters of earnings on the PERT A tell a different story.
- For five straight quarters in 2003-04 the earnings growth rate declined, then is went up two quarters and declined again.
- Current growth rate is much lower.

L-3 Quarterly Earnings

- **Numbers cause your eyes to glaze over? Check the PERT graph.**



Toolkit PERT A Graphs



Can display the growth line.

Can graph 4 different items

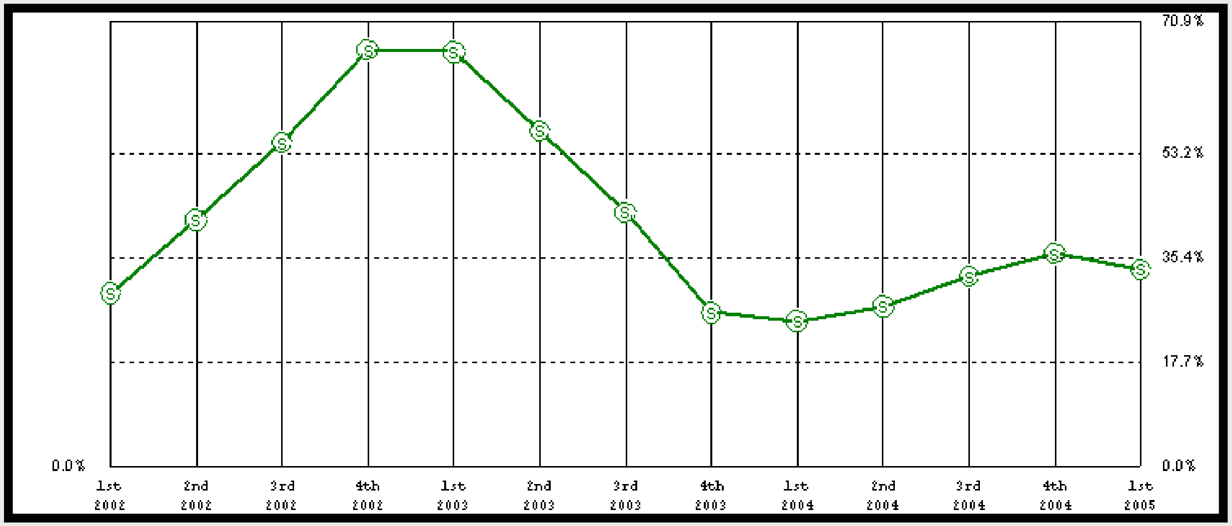
Can graph the quarterly numbers or the trailing twelve month numbers.

L-3 Sales

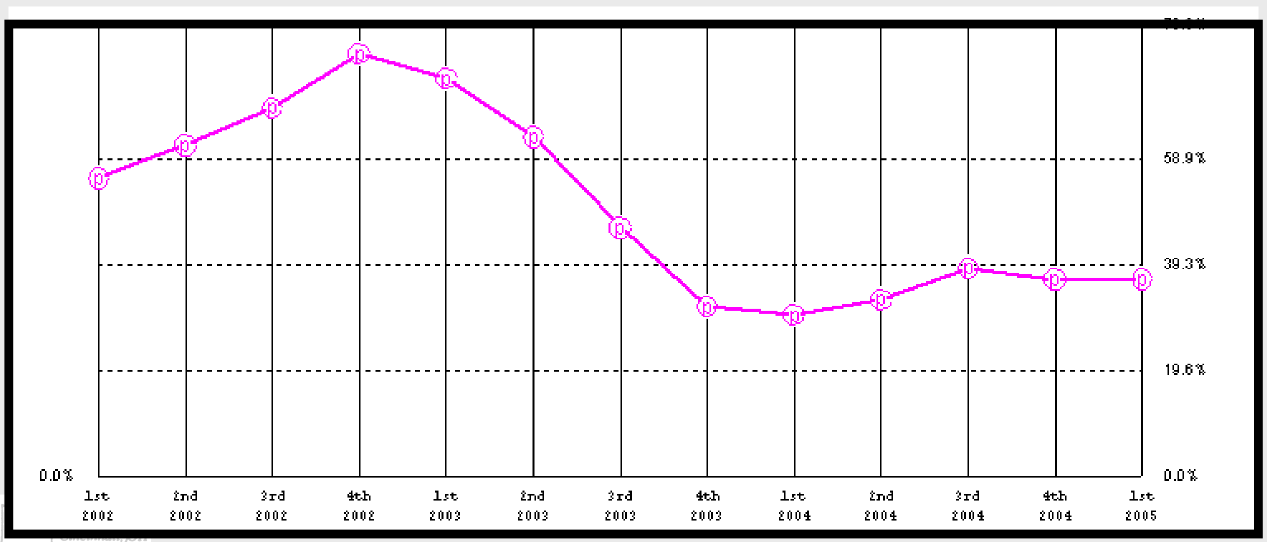
03/02	696.84	29.4
06/02	955.19	42.0
09/02	1,053.61	55.1
12/02	1,305.59	70.9
03/03	1,089.05	70.5
06/03	1,226.88	57.1
09/03	1,264.61	43.2
12/03	1,481.06	26.2
03/04	1,521.64	24.8
06/04	1,679.99	27.2
09/04	1,784.13	32.4
12/04	1,911.24	36.3
03/05	1,962.54	33.6

Sales tell a similar story. The actual dollar amount went down only once in three years, but the rolling average dropped five straight quarters.

