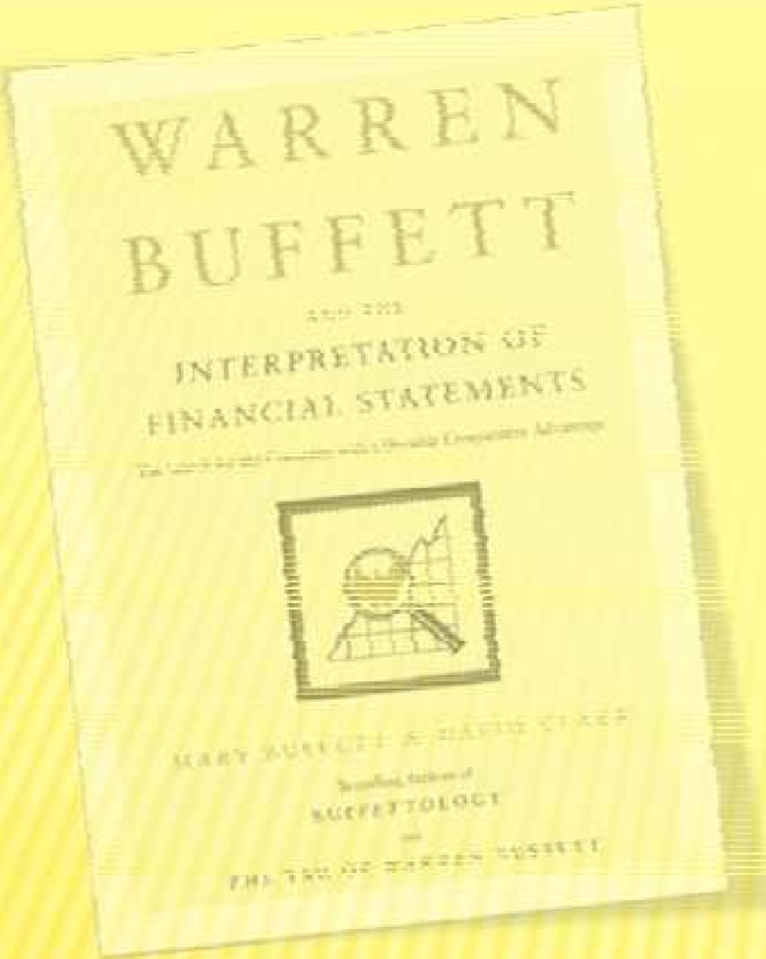

WARREN BUFFETT AND THE INTERPRETATION OF FINANCIAL STATEMENTS

The Search for the Company with a Durable Competitive Advantage

Book Reviewed by
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FSB 2

INTRODUCTION

Warren Buffett’s mentor and one of the greats of Wall Street, Benjamin Graham, never looked at a owning a position in a company for ten or twenty years. If t didn’t move after two years he was out of it.

Warren Buffett, on the other hand, after starting his career with Graham, discovered the tremendous wealth creating economics of a company that possessed a long term competitive advantage.

Therefore in this book we are going to look at the different ways by which Warren Buffett analyses companies he wants to invest in.

FLAME

TWO GREAT REVELATIONS THAT MADE WARREN BUFFETT THE RICHEST MAN N THE WORLD

The purpose of this book is to explore Warren Buffett's two great revelations-

How do you identify an exceptional company with a durable competitive advantage? How do you value this company ?

-to explain how he uses financial statements to put his strategy into practice.

VALUE INVESTING

Graham’s short term strategy

When he started practicing value investing in the 1930’s, he focused on finding companies trading at less than what they held in cash. He called it buying a dollar for 50 cents.

WHY STUDY FINANCIAL STATEMENTS?

Warren Buffett realized that all the companies that Graham sold under his 50% rule, continued to prosper year after year. So he started studying the financial statements of these companies to understand what made them such fantastic long term investments

WHERE DOES WARREN START HIS SEARCH FOR THAT EXCEPTIONAL COMPANY?

Warren Buffett looks for three basic qualities

- The company sells either a unique product or unique service.
- The company is a low cost buyer.
- Seller of a product that the public consistently needs.

Example: Coca Cola, Pepsi, Wrigley, Hershey, Budweiser, Philip Morris

WHAT WARREN THINKS ABOUT THESE COMPANIES

He likes to think of these companies as owning a piece of the consumer's mind, and when this happens , then the company has to seldom change its product, which you will see, is a good thing.

THE CHAIN REACTION

Consistency in Product

Does not have to invest repeatedly in R&D

Does Not have to invest in new Technology

Therefore Money piles up in the company

Resulting in lesser debt and therefore lesser interest payments and hence more money with the company to expand operations or buy back stocks which will drive up earnings and the price of the company stock

“CONSISTENCY" !!

When Warren looks at a company’s financial statement, he is looking for consistency.

