

# Ben Graham Net Net Stocks and a 7 Step Checklist to Make Money with Net Nets

One of my favorite strategies still revolve around Graham's Net Net stocks.

I sound like a weirdo, but it's dear to my heart.

But I've come and gone with this over the years because it's not easy to find good quality net net stocks in the US at the moment.

The last thing I want to do is compromise on quality, simply to follow a net net strategy.

Net net stocks work best when the markets are down and right now, it's not the best time for USA net net stocks.

One way that I measure market valuations is to simply look at how many net net stocks there in the market.

I did this a year ago and noticed that [the market wasn't cheap](#).

Sure there were some NCAV and NNWC stocks out there, but none of them were screaming buys.

But before getting into all the hows, whys and whens on buying and making money with net nets, let's review the basics first and work our way from there.

## Understanding Net Nets

Net net stocks are not just cheap stocks.

Cheap stocks reference anything where the current stock price is lower than the underlying intrinsic value.

Net net stocks are dirty, trodden, haven't had a bath in 10 years types of stocks.

It's a value investing technique where the stock is valued purely on its current assets.

- Cash
- Accounts receivables
- Inventory
- subtract debt

In fact, Graham basically said that net nets are stocks that are priced for liquidation.

Here's how he described how to calculate the net net value.

*Working capital (current assets less current liabilities) then subtract any debt not included in current liabilities.*

What Graham is describing is the NCAV (Net Current Asset Value). You can see that he's not talking about book value because he values intangibles and other non current assets as zero.

When people mention net nets, they usually mean NCAV. But I use NCAV as well as NNWC and you can see the difference below.

## **Calculating the NCAV (Net Current Asset Value) for Stocks**

The formula to calculate NCAV is simple and the idea is to find stocks where the NCAV is higher than the market price.

$$\text{NCAV} = \text{Current Assets} - \text{Total Liabilities}$$

To get a per share value, simply divide by the number of diluted shares outstanding.

$$\text{NCAV per Share} = (\text{Current Assets} - \text{Total Liabilities}) / \text{Shares Outstanding}$$

Graham's criteria for buying NCAV stocks was if the stock price was 2/3 of the NCAV.

e.g. If the NCAV per share was \$10, then Graham wanted to buy it when the stock price was at \$6.66.

More on that later.

## **Calculating the NNWC (Net Net Working Capital) for Stocks**

NNWC is a very close cousin to the NCAV but the difference is that NNWC is a fire sale liquidation calculation.

NNWC stands for Net Net Working Capital and the formula is as follows.

$$\begin{aligned} \text{NNWC} &= \text{Cash and short-term investments} \\ &+ (0.75 \times \text{Accounts Receivable}) \\ &+ (0.5 \times \text{Total Inventory}) \\ &- \text{Total Liabilities} \end{aligned}$$

Then divide by shares outstanding to get the per share value.

$$\text{NNWC per Share} = \text{NNWC} / \text{Shares Outstanding}$$

The big difference is that NNWC looks purely at liquid and tangible asset value. It doesn't include any prepaid expenses or even deferred taxes that NCAV does include.

Accounts receivables are marked down for doubtful accounts and inventory gets a 50% off haircut and to reflect a rapid fire sale.

When Circuit City was going through its liquidation, they didn't try to sell what they had left at 10% or even 20% off.

Prices were marked 50% and more because it just had to be cleared.

The key distinction however is that liquidations are very rare in the market. There are a lot of costs associated with liquidating and it takes a long time to fully unwind.

So NNWC is more of a theoretical number to help you see how conservative the valuation is.

## **Why You Would Buy a Net Net**

Knowing how to calculate NCAV and NNWC is all well and good, but what's the point?

If a stock is priced for liquidation, why even bother buying it?

Well, here are some reasons why I buy net net stocks.

1. Very easy to value
2. There is a solid floor
3. Most are simple businesses to understand
4. Nobody wants it
5. Small to micro caps usually
6. Low volume

I'm not talking about just any net net stock though. A net net has to pass a set of criteria before I buy it.

But I love the fact that it is so black and white.

Assuming you found a good one, your downside is protected by the liquid assets and you are buying with a huge margin of safety.

If the company has other long term assets like buildings or cash overseas, that's an included bonus if it can get unlocked.

It's such a rare strategy where you don't even have to know much about the industry or the future.

You can just focus on the individual business and that's it.

And because it's so simple, people stay away from it.

When I purchased Friedman Industries (FRD), it wasn't a net net at the time, but the downside was well protected with a NCAV of \$7.29 per share.

Right now, the stock price is \$7.57 so it's trading close to NCAV from when I first calculated it.

Whether it's by luck or just coincidence, you can see that the NCAV is acting as a floor for this troubled yet well managed company.