Check the PERT Graph



Sales Growth

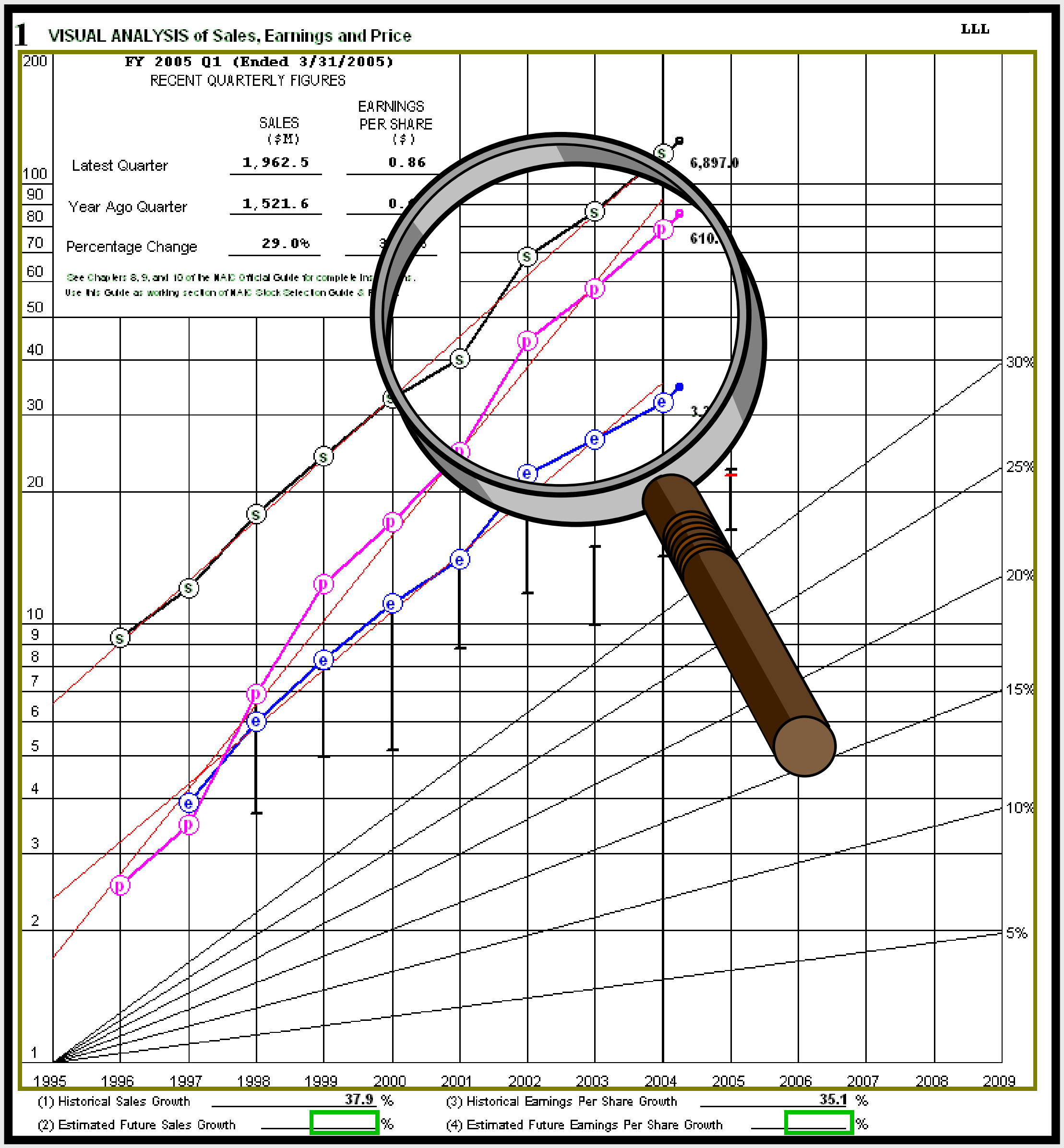


Pre-tax Profit Growth

Quarterly Numbers Review

- The numbers on the Stock Selection Guide tell a limited story.
- Check the PERT A Worksheet and/or PERT A Graph for a more detailed picture.
  - Examine the quarterly numbers
  - Examine the trailing twelve month numbers

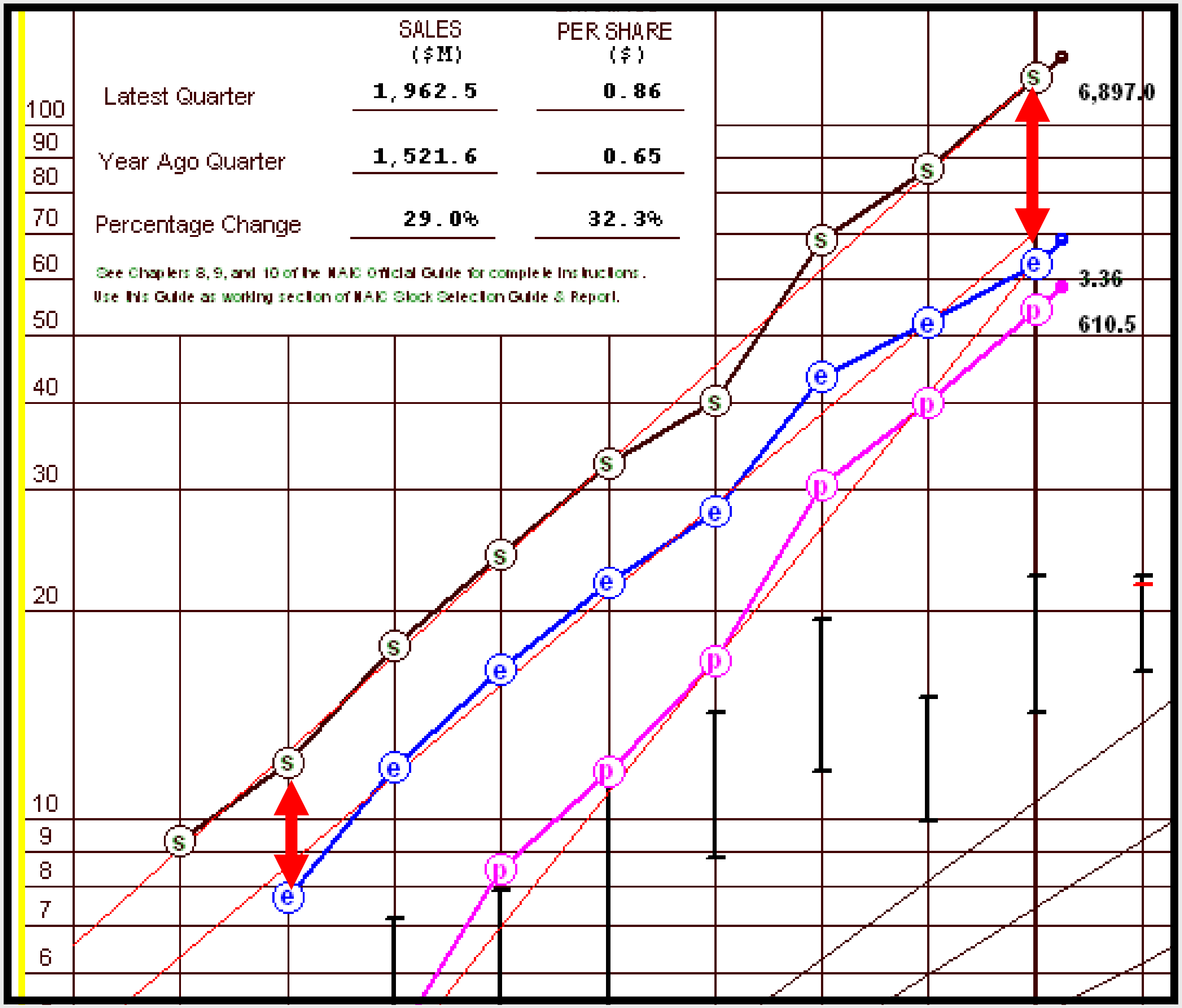
Take a Closer Look at the Graph



Looking at the Graph

- In well managed companies we will find that the pre-tax profit and the earnings grow at about the same rate as the sales.
  - Railroad tracks
- What does it mean when the pre-tax and earnings grow faster or slower than sales.

