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PRIVATE WEALTH

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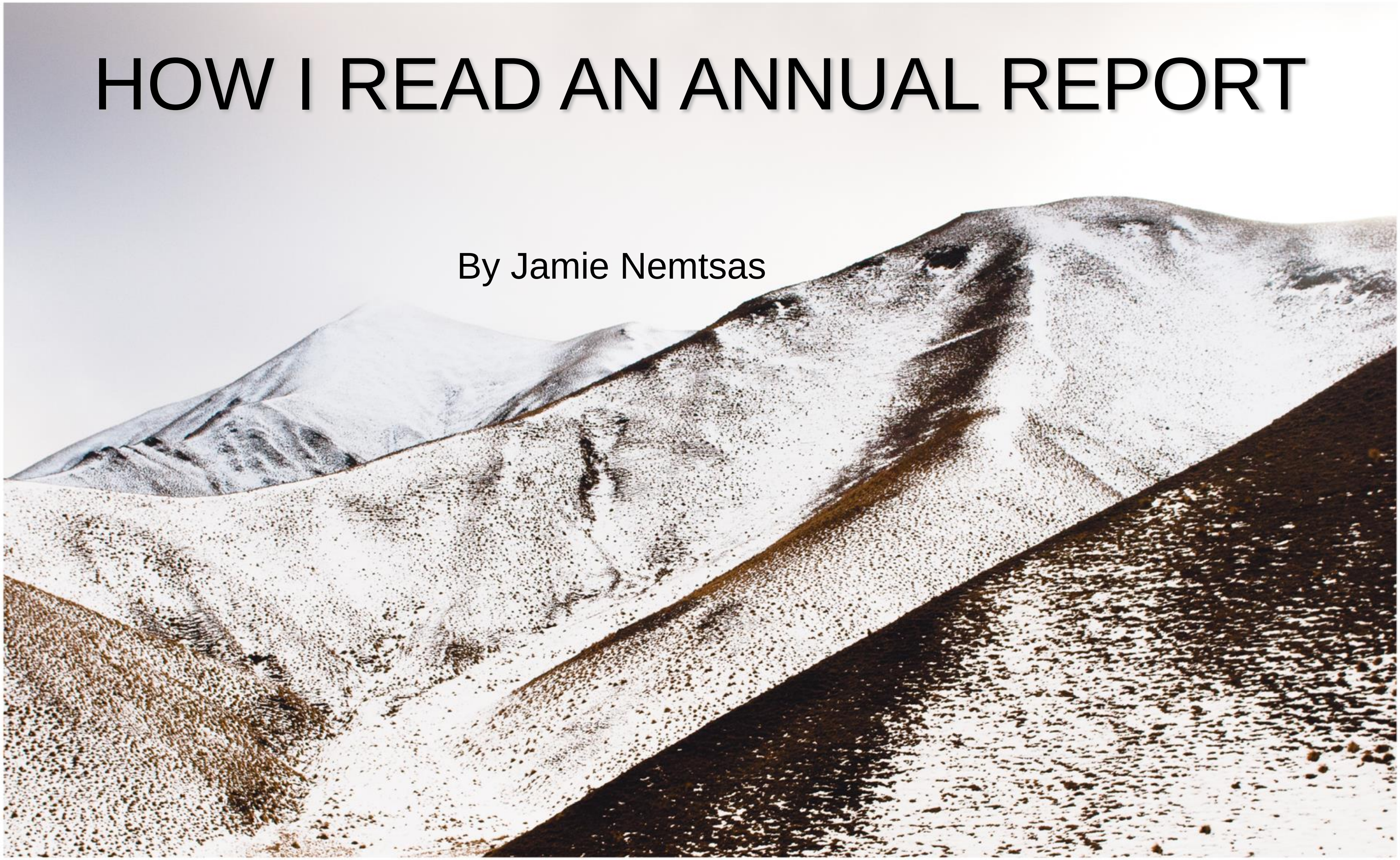
HOW I READ AN ANNUAL REPORT

By Jamie Nemtsas



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Disclaimer

The information in this presentation is of a general nature and has been prepared without taking account of your individual investment objectives, financial situation or particular investment needs. It is not intended as financial advice to retail clients. Before making an investment decision, you should consider the appropriateness of the information, having regard to your objectives, financial situation and needs. We recommend you consult with your financial adviser, who can help you determine how best to achieve your financial goals and objectives. Past performance does not guarantee future performance.

