Performing Financial Statement Analysis on 3 Stocks You've Heard About

> *I am a better investor because I am a businessman and a better businessman because I am an investor.*

Know who said that?

Warren Buffett.

Accounting is the language of business. If you want to improve your investing skills, it all starts with accounting.

But accounting is simply the alphabet of the language.

The misconception is that just because you know accounting, you're going to be good at investing.

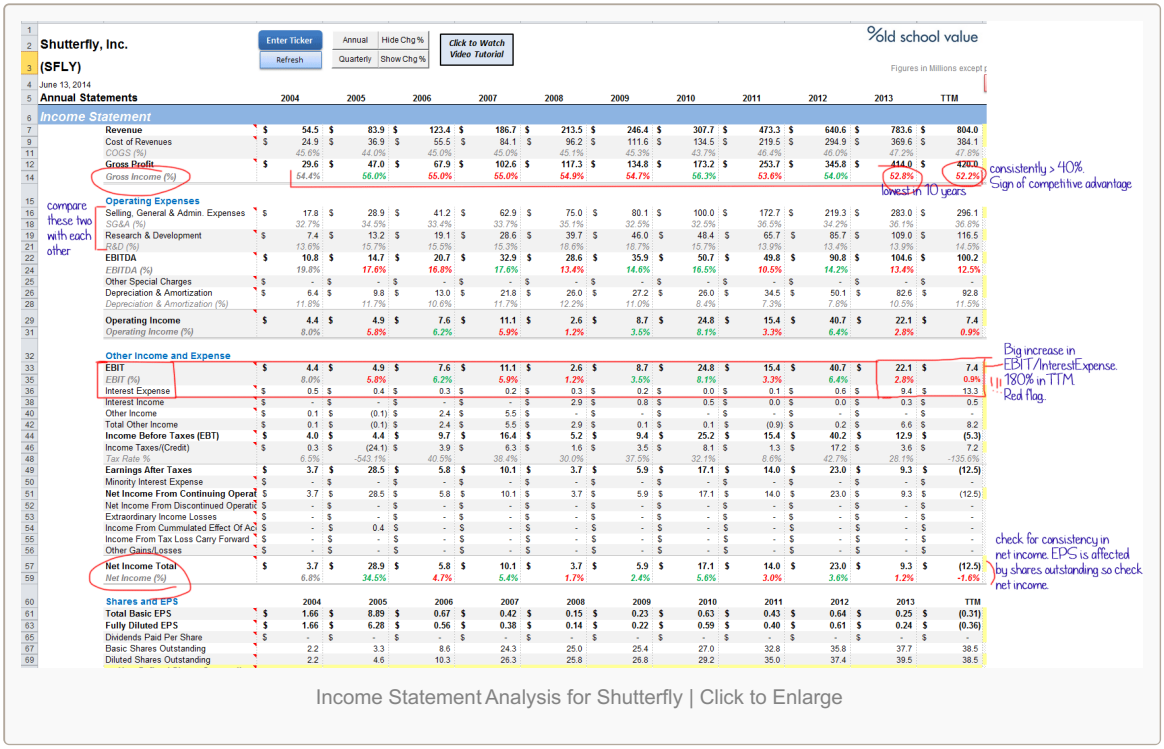
Wrong.

Being able to interpret what the accounting numbers tell you and seeing how certain accounting numbers interact with each other is when you become fluent in the language of business.

Here's a look at how Warren Buffett interprets the financial statements. Let's apply the concepts to three stocks.

I'm using the stocks from the Best Small Companies list. Get the spreadsheet with details for each stock.