L-3

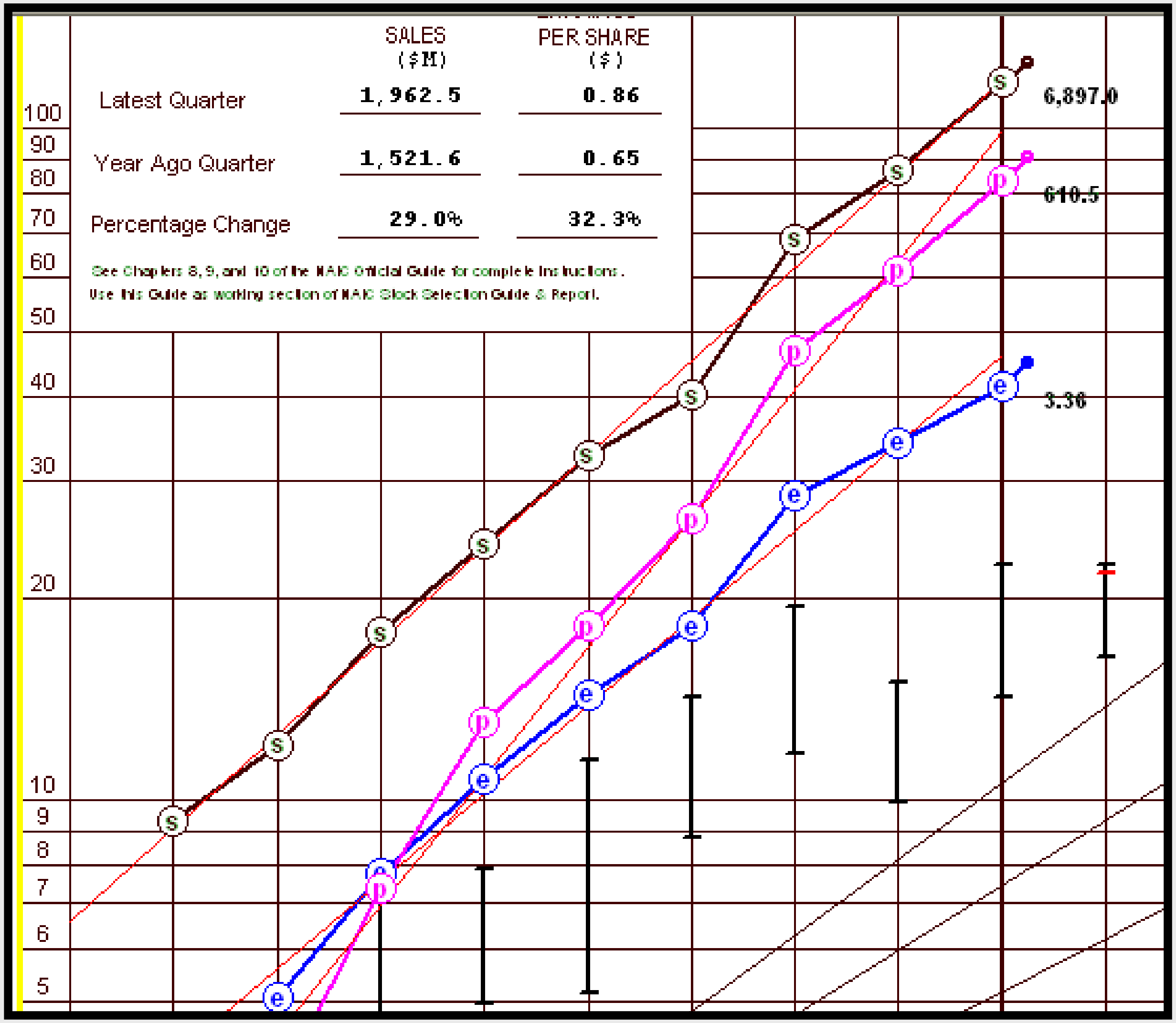


A close look at the graph shows that for the last few years, sales have been growing faster than earnings.

When Sales Grow Faster than Earnings

- Four possible causes
  - Management can not control costs
  - Management has sold more shares of stock.
  - The income tax rate has increased. (This is seldom the cause.)
  - There is some other form of stock dilution

L-3



A closer look at the graph shows that the pre-tax profit is growing faster than both sales and earnings.

Looking at L-3

- Since pre-tax profit is growing faster than sales that means the company is causing expenses to grow at a slower rate than sales.
- The two items included in earnings per share that are not in pre-tax profit are taxes and shares outstanding.