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Who are I?

Sornem Private Wealth
An independent financial advisory firm

Qualifications
Private investor
Long term member of the AIA
Certified Financial Planner
Founder of Murray River Organics Pty Ltd,
to be floated in November 2016

Post Graduate Diploma Applied Finance
Bachelor of Business, Marketing and Finance

DIY or Self Directed

A real DIY investor?,

A nice idea but a rare
Qualifications
Private investor

Self Directed Investor?
Brokers/Advisers
Newspapers/Newsletters
Friends/Family

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How well do you pay attention to detail?

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Why we are passionate on Annual Reports?

- The truth is always in an annual comes report somwhere?
- Post GFC – Research Houses, Brokers, analysts, experts, advisors all got things wrong.
- Always elect to receive the hardcopy of the annual reports.
- You don’t need to read the annual report like a novel. Instead approach it like a newspaper and jump around to the relevant sections to get the answers you need to decide whether you should buy or hold on to the stock.

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How to read an Annual Report

- Always request a hardcopy of the annual report.
- Get Four highlighters – Pink/Red, Orange, Green & Blue.
- Traffic light approach.
- Start highlighting sections. Each of the 8 sections.
- Green – Positive.
- Orange – As expected.
- Pink/Red – Concerned.
- Yellow – Confused.

Sornem Private – This is what we do. We manually go through the annual report and pick out important points, discrepancies and inconsistencies.

Introduction

What is an Annual Report?

- Comprehensive report on a company's activities throughout the preceding year.
- Gives shareholders information about the company's activities and financial performance.
- It also gives shareholders an analysis and assessment of the financial trends of the business over the past year
- Provides an outlook for the year ahead.

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Annual report checklist

1. Chairman, MD or CEO’s letter
2. Director’s Report
3. Profit & Loss
4. Balance Sheet
5. Cashflow statement
6. Auditor’s Report
7. Remuneration Report
8. Shareholder Information

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Chairman's Letter

What to look for in chairman's letter?

- Governance – This is a big issue.
- Tone of chairman's letter.
- Conflicts with Director's letter.
- Does it tell you what a great job management did during the year?
- Does it lay out the company's goals and strategies for the future?
- Are there any apologies for problems that occurred or board changes?

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Director's Report

- Reviews the progress of the business during the year with likely future developments.

What to look for in a directors report?

- Directors will be reluctant to dilute their interests by issuing new shares in a small company.
- Directors approaching retirement. Is there an obvious successor?
- The Tenure of Leaders is getting shorter – a longer term vision and succession planning is the key to a successful business.
- Have there been any additions to the board? Track record?
- Are there any non-executive directors?
- Skills Matrix
- Is CEO too powerful? Unchecked by a strong board of non-executives, can be dangerous.
- May disclose something that has happened during the year.

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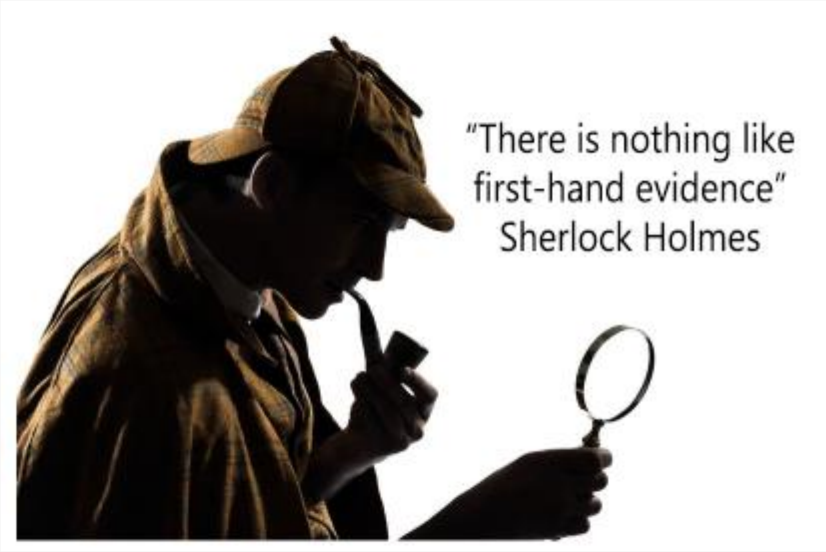
Financial Statements

