A BEGINNER'S WORKSHOP:
ANALYZING CASH FLOW
with Diane Graese, Director, Las Vegas Chapter

ANSWER to Final Exam:

SSG Analysis:

The company has a short trading history so we do not have ten years of data. But the company was founded in 1932 so there is a long company history. It could be researched in their Initial Public Offering (IPO) documents.

The SSG shows the company has been growing sales, pre-tax profits and earnings at about the same rate. There has been rapid growth that is slowing in the current year.

Rapid stock price appreciation occurred in 1996 and the trend continued in 1997. There seems to have been lots of exuberance and PEs increased rapidly as investors paid more and more for earnings… until 1998. During 1998 the stock price failed to break into new high ground and traded lower than the low in the previous year. The price trends in 1998 show a lot of selling pressure.

The SSG trend lines look respectable. The declining stock price suggests more sellers than buyers. Is this an opportunity to buy a good company at a good price? Or is the price drop portending more doom and gloom? Study of the cash flow statement will help us uncover what is happening.

Cash Flow Statement Analysis:

PRELIMINARY ANALYSIS:

This company decreased cash significantly in the current year after having increased it in the past two years.

Earnings are trending up. But Cash from Operations is erratic. Lots of items are listed and this area will require some investigation. There is a disconnect here requiring further investigation.

The Company has been using a lot of cash in their increasing investing activities. We'll want to explore the investments being made.

The Company raised a lot of money two years ago but this year repaid money. While the net activity balance in the current year is minimal, there are two large offsetting transactions that are probably worth investigating.

ANALYZING CASH FROM OPERATIONS:

Normalizing Net Income: Although I can see a Loss on Sale of Fixed Assets in 1998, the amount is not significant enough for me to adjust net income.

Computing Expected CFO: I normally wouldn't bother with this step because I can see what is happening here. But I do perform this step when the picture is not clear. I'll do it for you using rounded numbers:

	1998	1997	1996
Net Income	8,344	7,709	5,037
Add Depn	1,476	738	70
Add Amortization	377	218	137
Expected CFO	10,197	8,665	5,244
Difference	(9,698)	(3,394)	(4,342)
Reported CFO	499	5,271	902

The above shows we have huge differences between our expected cash flow and reported cash flow. In fact in 1998 and 1996 earnings are generating almost NO cash. The reason is pretty clear when we go looking for items to explain the difference.

Accounts receivable and Inventories have been increasing and using up all the cash:

AR	(5,243)	(2,211)	(3,377)
Inventory	(3,066)	(4,676)	(2,595)
Total explained	(8,309)	(6,887)	(5,972)

While we have to do the homework, there are several possible explanations.
We know we are dealing with a growing company, so in some ways it is not unusual to see receivables and inventories growing.

RECEIVABLES: We know from this line that while sales are growing, the company is not collecting cash. First I might compare the increase to the increase in fourth quarter sales over the prior year. But the size of the dollar amount here is what is scary. Remember Sales are gross dollars; net income is what is left from each sales dollar after expenses and taxes. Here we can see that the growth in sales is a very large percentage of net income.

It is possible that the company has changed their remittance policies to increase sales… adding extended payment terms. Or maybe they are so busy growing sales, they have understaffed their collection department. Some people might do some ratio analysis to compute Days Sales Outstanding. I don't bother as I can see that increasing sales isn't improving the company's cash flow.

INVENTORIES: With huge sales growth it is not unusual to see a company build inventory to enable future sales. But here is where one wants to make sure that the product does not go obsolete quickly or become a cyclical commodity. We also would want to look at the composition of inventory between raw materials and finished goods to make sure the finished goods are not growing too fast (a possible sign of slowing sales.) You might also compute an inventory turnover ratio… but again, I think we can see here that the result will be bad.

OTHER: While these two areas are of primary concern, there are a few other points in this section. I'm not going to bother calculating Free Cash Flow, because I can already see there is going to be a problem… there isn't any CFO so any capital spending will need to be financed elsewhere.

We can see that depreciation expense has increased quite significantly from 1996 to 1998. This is result of some big increases in capital spending or some other change to the nature of business operations as a result of acquisitions. Either way, this suggests some changes to operations and this is likely part of an explanation of changes to pre-tax margins.

In 1996 and 1997, the company improved their cash flow by delaying payment of bills (AP providing positive cash flow to operations). At some point, bills need to get paid and we see the turnaround in 1998.

CONCLUSION ON THIS SECTION: Business is booming but it isn't generating a lot of cash. Continued growth will depend on other sources of financing or some slow down to focus on better inventory and receivable management. The nature of the product is important for to project future sales. Is the company continuing to do gangbuster sales (people can't buy enough), or has everyone who wants one purchased it (a market that is starting to be saturated?) If sales start to decline, the company has a huge investment in inventory. What will it be worth? We don't have all the information but I'll suggest this picture is pretty scary.

INVESTING ACTIVITIES: The Company began expanding through acquisitions in 1997 and 1998. It appears that the acquisitions may have changed the nature of company operations since we now also see capital expenditures increasing in those same years. There are a lot of questions here requiring investigation. And if these new operations are in different areas, SSG projections may become more difficult as the forward going company will not look like the company on the SSG.

FINANCING ACTIVITIES: The Company had a large stock offering in 1996. It appears the proceeds were used to repay debt. When a company has a stock offering they usually put on a "road show." They go to visit analysts, pension and mutual fund managers, and anyone else who might buy the stock. The put on a presentation explaining the virtues of the company and why one should own stock. Hopefully this generates lots of enthusiasm so the company can raise a maximum amount of money. It also helps explain the huge rise in the stock price and why there was excessive enthusiasm.

We also see that this huge push also helped executives who likely received lots of stock options with the IPO. We see lots of cash being generated in 1997 due to stock option exercises. But what happened to those shares…. do executives still own them? Time to go look at the stock option footnote, the proxy statement and insider trading filings.

In 1998, the net financing result suggests they used cash to repay debt. But the line items tell another story. The company borrowed $12 million and used the money to buy stock. This transaction changes the debt to equity picture in a big way. And while the SSG might show increasing ROE, the improvement is the result of having changed the risk profile of the company.

This is a growing company that is not generating cash. To the extent the company has used their line of credit to buy stock, this reduces the availability of credit to continue to grow the business. One must wonder whether they will have the ability to raise cash in the next year to continue to finance operations.

To me, the stock buyback appears to be a desperate attempt to prop up the stock price by creating an impression of lots of buyers in the stock market. And it does help EPS calculations by reducing outstanding shares. But I don't see it as being in my interest.

CONCLUSION: I see a lot of things that scare me. Lack of operating cash flow. Possible changes to business operations making future analysis difficult. Financing transactions that seem to help executives who have lots of options but which may be mortgaging the future of the company. And almost no remaining cash on the balance sheet. Despite a reasonable looking SSG, my cash flow analysis says move on.

You can look at the SSG today and see that Ballantyne did run into trouble in the following years.

Hopefully this workshop will help you avoid situations like this in the future.