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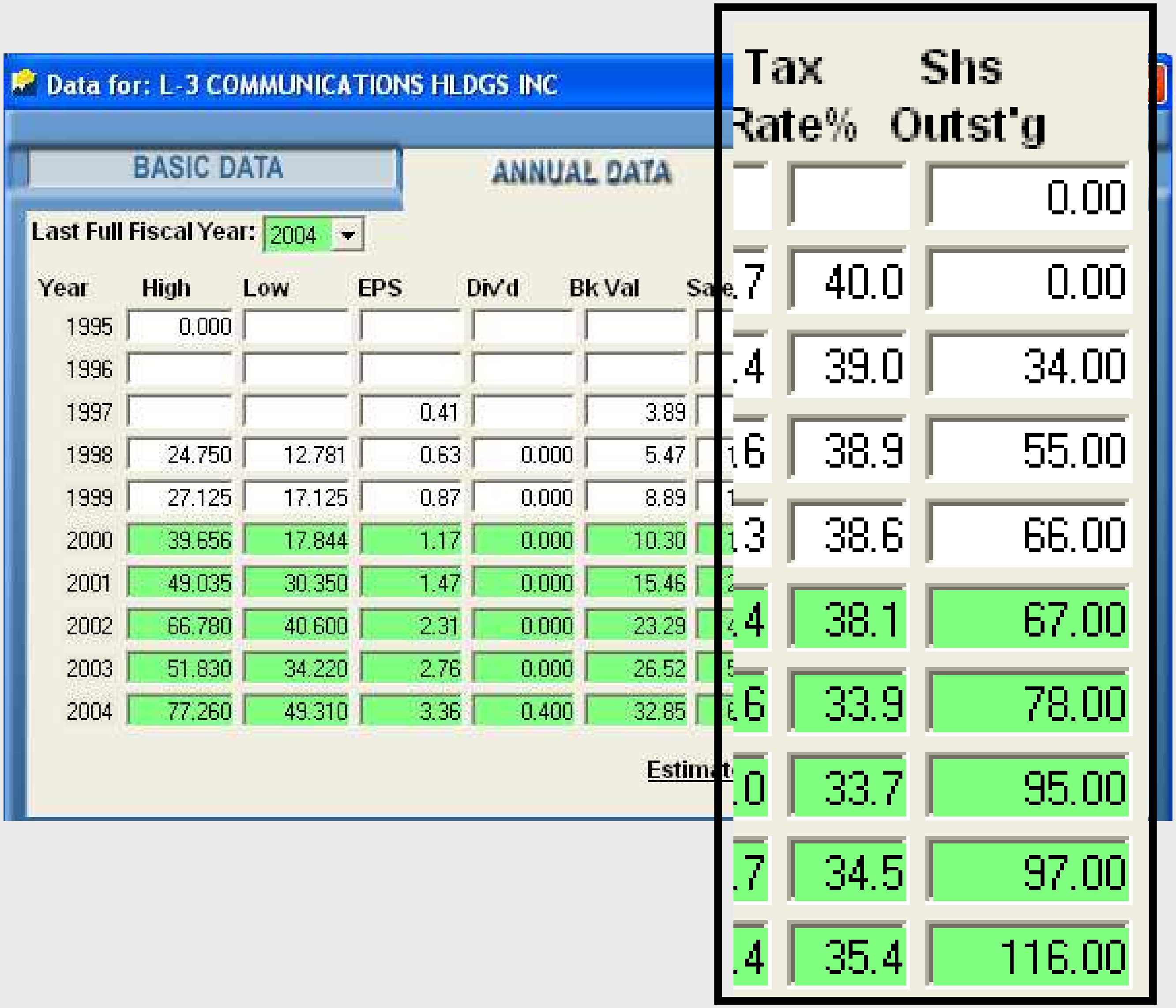
L-3

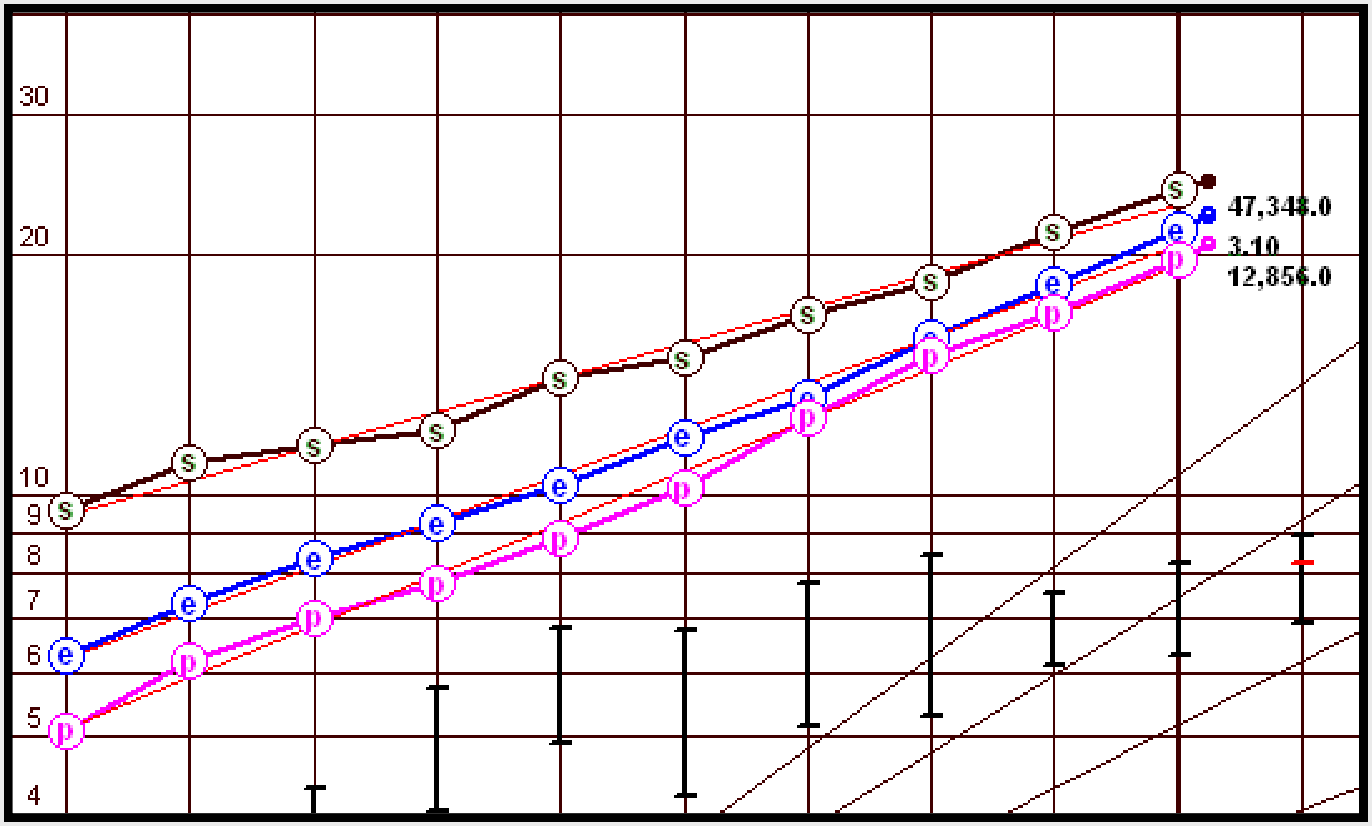


Tax rate is decreasing which would increase EPS. The shares outstanding has increased dramatically.

This is slowing the EPS growth rate.