- Does it consistently have high gross margins
- Does it consistently not have to spend high amounts on R&D
- Does it show consistent earnings Does it show consistent growth in earnings

THE FINANCIAL STATEMENTS

- Financial Statements come in three distinct types:
  - Income Statement
    - From this Warren Buffett can determine such things as
      - company margins
      - Its Return Equity
      - Consistency and Direction of its earnings
  - Balance Sheet
    - In this Buffett uses indicators such as the amount of money the company has or the amount of long term debt it carries
  - Cash Flow Statement

THE INCOME STATEMENT

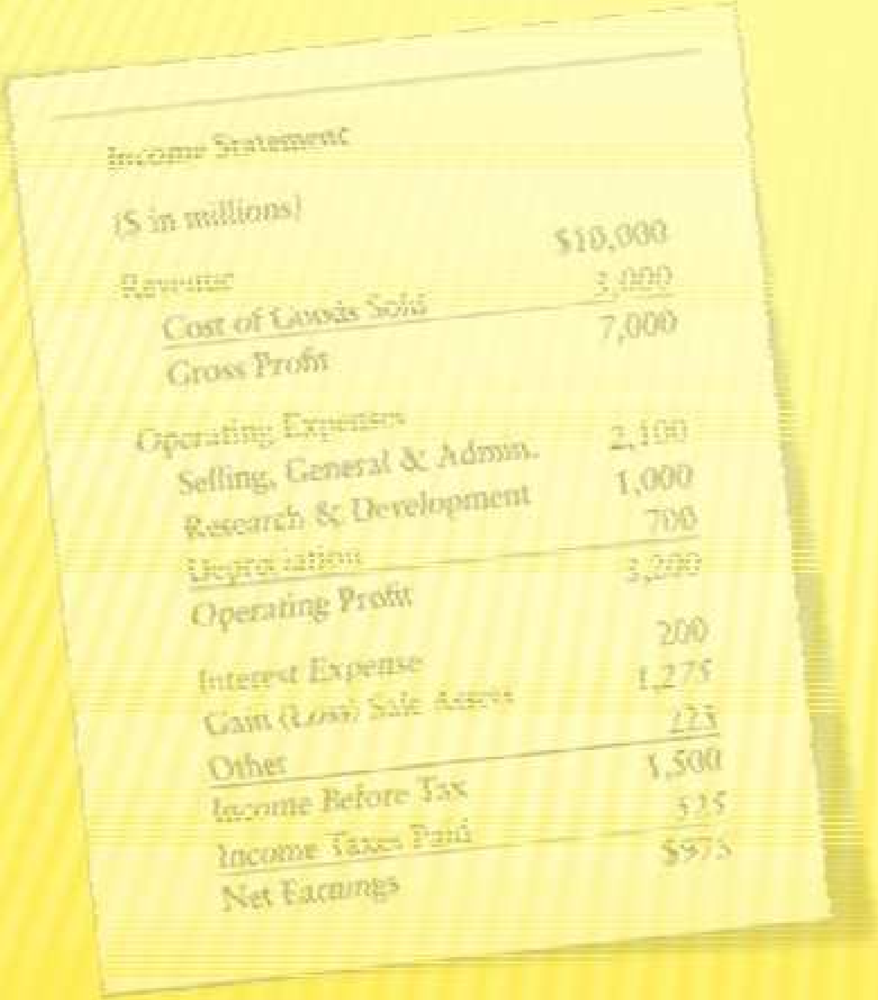
Income Statement

($ in millions)

Revenue	$10,000
Cost of Goods Sold	3,000
Gross Profit	7,000
Operating Expenses	
Selling, General & Admin.	2,100
Research & Development	1,000
Depreciation	700
Operating Profit	3,200
Interest Expense	200
Gain (Loss) Sale Assets	1,275
Other	225
Income Before Tax	1,500
Income Taxes Paid	525
Net Earnings	$975

Warren Buffett always starts with the firm's Income statement.

WHAT DOES THE INCOME STATEMENT TELL US?



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Revenue

This is the amount of money that came in during the period of time in question.

Cost of Goods Sold

It is either the cost of purchasing the goods or the cost of manufacturing those goods.

Gross Profit

Revenue - COGS

WHAT DOES WARREN BUFFETT UNDERSTAND FROM GROSS PROFIT

He uses it to calculate Gross Profit Margin.

Gross Profit/ Revenue = Gross Profit Margin

According to Buffett Companies with consistent high gross profit margins tend to be better companies to invest in for the long term.