- Displays the financial performance data
- They are the bread and butter of the annual report.
- Be sure to watch for footnotes to the financial statements.
- You may notice information on bad debts, write-downs, mismatches between profits and cash flows or inventory build ups.

Here are the 3 main reports:

1. Profit & Loss statement
2. Balance Sheet
3. Cash Flow statement



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Profit & Loss Statement

The P&L statement provides information on the company's performance, and its profitability. You can use the P&L to compare last year's performance with the previous one.

- Is the business doing well?
- Are all divisions doing well, any future write-offs possible?
- How safe is the dividend?
- How much is it making for every share on issue (EPS)?
- How does the company compare to its competitors?
- Watch and understand how the E is calculated. Eg. abnormals, inventory re-values, Sgara (self generating and regenerated assets), new finance leasing standards.
- How profit is worked out - Ebitda, NPAT, EBIT, Gross profit?

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Balance Sheet (Assets = Liabilities + Equity)

Also known as a "statement of financial position" shows a company's assets, liabilities and owners' equity (net worth). Balance sheet formula is:
Assets = Liabilities + Shareholder’s Equity.

- Long term and short term debt
- Negative or deficit retained earnings
- Negative equity
- Negative net tangible assets
- Low current ratio.
- Work in Progress (WIP) is overstated – SGH
- Carrying value of assets
- Real value of assets
- Inventories – Dick Smith
- Biological assets – Livestock at fair value?
- SGARA - Gains/Losses from changes in fair value. Tassal Group.

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Balance Sheet - Slater & Gordon WIP

Work in progress (WIP) - Is accounting jargon for services provided where the revenue hasn't been received or invoiced.

- Slaters used a percentage of completion method. The more work it does on a case, the more its WIP, and its earnings increase.
- Shows continual growth in firms revenue’s as each case is settled.
- But WIP at 'no win, no fee' law firm is worth 100% or nothing.
- Slater's WIP grew since it floated, largely through its acquisitions and after the Quindell deal – From $300m to $1 billion (Slater’s biggest asset).
- A rise in WIP points to a firm completing more work than getting paid for.
- The problem with WIP is that while earnings are growing, the cash isn't coming through the door. Slaters may be showing spectacular growth in accounting profits, but its free cash flow was negative.
- In Feb 2016 - $876.4m was written down by Quindell.

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Cash Flow Statement

- **A healthy business generates positive net cash flow**
- **A bad business will use o**utside financing to operate. Dick Smith.
- **3 sections** - operating activities, investment activities and financing activities.

What to look for in a cash flow statement:

- **Positive cash flow** from operating activities. Should be near the profit.
- **Consistent investment activity**. Typically negative net cash flow from investment activities as company buys more assets than it sells.
- **Conservative use of financing.** Should show negative cash slow from financing activities. It suggests the business is using its cash flow from operating activities to pay dividends and pay off its outside financing.

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Auditor's Report

Provides an opinion on the validity and reliability of a company's financial statements. But don't always trust it.

Things to look for:

- Methods used are not in complete agreement with appropriate accounting standards.
- Auditors unable to check some of the information in the accounts.
- Special purpose financial statements.
- Modifications to statements.
- Qualified auditors report.
- Emphasis of matter.
- Adverse opinion.
- Disclaimer of opinion.
- The auditor found nothing wrong with Dick Smith's Annual Report.
- Note – New global Auditing standards to be brought out. i.e – Key audit matters.