It's just a matter of keeping an eye on the NCAV each quarter to make sure that there is no sudden deterioration.

## Why You Wouldn't Buy a Net Net

There are very real reasons for why you wouldn't buy net nets though.

The main one is that any company trading at or below NCAV/NNWC is going through some serious troubles.

Here are some reasons companies become net nets.

- Just lost their major customer who makes up 95% of sales
- Management was embezzling money for years and cooking the books



- Their main product is making CD's
- They have no operating business
- The market doesn't believe their new drug will ever get approved
- and the list goes on

Definitely some scary reasons.

Actually, let's face it.

They are garbage.

I'm sure you've walked into a store and saw a table or a small basket with items being liquidated.

Everything is so cheap.

But 99% of them are useless.

Why would you want an open pack of sliced cheese that is close to expiration for just 50c?

What are you going to do with that slow and outdated laptop with some keys missing?

That's what net nets are like after all and it definitely doesn't suit everybody.

It requires a certain type of personality to make net nets work.

The type of person who buys that pack of cheese, makes a nice sandwich and sells it to his friend for a few bucks and makes a profit.

Or the type of person who pulls the laptop apart and sells the parts for a nice profit.

Net nets are a big no no if you have the following traits:

- Don't want volatility
- Want to hold something for as long as possible with very minimal turnover
- Don't like buying small caps
- Don't like analyzing OTC stocks
- Want to stick to mainstream ideas
- You have to look important to others
- You want to brag that you found the next GOOG, TSLA, MSFT

And this is perfectly fine because being comfortable with where you place your money is very important.

## **Net Net Buying Checklist – 7 Simple Rules to Follow**

But if you are not limited to large caps and don't mind net nets, here's a brief checklist you can follow to make sure you reduce your risk as much as possible.

### **1. Stay Within Circle of Competence**

It's a cliché but it's true.

Although you only have to focus on the business itself, you are looking at a company that has a lot of troubles. So it's easier to stick to what you know.

## **2. No Chinese stocks**

Unless it's Alibaba, most Chinese stocks are still very shady. Especially the smaller ones. High chance of fraud so why risk it. The idea is to buy cheap net nets that will lower risk.

Not to find ones that you think will go up by 1,000%.

## **3. Has a Valid Operating Business**

Stay away from net nets where their business model is totally outdated as the value will erode.

A company could have a solid balance sheet, but if it's main business is photo printing or backup data with CD's, run away.

## **4. Low Cash Burn**

Make sure the company has enough money to last for several years even if it keeps losing money.

Get the TTM FCF or last year numbers and divide it by how much money they have on the balance sheet.

Here's the example with FRD again.

On the balance sheet, they have \$10.8m in cash and the TTM FCF is a negative \$5.4m.

And this is what the company confirmed in their last filing.

*Notwithstanding the current market conditions, the Company believes its cash flows from operations and borrowing capability due to its strong balance sheet are adequate to fund its expected cash requirements for the next 24 months. – FY2015 Q1 10-Q*

You can do the same thing with Cash from Operations and compare it with the FCF figure to see how much of a difference there is.

But stick with FCF if you can.

You can also use the average of the last 2 years, but it's not a good idea to average more than 2 years because you don't want to fool yourself into thinking that the situation is better than it is.

A low cash burn is your safety net.

A lot of the value is tied up in cash, so if the burn rate is high, you will be fighting against time as you see the NCAV value drop.

## **5. No Debt or Very Easily Manageable**

Looking for safe net nets is key and debt is a killer for most small businesses.

When you consider that net nets are;

- struggling with their main operating business

- or losing money

the last thing you want is debt crushing them further.

## 6. No Insider Selling

I want to see insiders committed to saving the company, looking for ways to sell it or just extract value out of it.

Insider selling when the stock is at its lowest price point is a sign that management doesn't care about anything other than filling up their pockets before the company rolls over dead.

## 7. Signs of Buybacks

The opposite of #6.

If management understands that the sticker price on their company is ridiculous, they can continue to buy up shares to increase the value of each share.

PRLS went from having 18.1m shares outstanding in 2009, to 2.7m.

Net Net Hunter also has a [good checklist](#) to check out.

## Be Patient and Wait for Those Graham Net Nets

Now Graham researched and tested many strategies throughout his career.

There are many research papers detailing the profitability of net nets. I even used [net nets to show how you can time the markets](#).

And right now, I'm waiting.

Actually, I've been waiting for several years. As the rising market has lifted all boats, there aren't many net nets around.

Net nets in a fair to overvalued market are very high risk indeed.

But it shouldn't be neglected.

It doesn't have to make up a large portion of your portfolio, but when the opportunity strikes, you should consider allocating about 10-20% of your portfolio to net nets.