Companies with good Gross Profit Margin

Coca Cola:60% or better

Wrigley Co. : 51%

Microsoft: 79%

Companies with low Gross Profit Margin

United Airlines: 14%

General Motors : 21%

Goodyear Tires: 20%

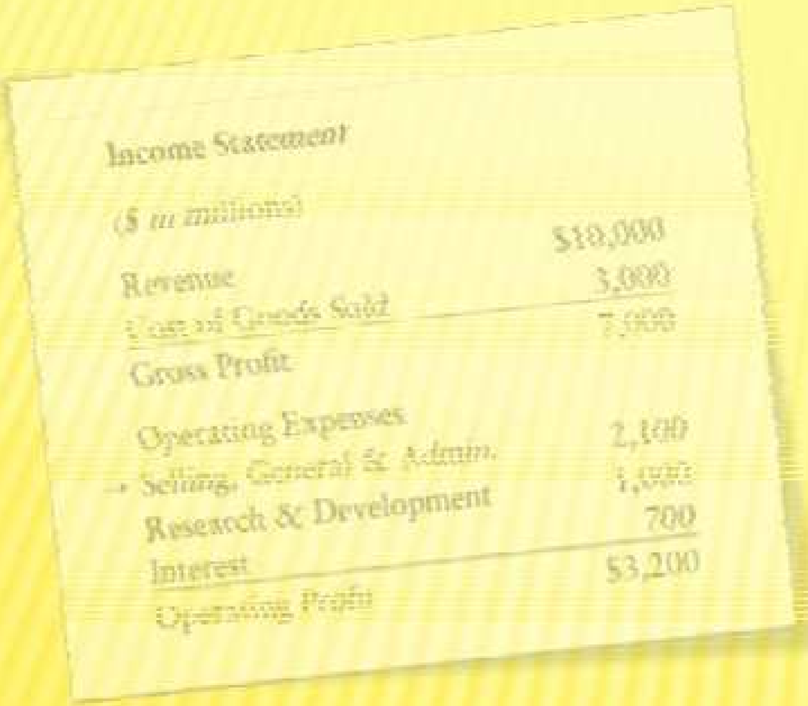
THE BIGGER PICTURE

Any GPM of 20% or lower is usually an indicator that the industry is fiercely competitive where no one company can take a competitive advantage over the others.

GPM is not fail-safe.it is only an early indicator to look for consistency. Therefore GPM for the last ten years or more should be looked at for a better picture.

Some reasons why the GPM may be low and the company may lose competitive advantage is because of high research costs, high selling and administrative costs or high interest costs on debt Overall If companies have a GPM of 40% or more then they have a competitive advantage in that industry and below which it hints that the industry is highly competitive

OPERATING EXPENSES



Companies like,

Coca Cola spend 59% of their gross profit on SGA.

P&G consistently spends around 61% .

GM on the other hand has spent from 23% to 83% and Ford has spent 89% to 780% which means they are losing money like crazy In the world of business anything lower than 30% is fantastic.

However there are many companies with a expense of 30% to 80% which just shows that the industry is highly competitive.

WHAT DOES WARREN BUFFETT INFER FROM THIS

He steers clear of companies with consistent high SGA expenses.

Economics of the company with low SGA expenses but high R&D expenses will suffer in the long term.

Therefore even at a low price, one will only get mediocre results

RESEARCH AND DEVELOPMENT EXPENSES

Buffett looks at this very keenly in identifying good long term investments.

Mostly companies often have an advantage due to a patent or an advanced technology. Therefore at some point in time it will lose its patent and technology will advance. This is always a threat.

For Example:

Merck must spend 29% of its gross profit on R%D and 49% on SGA expenses, which adds up to 79%. If Merck and Co. fail to invest this kind of capital in the future, it loses its competitive advantage.

Warren Buffett's advice:

When companies have to spend heavily on R&D, they have an inherent flaw and this will sooner or later affect its long term economics, which means they are not a sure thing and therefore Buffett is not interested in such investments.

INTEREST PAYMENTS

The ratio of interest payments to operating income can also be very informative as to the level of economic danger the company is in.

The rule here is simple: In any given industry the company with the lowest ratio of interest payments to operating income is likely to have a durable competitive advantage in the future, and that's the way Buffet likes it.

INCOME TAXES PAID: HOW TO TELL WHO TELLING THE TRUTH

Check the Operating Income reported in the SEC and deduct 35% which is approx. the tax and check to see if the remainder is equal to the amount, after the taxes are removed, shown on the balance sheet.

Buffett says that companies that are trying to mislead the authorities usually mislead their share holders as well. Stay away.

NET EARNINGS

One year's net earnings don't impress Warren Buffett. There has to be consistency in the net earnings. One should look at the ratio of net earnings to total revenues.

Its better to invest in a company that has net earnings $2 million on $10 million revenue rather than a company who has net earnings $5 million on $100 million revenue. But beware in banks when the ratio is really high but in actual sense the banks are actually taking in a lot more higher risk and gaining in the short term but this may be disastrous in the long term.