Shutterfly (SFLY) Income Statement Analysis



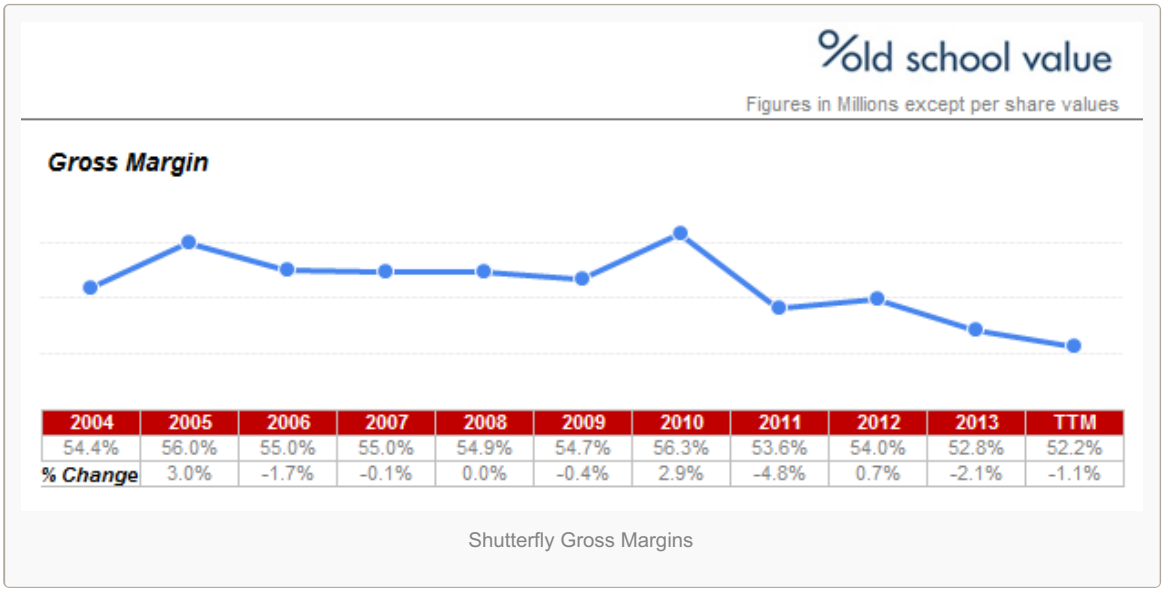
Income Statement Analysis for Shutterfly | Click to Enlarge

Online printing is a highly competitive space with most of the business coming in during the Christmas season.

A lot of competition online and offline. You can get your photos, photo books, prints and other items printed on in many locations like Costco, Wal-Mart, Staples, Office Depot.

Gross margins above 40% is a sign of a competitive advantage, but it also means competitors will continually attack, wanting a piece of the pie.

Shutterfly has averaged gross margins of 54% over the past 10 years but it's been going down the past 5 years. Revenues continue to grow nicely in the process though.



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	TTM
	54.4%	56.0%	55.0%	55.0%	54.9%	54.7%	56.3%	53.6%	54.0%	52.8%	52.2%
% Change		3.0%	-1.7%	-0.1%	0.0%	-0.4%	2.9%	-4.8%	0.7%	-2.1%	-1.1%

Shutterfly Gross Margins

Sales Goods and Administration (SG&A) is creeping up. It's been consistent, but I've never been a fan of increasing SG&A.

When you consider that **R&D expense** is also consistent, I don't see any alarming signs with expenses.

The area that does raise eyebrows is the debt level. Previously Shutterfly had no debt, thus no interest.

However, their **interest expense ratio (Interest Expense/EBIT)** over the trailing twelve months is 180%.

They are paying back more than they are making.

Red flag.

Then you get to **net margins** which have always been razor thin to begin with.

Now it's negative due to losses.