Remuneration Report

Outlines the remuneration strategy, framework and conditions of employment for directors and management personnel.

So what do you look for:

- The CEO's and the executive team pay should be of interest as it tells a great deal about the power that the CEO has over the Board and ultimately how effective the Board will be in overseeing the actions of management.
- What are the Long Term Incentive Plans?
- How aspirational are management?
- Are management being paid to grow the value of the company?

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Spread of shareholders

Shows 20 of the largest shareholders.

Having a controlled register

Advantages

- Lower volatility
- Investment capital
- Monitoring of management
- Good negotiator
- Experience – Warren Buffett
- Confidence
- Networks from shareholder

Disadvantages

- Influences the board
- Blocking stake in a takeover
- Leverage
- Has own self interests
- Conflicts of interest
- Lower liquidity

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Corporate Disasters

1. Dick Smith
2. Centro
3. Slater & Gordon
4. Forge Group
5. One.Tel
6. Hastie Group
7. Gunns Limited
8. Great Southern Limited
9. Babcock & Brown Limited
10. Timbercorp Limited

Colours of Life

What colour did you mark these sections?

1. Chairman, MD or CEO's letter ☐
2. Director's Report ☐
3. Profit & Loss ☐
4. Balance Sheet ☐
5. Cashflow statement ☐
6. Auditor's Report ☐
7. Remuneration Report ☐
8. Shareholder Information ☐

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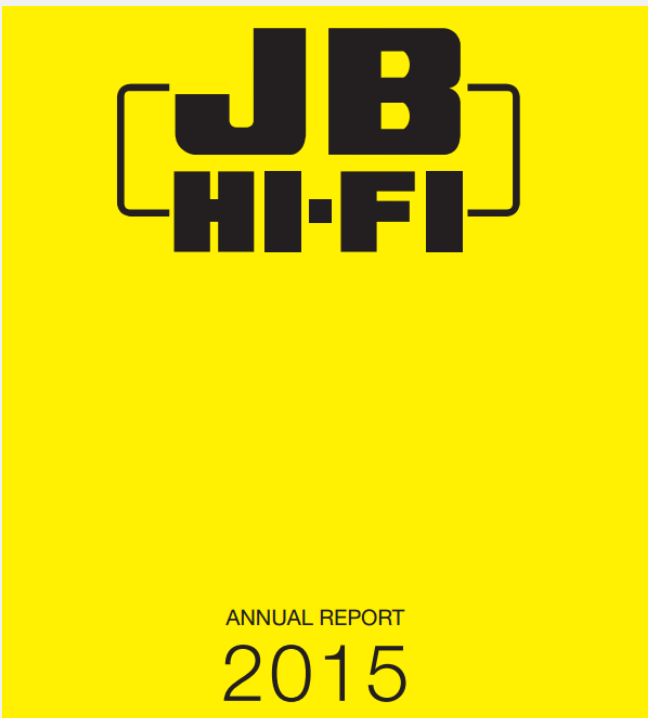
Case Study – JBH vs DSH

JB Hi-Fi	Dick Smith
	

JB Hi-Fi

Why do we like JB Hi-Fi?

- Strong sales
- Simple inventory system, no centralised system.
- Stores are packed.
- Reputable brand.
- Has been trading for years.
- Good management.
- Market leader.
- Dominant position.
- Cheap prices.
- Great customer service.

We all know who Dick Smith is

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Why did Dick Smith Electronics fail?

Dick Smith had too much "crap" it couldn't sell. It carried excess inventory that was unsaleable / overpriced & can be traced prior to the float.

- Anchorage only spent $20m
- Anchorage wrote-down assets. $58m off inventory, $55m off plant and equipment and $8m provisions = $120m. The perfect Window Dressing opportunity prior to the float.
- As at November 2012 they had inventory of $371m which they wrote down to $312m.
- Then by June 2013 inventory dropped to $171m when the company was about to be sold. This points to a huge clearance sale.
- This produced a huge $140m benefit to operating cash flow which Anchorage used to repay Woolworths.
- Write-downs were not mentioned in the DSH prospectus or the Auditor's report. So this is a good example where an auditor's report has not protected investors.
- The big clearance sale leaves the company with no stock in 2014. This can't last retailers need to sell things so inventories rose to $250m in 2013-14 and $300m in 2014-15 – shareholders footing the bill.
- Profit and loss statements never matched cash flow. DSH made a NPAT of $37.4m yet cash flow was negative. DSH had to borrow.