Cincinnati, OH

When Earnings Grow Faster than Sales

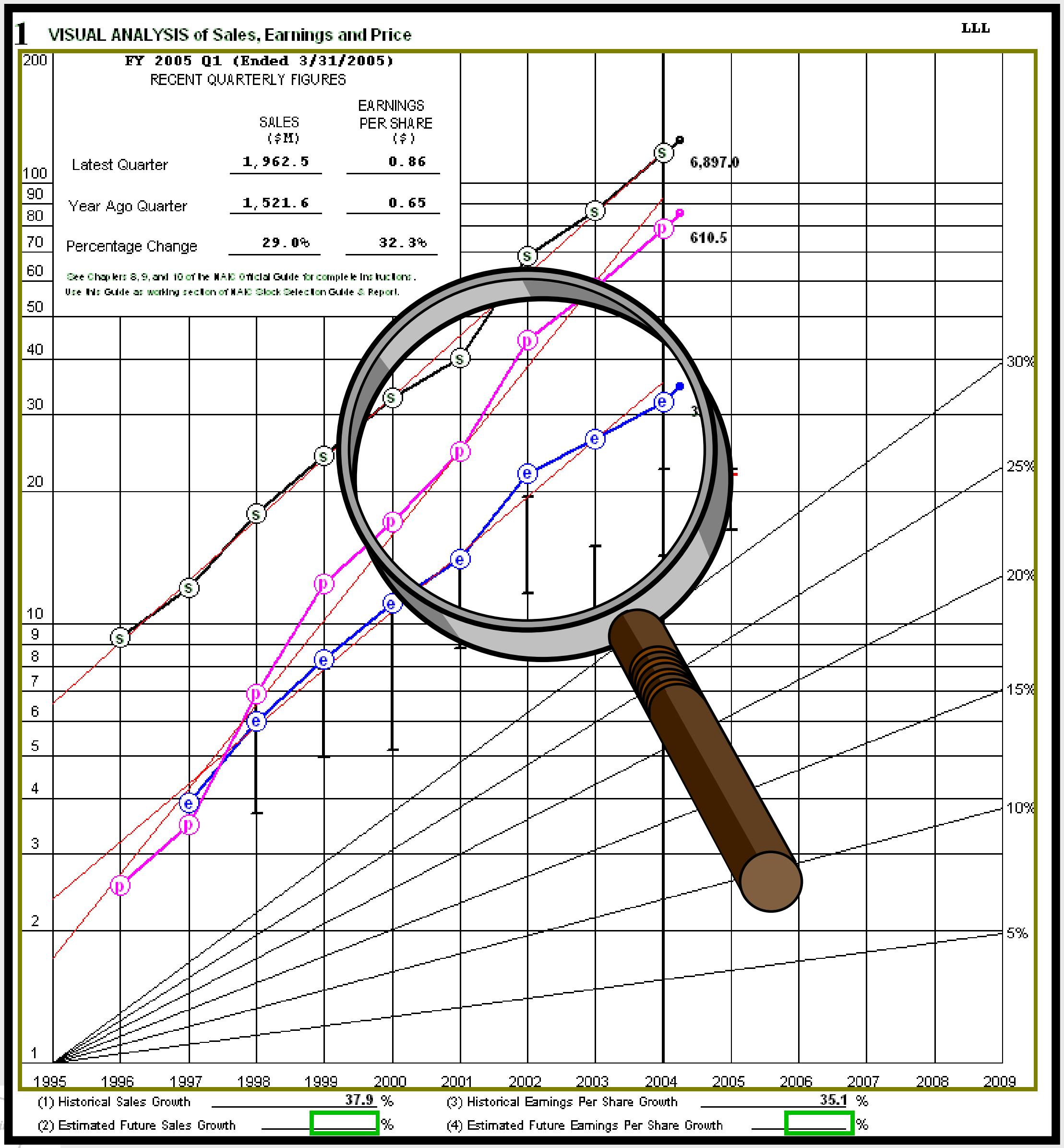


Earnings come from sales so when earnings are growing faster than sales we need to understand what is happening.

Earnings Are Growing Faster than Sales

- **When earnings are growing faster than sales we need to determine which of the following has happened.**
  - **Management has cut the cost of goods sold or the overhead.**
  - **The company is buying back shares.**

Look for Trends



The last five years are always more important than the first five years.

Determine what has caused the change.

Reasons a Trend may Change

- Increased competition
- New innovation or product that is superior to competitors
- The firm entered a new market
- The firm has made acquisitions or divestitures
- The company has increased or decreased the outstanding shares of stock

Management

Management

Management

Good management is the key to a great company.

Management

- Management has two jobs.
- Their first job is to make money.
  - Section 2A on the SSG
- Their second job is to spend money.
  - Section 2B on the SSG.

Section 2A

- Section 2A on the SSG tells us if management is making money.
- We use Pre-Tax Profit as a percent of sales.
  - It is the best way to determine if management can make a profit.
  - It is a way to compare a company with its competitors.

Why We Use Pre-Tax Profit

- Net profit includes taxes.
  - Taxes not fully under the control of management.
  - Sometimes taxes can make a company’s profit look better than it really is.
- Earnings Per Share (EPS) are affected by the number of shares outstanding.

What Section 2A Tells Us

- **Pre-Tax Profit as a Percent of Sales tells us if management is able to control costs.**
- **Good management**
  - **Keeps the growth of expenses in line with the growth of sales.**
  - **Keeps the growth of expenses competitive with other companies in the industry.**

Section 2A

- **What we look at:**
  - Numbers to be trending up or even

2 EVALUATING MANAGEMENT Company CINTAS CORP (CTAS) 07/08/05

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	16.4	16.7	17.5	15.0	15.4	16.4	16.5	16.4	14.7	15.5	15.9		EVEN

- **Think of the number as the amount of each dollar that is converted to pre-tax profit.**
- **Is this a good amount?**
  - Varies from industry to industry
  - Check the competitors

Pre-Tax Profit as % of Sales

2 EVALUATING MANAGEMENT — Company CINTAS CORP (CTAS) 07/08/05

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	16.4	16.7	17.5	15.0	15.4	16.4	16.5	16.4	14.7	15.5	15.9		EVEN

2 EVALUATING MANAGEMENT — Company G&K SERVICES INC -CL A (GKSRA) 07/08/05

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	11.5	12.2	13.6	10.5	11.8	10.9	9.3	10.1	7.8	8.0	9.2		DOWN

2 EVALUATING MANAGEMENT — Company UNIFIRST CORP (UNF) 07/08/05

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	8.9	9.8	10.7	11.6	9.6	6.1	6.5	7.5	8.0	7.6	7.1	EVEN	

Pre-Tax Profit as % of Sales

Warning sign!