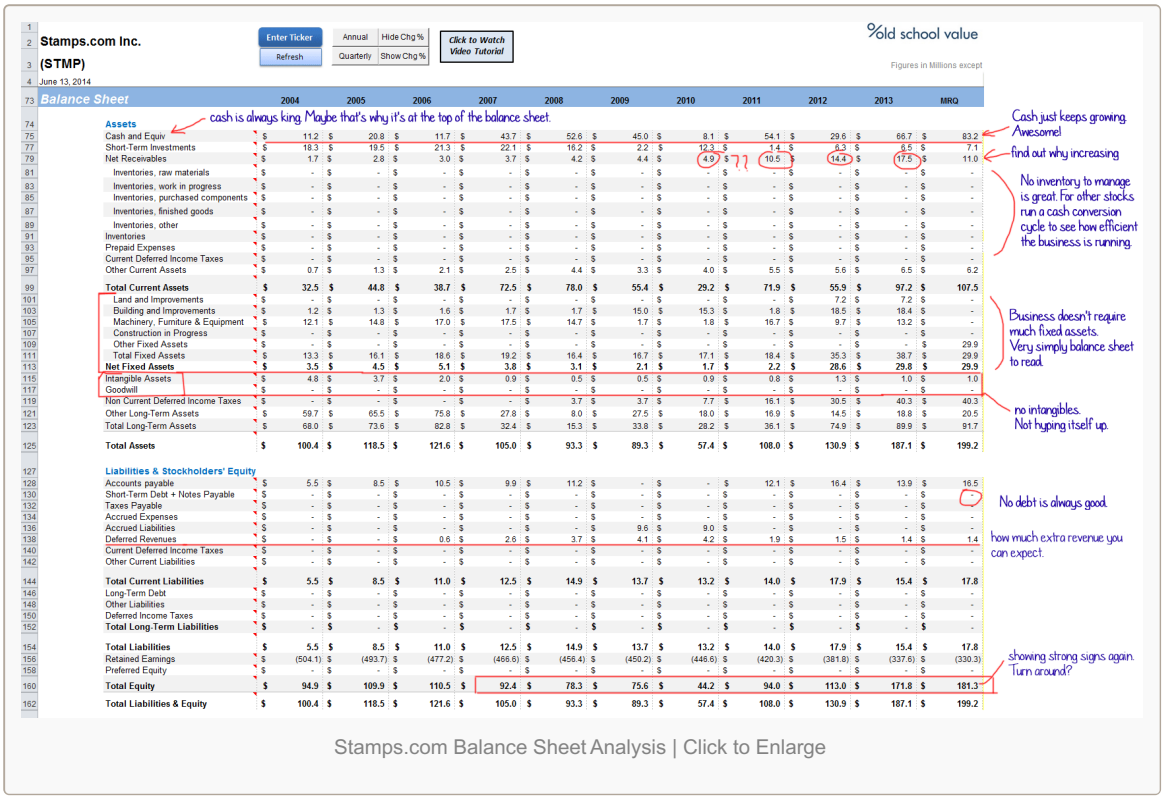
Something obvious, but companies with a competitive advantages don't report negative net income.

Shutterfly operates in a commodity business where they do have an advantage in cost and scale. However, pricing power does not exist in the industry.

Do the same thing for Vistaprint (VPRT) and you'll see similar patterns. Strong advantage in terms of scale, but margins are horrible.

Stamps.com (STMP) Balance Sheet Analysis

Now turn your attention to Stamps.com and what it's balance sheet tells you using some of Buffett's methods.



Stamps.com Balance Sheet Analysis | Click to Enlarge

Looking at the very top of the balance sheet to the **cash line**, it's been increasing at a nice rate.

What does that tell you?

> *A high number means either:*
>
> *1) The company has competitive advantage generating lots of cash*
>
> *2) Just sold a business or bonds (not necessarily good)*

The correct answer for Stamps.com is number 1. They run an online postal service for people easily pay and print shipping labels.

It's a nice business too. Not many competitors, more people are selling on Amazon and eBay and the trend will continue going up.

And there's **no debt** to ruin the strong financial position.

Since this is an online service business and a reseller of the USPS service, there is **no inventory** to worry about.

For any other company, inventory is tied to **cash conversion cycles** and **working capital**.

Something Stamps.com doesn't have to worry about.

The only thing I can point out in the balance sheet is the **net receivables** line.

It's increased dramatically over the past few years and you have to wonder whether Stamps.com is giving generous terms to attract big customers.

