Summer 2007 **VOLUME 13:2**

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

OFFICE EXPANSION

As we begin our fourteenth year of helping valued clients achieve their financial goals, we are most gratified by and grateful for the extraordinary business growth we have experienced over the years. Due to the trust, confidence and loyalty of our wonderful clients, assets under PDV's management recently reached yet another record high.

Client satisfaction appears high, as clients have consolidated accounts previously managed elsewhere with us or referred relatives, friends or colleagues to us, or both. We greatly appreciate your support — thank you! To accommodate and service the growth in our business, we're excited to announce that we have just expanded into another office suite that adjoins Suite 400. Please do come by to say hello and see our new offices!

PDV Equity Research

By Louisa Ho, *Portfolio Analyst*
Che H. Lee, *President*

Here at PDV, we take pride in the quality and depth of our research and analysis in making investment decisions on our clients' behalf. In this article we give you a general overview of some types of data and information we evaluate.

Financial Condition

When investing, a solid defense is more important than a strong offense. Central to playing good defense is our attraction to financially strong companies. High financial strength enhances a company's ability to expand its business, withstand downturns, and ward off competitors. With robust financial backing, a company has the flexibility to generate returns to shareholders by paying increasing dividends and/or buying back shares.

There are numerous financial ratios we analyze to evaluate a company's financial strength. Essentially, low debt levels, good cash flow and plentiful funding sources equate to a strong financial condition.

Inside This Issue:

Figuring out the debt level is often more complicated than simply summing up all the liabilities on the balance sheet, as certain liabilities should not be considered debt at all. An example would be deferred revenues, which correspond to an obligation to provide goods and/or services in the future for money already received. Since the nature of such obligation is primarily non-monetary, it should not be classified or treated as debt.

In contrast, there are obligations that should be deemed debt, but are nevertheless not reflected on the balance sheet due to accounting rules. These are also known as “off-balance sheet” liabilities. For instance, a company’s obligations, as tenant, under operating leases are typically not reported on the balance sheet. It is true that the obligation to pay rent under such leases differs somewhat from the liability for interest expense because of the landlord’s duty to mitigate damages under the law if the tenant breaks the lease. However, this does not negate the fact that at least some portion of the operating lease obligations should be treated as debt. Not doing so would give a misleading view of a company’s financial strength. This is especially significant to firms relying heavily on operating leases, such as retailers. We therefore include a large portion of the future obligations under operating leases, discounted to present value, in our calculation of a company’s debt level.

With respect to potential funding, we look for both internal as well as external sources. Besides existing cash, marketable securities and equity in real estate assets, we pay particular attention to the company’s ability to generate free cash flow, defined as cash flows from operating activities minus expenditures for maintaining the business at current levels. Free cash flow (a type of internal funding) is vital because it facilitates growth initiatives, external acquisitions, debt reduction, share repurchase and/or dividend payments. Shrinking free cash flow not only indicates the possibility of operating problems, it might also force a company to take on debt or look to other external funding sources, such as dilutive equity issuance. Even worse, if access to financing is limited, a company with insufficient free cash flow may not have the liquidity to stay in business for long.

It is however important to note that debt financing is not always negative. If the potential returns from an investment substantially exceed the cost of debt, funding such an investment through a reasonable level of debt is actually sensible.

<u>Growth Prospects</u>

Identifying a company’s long-term growth prospects is crucial to determining its underlying business value. This value, in turn, needs to be compared to the current market trading price to decide whether a potentially undervalued investment exists. While the market can and does undervalue companies for many different reasons, one of the most common ways is by underestimating a company’s long-term growth potential.

Such long-term growth prospects depend on a host of external and internal factors. The opportunity for a company to grow is more plentiful in a market that is itself expanding and with mild competition present. But even in a market approaching saturation and where competition is intense, a company can still grow if it has advantages that lead to market share gains over time at the expense of its competitors. Examples of these advantages include superb financial strength, high operating efficiency, attractive product offerings, ability to internally develop or externally acquire new products or services, good operating and capital allocation abilities etc. Even better is when the advantages are actually unique to the company, such as brand name recognition, exclusive product offerings and technological leadership.

The more advantages a company has over its competitors, the more likely it can fend off competition and overcome temporary challenges. And the longer a company can sustain its advantages, the more promising its long-term growth prospects will become.

International markets offer another big opportunity for growth. As the world becomes increasingly connected, and the huge populations of emerging and semi-developed countries gain access to US goods and services, companies that can overcome cultural barriers and give the consumers in these countries what they want or need will boost their growth prospects substantially. We are attracted to companies that are poised to benefit from these developments via their foreign operations.