2 EVALUATING MANAGEMENT Company CINTAS CORP (CTAS) 07/08/05

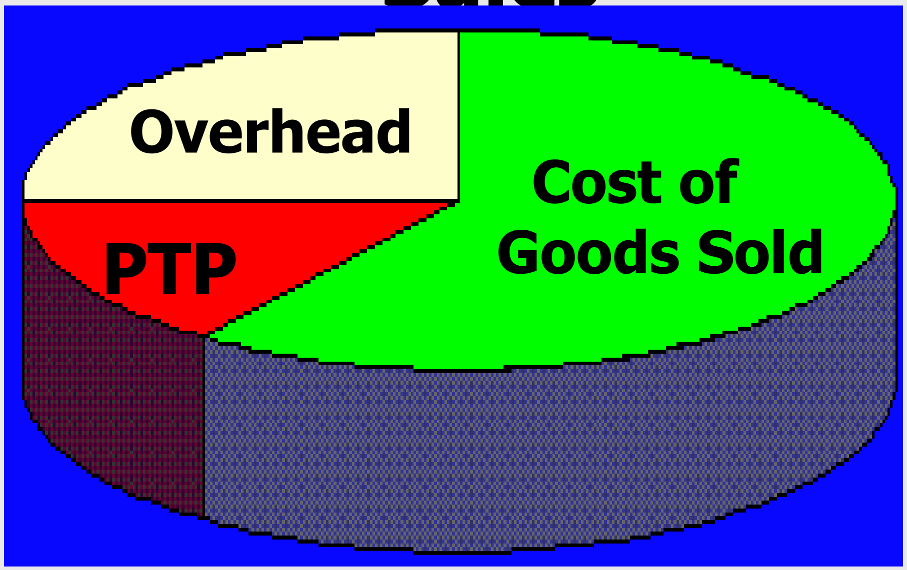
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	16.4	16.7	17.5	15.0	15.4	16.4	16.5	16.4	14.7	15.5	15.9		EVEN

- A decline of 2% in any one year is significant.
- A slow decline over several years is significant.
- Don’t just guess at the cause—do your research.

Pre-Tax Profit as % of Sales

- Three items influence the Pre-tax profit:
  - Sales
  - Cost of Goods sold
  - Overhead

Sales



- Increasing or decreasing any of these items changes the ratio.

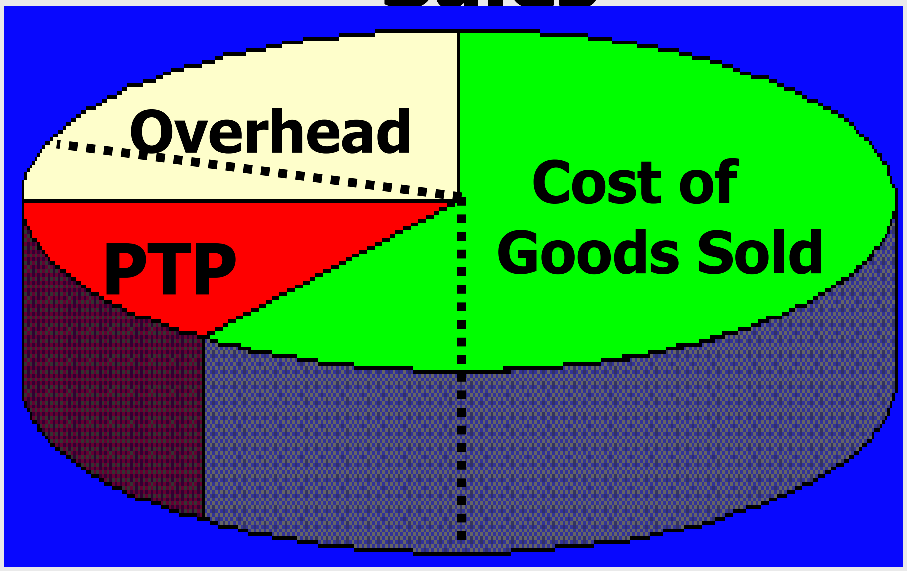
Understanding the Terms

- **Cost of Goods Sold includes all expenses related to cost of producing the finished goods or services for sale**
- **Overhead includes all other expenses.**

Pre-Tax Profit as % of Sales

- There are only three ways to increase the dollar amount of Pre-tax profit.
  - Increase sales
  - Decrease the cost of goods sold
  - Decrease Overhead

Sales



Research the Problem

- In well managed companies we expect the Cost of Goods Sold and the Overhead to grow at about the same rate as the sales.
- Need to know which of these three tems changed?
- Additional information you need found in the Income Statement and Management Discussion and Analysis in the 10K or the Annual Report.

Don’t Guess

- Begin with the Income Statement
  - Find out how much Sales, Cost of Goods and Overhead grew
  - This tells you where the problem is
- Management Discussion & Analysis tells you what caused the problem
- When you know what the problem is you can decide if the problem is long term or short term.

Income Statement

CONSOLIDATED STATEMENTS OF INCOME

(In thousands except per share data)

Years Ended May 31	2002	2001	2000
Revenue:			
Rentals	$1,753,368	$1,610,606	$1,424,892
Other services	517,684	550,094	477,099
	2,271,052	2,160,700	1,901,991
Costs and expenses (income):			
Cost of rentals	953,352	896,539	807,301
Cost of other services	360,330	367,894	315,138
Selling and administrative expenses	580,469	529,063	456,628
Interest income	(5,636)	(4,369)	(4,742)
Interest expense	10,952	15,119	15,907
	1,899,467	1,804,246	1,590,232
Income before income taxes	371,585	356,454	311,759
Income taxes	137,334	134,003	118,372
Net income	$ 234,251	$ 222,451	$ 193,387
E			1.16
D			1.14
Dividends declared and paid per share	$ .25	$ .22	$ .19

Rentals grew 9%

Other revenues declined

Total sales grew 5%

Cost of rentals grew 6%

Overhead grew 4%

The problem was a decline in other revenue.

Management Discussion

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Fiscal 2002 Compared to Fiscal 2001

Fiscal 2002 marked the 33rd year of uninterrupted growth for Cintas. Total revenue was $2.3 billion, an increase of 5% over fiscal 2001. Revenue from the Rentals segment increased 9%, primarily due to a combination of acquisitions and growth in the customer base. Other Services revenue decreased 6%, primarily due to a delay in customer purchases driven by slow economic conditions and a decline in the hospitality and airline industries resulting from the events of September 11. Despite slow economic growth, internal growth in the Rentals segment averaged over 4% for the year.

Pre-tax income was $372 million, a 4% increase over fiscal 2001. Pre-tax income from the Rentals segment increased 8% over the prior year, primarily due to higher rental revenue. Pre-tax income for the Other Services segment decreased 37% from the prior year, due to lower sales volume and excess capacity costs.

Net … lower interest rates, a lower average leve… ties in fiscal 2002. Cintas' effective tax rate … y due to tax planning efforts.

Net … of $1.36, both represent a 5% increase ove… 20% in fiscal 2001.