Ratio > 20%, Good
Ratio < 10 % Bad

PER SHARE EARNINGS

08	$2.95
07	$2.68
06	$2.37
05	$2.17
04	$2.06
03	$1.95
02	$1.65
01	$1.60
00	$1.48
99	$1.30
98	$1.42

08	$2.50
07	$(0.45) loss
06	$3.89
05	$(6.05) loss
04	$6.39
03	$5.03
02	$3.35
01	$1.77
00	$6.68
99	$8.53
98	$5.24

Take a look at the earnings per share over a period of ten years. If the price of the per share is consistently rising then that shows that the company is a good investment.

But if the price per share is erratic then we must understand the company is prone to booms and busts and the industry is fiercely competitive.

It means that when demand rises the company increases production but expenses increase too and there will soon be excess supply and therefore the company will lose money until the next boom.

How Warren Buffett views the balance sheet

INVENTORY

When looking for a company with a durable competitive advantage, look for inventory and net earnings that are on a rise.

This indicates that the company is finding profitable ways to increase sales, and that increase in sales has called for an increase in inventory, so the company can fulfill orders in time.

NET RECEIVABLES

Companies that are doing well can afford to give better payment terms, instead of 30 days, they may give vendors 120 days.

This will cause an increase in sales and an increase in receivables.

If a company is consistently showing a lower percentage of Net Receivables to Gross Sales than its competitors, it usually has some kind of a competitive advantage.

GOODWILL

When company A buys another business and pays a price in excess of the acquired business's book value then the excess is recorded in company A's balance sheet under the heading of goodwill.

Whenever we see an increase in good will of a company over years, we can assume that it is because it out buying other companies. If it stays the same year after year then it means that the company is under paying or is not acquiring any companies.

RETURN ON ASSET RATIO

It is the ratio of net earnings on total assets. A higher ratio is better but may not always the best. Capital always presents a barrier to entry into any industry, and one thing that makes a company's competitive advantage. Coca Cola has return on asset ratio of 12% and an asset value of $43 billion

P&G has a return on asset ratio of 7% and an asset value of $143 billion

Moody's has a return on asset ratio of 43% and an asset value of $1.7 billion.

Here we might see that moody has a higher Return on asset Ratio but in the industry it will be easier to compete with Moody than with Coca Cola.

LONG TERM DEBT

A company that has been carrying little or no long term debt in the past ten years then there's a good chance that the company has some kind of a competitive advantage in that industry.

Warren's historic purchases have sufficient yearly net earnings to pay off all its long term debt in a matter of 3 or 4 years. Thats what Warren looks for.

DEBT / EQUITY RATIO

P&G has an adjusted ratio of .71
Wrigley Co. has a ratio of 0.68
Goodyear tire has a ratio of 4.35 and
Ford has a ratio of 38.0

The bottom line is that other than financial institutions a D/E ratio of less than 0.80 is a good chance that the company has some kind of competitive advantage.

RETURN ON SHAREHOLDERS EQUITY

Shareholders Equity = Company's total assets - Total Liabilities
Return on Shareholders Equity = Net Earnings/shareholder's equity

A higher ROE means the company is making good use of the earnings it is retaining. As time goes by the high returns will add up and increase the underlying value of the business. But sometimes a company might have negative ROE. There are 2 reasons for this.

1. The company doesn't need to retain earnings and pays it back to the share holders. (long history of high net earnings but negative ROE)
2. a company might have really low net earnings and low assets.This is a mediocre company.

Option 1 is the company with the competitive advantage.

HOW WARREN BUFFETT DETERMINES THE RIGHT TIME TO BUY

In Warren's world the price you pay directly affects your return on your investment.

The higher price you pay the lower is your initial rate of return. Warren bought Coca cola in 1987 for $6.50 with an initial rate of return of 7%.By 2007 the share was giving a return of39.9% But if he had payed $21 in 1987.then initial return would be 2.2% and now in 2007 it would be just12%.

So basically buy in a Bear market for starters. Though they might seem higher than other "bear market deals", they are better deal in the long run.

Stay away from these stocks at the height of the bull markets as they will be very expensive and it is possible that even these companies may not always give a good return if you pay too much for it.

WHEN TO SELL?

His mantra is to never sell your share in these businesses. The longer you hold on the better the gain.

But if you do need to sell then:

- Sell when the bull markets send the price of it through the ceiling and the earnings from this sell would surpass even the long term gains you predicted.
- Sell when you feel the company might be losing it competitive advantage like newspaper or TV companies with the rise of the internet.
- Sell when you feel there is a bigger opportunity awaiting.

SELL…?

A simple rule is that when we see P/E ratios of 40 or more (and this sometimes happens) then it might just be the right time to sell. But if we do sell then it is not worth buying immediately something else. Take a break and invest in bonds and wait for a bear market which is around the corner to give you another opportunity soon.

Thank you