Risk Factors

No company is perfect. Every company faces a myriad of risks. Some of these are quantifiable, such as financial leverage, while others are qualitative in nature (e.g. the risk of failing to overcome cultural barriers in international markets). Having to take the quantitative and qualitative risks into account when doing our research and analysis explains why a security analyst's job is often described as "part art, part science."

A non-exhaustive list of risks that can cloud the merits of an investment include the following: product or technological obsolescence; delays in launching new products or services; litigation; inability to locate suitable real estate sites at reasonable rents; deflationary price trends (particularly true for technology companies); saturation or cannibalization; rising health care, utility, personnel or commodity costs; liquidity crises that are market driven or specific to the company; failure to overcome cultural barriers; regulatory setbacks; merchandising missteps; or poor acquisitions etc.

Accounting Analysis

Financial data reported according to Generally Accepted Accounting Principles (GAAP), while legally compliant, do not necessarily portray a company's financial condition and earnings accurately. Valuation based on inaccurate data is bound to be misleading. As the saying goes, "garbage in, garbage out." When performing valuation analysis, what is most important is getting a sense for what is likely to be a reasonable range of a company's earnings power under normal conditions going forward, rather than the current level of reported earnings.

Earlier in the discussion on determining a company's financial condition, we presented a couple of examples where the balance sheet alone may not provide a realistic view of a company's financial strength. Likewise, reported earnings per GAAP can over- or understate a company's normalized earning power.

One common example occurs under the heading "one-time non-operating charges." If these charges are truly non-operating and occur very infrequently, then it is reasonable to exclude them completely from what the company is likely to earn under normal conditions. In this event, reported earnings that include such expenses would unduly penalize the company.

Unfortunately, such charges often have a nasty habit of recurring, and sometimes relate to events that straddle operating and non-operating activities. In these cases, it would be unduly harsh to include the entire charge against reported earnings, but it would be too lenient to exclude the charges completely. We attempt to obtain a clearer picture of the company's normalized earnings by including only a portion of these charges, depending on the frequency and amounts of such charges over the past 5 years, using a complicated averaging process.

As GAAP offer wide latitude to companies in reporting financial data, any discrepancy between reported and normalized earnings could be the result of aggressive accounting that sometimes crosses the line of what is legal. The term "quality of earnings" is used to qualify how conservative the accounting results are presented. The quality of earnings directly relates to the degree of conservativeness used to report results.

There is no single "silver bullet" to ferret out accounting manipulations, though there are many tools we use to look for clues of overly aggressive accounting. One way to gauge the earnings quality is comparing the company's free cash flow (FCF) with reported net earnings, especially over a multi-year period. FCF will be lower than reported net earnings if a company generates less cash than the net earnings reported on income statement. This could be a result of some operating issues such as difficulty with collecting receivables or selling inventories. Almost all companies experience such discrepancy from time to time, but these metrics tend to converge over time. If reported net income is persistently higher than FCF, then it is prima facie evidence of overly aggressive accounting, possibly bordering on fraud in select cases.

Margin Analysis

Margin analysis is important because it provides information on a company's profitability. Gross margin indicates how efficiently management is using labor and supplies in the production process. Operating margin indicates how well management is running its business operations and controlling operating expenses. Net margin indicates how successful management has been in generating bottom-line, after-tax profit from the entire business.

When a company has relatively high margins compared to its competitors, it usually means the company has some sort of durable advantage (e.g. economies of scale) or important intellectual property (e.g. valuable patents). The higher the margins, the bigger cushion a company has to withstand downturns and fend off competition.

Margin contraction is generally undesirable, especially if it is the combined result of declining sales and rising operating costs. However, if margins decline primarily because of heavy spending on research and development, or investment activities that will improve long-term operating efficiency, then it should not be viewed as a permanent problem, because margins ought to rebound when the company eventually is in a position to leverage the investments.

Concluding Thoughts

It is important to realize that no company or investment is perfect, and each decision must properly and appropriately balance the associated rewards against the risks. This process is made more difficult by the fact that evaluating both quantitative and qualitative factors is fundamentally "part art, part science."

Ultimately, the overall profile of an investment, after taking both positive and negative attributes into account, must be judged against its prevailing market trading price. A company can be attractive, notwithstanding negative attributes, if those attributes are more than adequately discounted by a low current stock price. Likewise, a company with an overwhelming number of positive attributes might nevertheless be a poor investment, if the currently high stock price more than adequately reflects these positives.