Cash, cash equivalents and marketable securities decreased by $25 million in 2002, or 23%, primarily due to the acquisition of Omni. The cash, cash equivalents and marketable securities will be used to finance future acquisitions and capital expenditures. Marketable securities consist primarily of municipal bonds and federal government securities.

Causes:

Poor economy and 9/11

If Cost of Goods Sold is the Problem

- Management can decrease the cost of goods sold by:
  - negotiating with employees
  - negotiating with or finding alternative suppliers
  - increasing efficiencies (usually by making capital improvements)

If Overhead is the Problem

- **Overhead expenses are often more difficult to lower quickly.**
- **They include all expenses not associated with creating the product or service**
  - **Advertising**
  - **Utilities**
  - **Leases**
  - **Management expenses**
  - **Gasoline**
- **Decreasing any of these will increase Pre-Tax Profit.**

Sales

- Companies can increase the amount of PTP by increasing sales
- Increase sales by:
  - expanding territory
  - taking market share from competitors
  - increasing the price per unit
- If any of these decrease, sales will decline.

?

- **Before we go on, are there any questions about using pre-tax profit as a tool for judging management.**

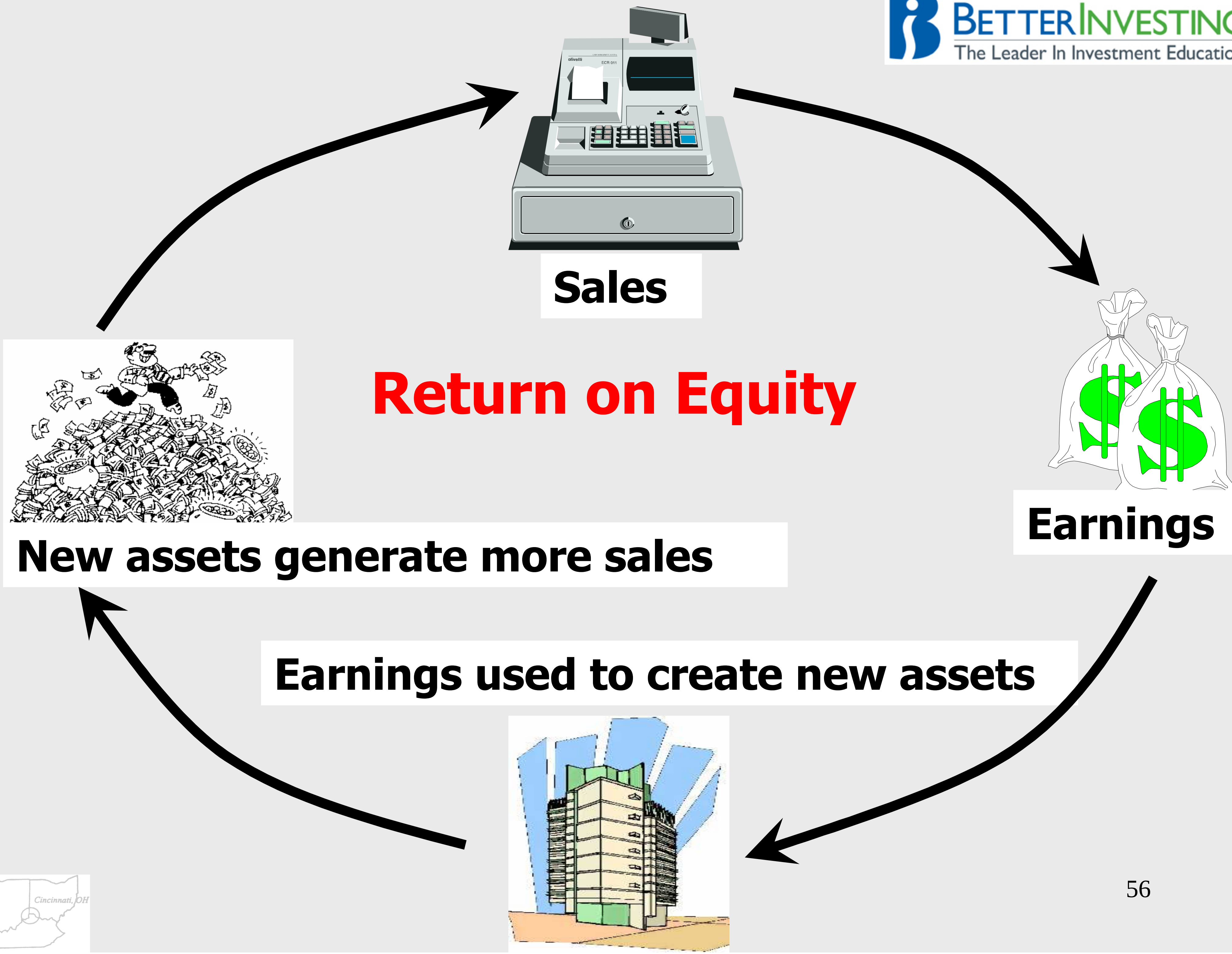
Return on Equity

- Pre-tax profit (Section 2A) tells us if a company has made money
- Return on Equity tells us if management can spend that money in a way that grows the value of the company.
- As the value of the company grows, so will the piece that we own become more valuable.

Some Basic Definitions

- **Retained Earnings** - The earnings that are left after all expenses, taxes and dividends have been paid. These are the earnings management keeps to grow the company. The retained earnings add to shareholders equity each year.
- **Assets** - Everything the company owns that has value. This includes things owed to the company.
- **Liabilities** - Everything the company owes. This includes both short term and long term debt.
- **Equity** - That which is left after liabilities are subtracted from assets. The equity is what the shareholders own.

Return on Equity



Return on Equity

- The primary test of management economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and **NOT** the achievement of consistent gains in earnings per share. *

- *Warren Buffet, Berkshire Hathaway, 1979 Annual Report

Return on Equity

- We want the numbers to be trending up.
- We look for the number to be as large as possible.
- We compare the ROE to the competitors and to the industry average.

What is a “Good” ROE

“The investor usually finds the greatest opportunity in companies where the percent earned on equity is above 20 percent. This is a very significant indicator of the rate at which shareowner value is increasing.”