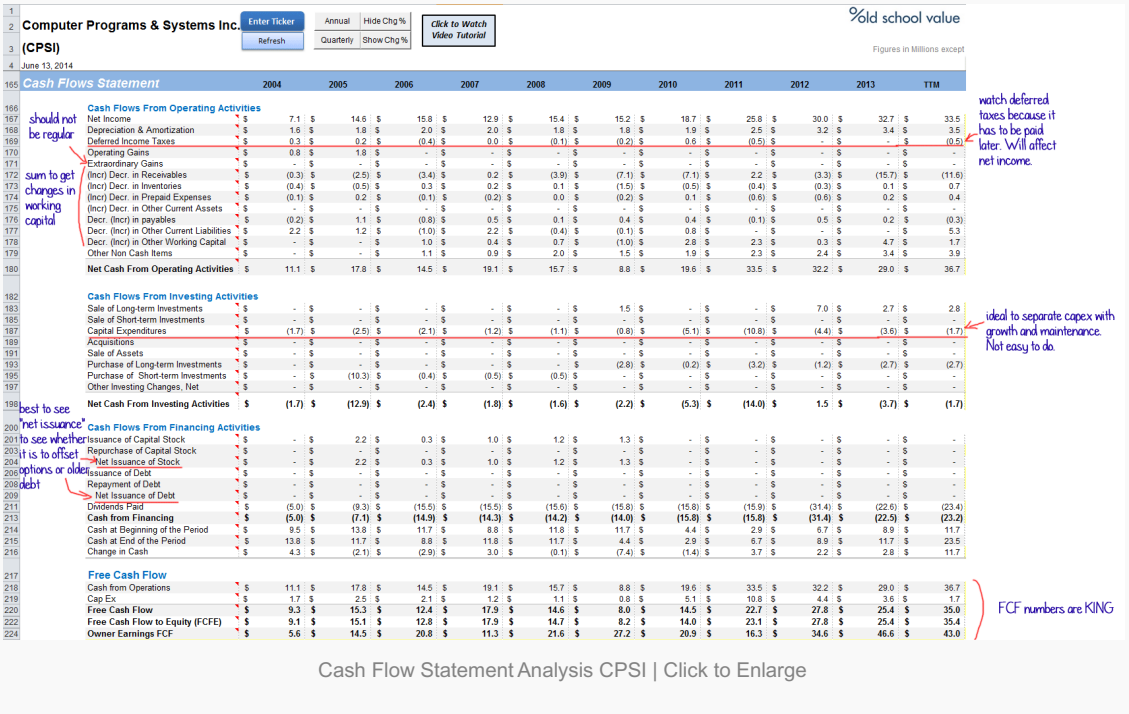
Overall, the balance sheet is very clean and simple to go through. No strange assets or liabilities to dig into and low asset requirements to run the business.

Even **intangibles and goodwill** is kept to a minimum. At least the company isn't trying to make itself look like it's worth more than it really is.

Stamps.com balance sheet shows that it's on a healthy run. Much better than when it spiked and crashed in 2006.

Stamps.com Improved Performance Since 2006

Computer Programs & Systems (CPSI) Cash Flow Statement Analysis



Cash Flow Statement Analysis CPSI | Click to Enlarge

Cash flow statement analysis is harder than the income statement or balance sheet. It's broken up into 4 sections, there are less options to create certain ratios, cash inflow and outflow numbers are difficult to relate to one another, and the numbers always need adjustments or additional calculations to make sense.

Here are some examples of what I mean.

- You can't just look at the change in receivables. The entire changes in working capital needs to be calculated.
- You can't make a ratio out of Sale of Assets or Issuance of Debt.

- Free Cash Flow and owner earnings are non standard numbers always up for interpretation.

So with the cash flow statement, you need to check year over year for trends and changes to detect warning signs.

Everything can't be as quick and convenient as **ratio analysis**.

The main tip from the **Buffett Financial Statement Interpretation** article is to **compare capex to net income**.

> *To compare capex to net earnings, add up total capex for ten-yr period and compare with total net earnings over the same period*

If the sum of capex divided by sum of net income is less than 50%, then there is a chance of durable competitive advantage.

If the ratio is less than 25%, the company probably has a competitive advantage.

But what other things should you look at on the Cash Flow Statement?

Capital expenditures is an item I always look at because it's a huge factor when it comes to doing a DCF. The other day, I posted how I come up with a **DCF growth rate** using multiple CAGR time frames and then taking the median to normalize the numbers.

You can do the same thing with capex to get a better estimate of traditional spending.

You can then take it even further by splitting capital expenditures as either growth capex or maintenance capex. For most businesses, this is hard to figure out.

It's easier for retail stocks like Whole Foods Market (WFM) because they clearly tell you what the growth and maintenance numbers are.

Or you can use Bruce Greenwald's method of **estimating maintenance capex**.

Here are some extra notes to perform a cash flow statement analysis.

About Jae Jun

Jae Jun is the founder of Old School Value. He is on a mission to provide practical and actionable value investing tools, tutorials and educational material to help empower the individual investor. Keep in touch with Jae via any of the methods linked below.