Starting and Running A Profitable Investment Club, page 96 (1998 edition)

Cincinnati, OH

BETTERINVESTING™
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Compare the ROE

2 EVALUATING MANAGEMENT Company CINTAS CORP (CTAS) 07/08/05

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A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	16.4	16.7	17.5	15.0	15.4	16.4	16.5	16.4	14.7	15.5	15.9		EVEN
B % Earned on Equity (E/S ÷ Book Value)	17.0	17.2	17.6	19.0	18.9	18.4	17.9	16.2	15.0	14.5	16.4		DOWN

2 EVALUATING MANAGEMENT Company G&K SERVICES INC -CL A (GKSRA) 07/08/05

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	11.5	12.2	13.6	10.5	11.8	10.9	9.3	10.1	7.8	8.0	9.2		DOWN
B % Earned on Equity (E/S ÷ Book Value)	15.5	16.1	17.2	16.2	15.8	14.0	11.3	11.3	8.9	8.5	10.8		DOWN

2 EVALUATING MANAGEMENT Company UNIFIRST CORP (UNF) 07/08/05

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	8.9	9.8	10.7	11.6	9.6	6.1	6.5	7.5	8.0	7.6	7.1	EVEN	
B % Earned on Equity (E/S ÷ Book Value)	12.3	12.9	13.2	13.5	9.1	7.3	7.8	8.6	8.7	9.1	8.3	UP	

Which company does the best job of using your equity to grow future returns?

ROE

- A company can increase the ROE in three ways:
  - increase the net profit margin
  - increase the Asset Turnover rate
  - increase the financial leverage
- If any one of these drops, the ROE could go down.

Net Profit Margin

	Sales
Minus	Expenses
Equals	Pre-tax Profit
Minus	Taxes
Equals	Net Profit

Net Profit Margin is net profit expressed as a percent.

Net Profit Margin

- To find net profit margin divide net profit by sales
- The numbers you need are found on the income statement.

Total Revenues $2,271,052

Years Ended May 31	2002
Revenue:	
Rentals	$1,753,368
Other services	517,684
	2,271,052
Costs and expenses (income):	
Cost of rentals	953,352
Cost of other services	360,330
Selling and administrative expenses	580,469
Interest income	(5,636)
Interest expense	10,952
	1,899,467
Income before income taxes	371,585
Income taxes	137,334
Net income	$ 234,251

Net profit is $234,251

ROE

2 EVALUATING MANAGEMENT — Company CINTAS CORP (CTAS) 07/08/05

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A	% Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	16.4	16.7	17.5	15.0	15.4	16.4	16.5	16.4	14.7	15.5	15.9		EVEN
B	% Earned on Equity (E/S ÷ Book Value)	17.0	17.2	17.6	19.0	18.9	18.4	17.9	16.2	15.0	14.5	16.4		DOWN

- **Usually if both the pre-tax profit and the Return on Equity drop in the same year, it means there is a problem with the net profit margin. The components of Net Profit Margin are sales, cost of goods sold, overhead and taxes.**
- **However in this instance the net profit margin was 10% in both 2001 and 2002. We need to look at assets and leverage.**

Asset Turnover Rate

- **Asset turnover rate tells us how well management is using the assets to grow sales.**
- **Divide sales by assets to find this ratio.**
- **Higher numbers are better**
- **This number varies from industry to industry.**
  - **Compare companies in the same industry.**

Asset Turnover Ratio

- The numbers we need are found on the Income Statement and Balance Sheet.
- In 2001 the Asset Turnover Rate was 1.24 which means for every dollar of assets they generated $1.24 in revenue.
- In 2002 the Asset Turnover Rate dropped to .90.
  - This tells us that equity was invested in assets that did not increase future revenue.

When the Asset Turnover Rate Drops

- Start by checking these four assets
  - Cash on hand
  - Inventories
  - Receivables
  - Goodwill

  We expect each of these items to increase about the same amount as sales.

Cintas Balance Sheet

Assets

Liabilities & Shareholder Equity

Assets				
Current assets:				
Cash and cash equivalents	$	40,628	$	73,724
Marketable securities		44,458		36,505
Accounts receivable, principally trade, less allowance of $9,229 and $8,765, respectively		283,234		244,450
Inventories		193,821		214,349
Uniforms and other rental items in service		280,936		242,172
Prepaid expenses		10,173		8,470
Total current assets		853,250		819,670
Property and equipment, at cost, net		778,402		702,132
Goodwill		678,598		123,753
Other assets		208,984		106,669
	$	2,519,234	$	1,752,224
Liabilities and Shareholders' Equity				
Current liabilities:				
Accounts payable		60,393	$	42,495
Accrued compensation and related liabilities		29,004		35,140
Accrued liabilities		131,705		81,548
Income taxes:				
Current		11,791		13,412
Deferred		61,372		57,703
Long-term debt due within one year		18,369		20,605
Total current liabilities		312,634		250,903
Long-term debt due after one year		703,250		220,940
Deferred income taxes		79,591		49,066
Shareholders' equity:				
Preferred stock, no par value: 100,000 shares authorized, none outstanding		—		—
Common stock, no par value: 425,000,000 shares authorized, 169,930,290 and 169,370,563 share		66,508		62,409
Retained earnings		1,365,136		1,174,330
Other accumulated comprehensive loss:				
Foreign currency translation		(4,863)		(5,424)
Unrealized loss on derivatives		(3,022)		—
Total shareholders' equity		1,423,759		1,231,315

Comparing Assets to Sales

- In 2002 Cintas revenue grew 5%.
- Cash on hand dropped.
- Inventories declined.
- Receivables grew 15.9%
- Goodwill grew 448%.
  - Cintas made an acquisition and created a lot of goodwill that did not produce future revenue.

Return on Equity

- **Section 2B in the Stock Selection Guide is the only place on the SSG that warns you to check these four important items on the Balance Sheet**
- **Large increases in Cash on hand, Inventories, Receivables and Goodwill are often very early warning signs of problems that are just beginning.**

Financial Leverage & ROE

- **Financial leverage (borrowing money) is not necessarily a bad thing.**
  - **The borrowed money should earn more than it costs in interest.**
- **Financial leverage can enhance the ROE.**
- **There is a risk to borrowing money**
  - **Interest has to be paid.**

Financial Leverage

- The Financial Leverage Ratio tells us how much a company is using borrowed funds.
- Divide the total assets by the Shareholder Equity to determine the financial leverage.

Financial Leverage

- The financial leverage grew from 1.42 to 1.76 .
  – This is a significant amount.
  – Long term debt almost tripled.
  – Funds were used for acquisition. If the acquisition adds more to the bottom line than the interest costs, it will ultimately enhance the ROE.

Section 2B Return on Equity

- Section 2B tells us how good management is at using the retained earnings, borrowed money, and other income to grow future sales and earnings.
- A drop in Section 2B is often an early warning sign of a developing problem.

Conclusions

- A few extra minutes taking a closer look at your Stock Selection Guide will disclose any areas where problems are developing.
- Determine what is the cause of the problem so that you can make an informed decision about whether to buy, hold or sell the stock.