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Dick Smith Prospectus Forecasts

	Pro forma historical				Pro forma forecast	Statutory forecast
($m)	FY2011	FY2012	FY2013	1Q2014	FY2014	FY2014
Sales	1,281.1	1,369.5	1,280.4	273.3	1,226.0	1,226.0
Gross profit	335.2	340.0	303.6	68.4	307.8	307.8
EBITDA	36.5	32.6	23.4	11.6	71.8	46.6
EBIT	23.9	20.1	10.9	9.0	58.7	33.5
NPAT	15.9	13.2	6.7	6.1	40.0	11.5

Notes: The Financial Information presented above is a summary only and should be read in conjunction with the more detailed discussion of the Historical Financial Information and the Forecast Financial Information in Section 5, including the assumptions, management discussion and analysis and sensitivity analysis, as well as the risk factors set out in Section 6. A reconciliation of the pro forma forecast and statutory forecast income statements is provided in Section 5.7.

Dick Smith's FY2011, FY2012 and FY2013 pro forma historical financials were impacted by the corporate strategy and operational execution adopted by Dick Smith under its previous management and owner. DSE was acquired by Dick Smith Sub on 26 November 2012. Immediately upon Acquisition, the new management team, led by Nick Abboud drove a significant transformation of the business through a comprehensive program of strategic, customer, operational and cultural transformation initiatives.

The transformation and growth initiatives underpin Dick Smith's forecast growth to an expected pro forma EBITDA of $71.8 million in FY2014. The Directors believe that the significant increase in the underlying profitability of Dick Smith and the sustainability of the increase have been evidenced in the 1Q2014 results. It is expected that this transformation program will continue to deliver additional financial benefits in the coming years.

Prospectus forecasts were wildly bullish if not delusional.

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Why did Dick Smith fail?

(b) **Assets acquired and liabilities assumed at the date of acquisition**

	Book value 25 November 2012 $'000	Fair value adjustments $'000	Fair value 26 November 2012 $'000
Current assets			
Cash and cash equivalents	12,617	–	12,617
Trade and other receivables	29,151		29,151
Inventories	370,550	(58,475)	312,075
Other current assets	1,594	–	1,594
Non-current assets			
Plant and equipment	119,444	(54,765)	64,679
Deferred tax assets	4,460	37,832	42,292
Current liabilities			
Trade and other payables	(172,505)	(2,195)	(174,700)
Current Provisions	(12,383)	(348)	(12,731)
Non-current liabilities			
Non-current provisions	(5,812)	(8,109)	(13,921)
Fair value of net assets acquired			**261,056**

(c) **Discount arising on acquisition**

	26 November 2012 $'000
Fair value of identifiable net assets acquired	261,056
Consideration transferred	(115,208)
Discount arising on acquisition	**145,848**

Prior to the acquisition there were no operations of Dick Smith Sub-holdings Pty Limited.

Write-downs = $120m.

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Why did Dick Smith fail?

	Note	Year ended 29 June 2014 $'000	10 month period ended 30 June 2013 $'000
Cash flows from operating activities			
Receipts from customers		1,316,364	890,363
Payments to suppliers and employees		(1,261,131)	(772,397)
Interest and other costs of finance paid		(2,854)	(2,311)
Tax (paid)/received		(721)	858
Interest received		519	1,108
Net cash provided by operating activities	15(a)	**52,177**	**117,621**
Cash flows from investing activities			
Payments for plant and equipment		(30,523)	(2,492)
Proceeds on sale of plant and equipment		518	–
Payment for acquisition of business, net of cash acquired	15(b)	(24,000)	(78,591)
Net cash used in investing activities		**(54,005)**	**(81,083)**

Used Cashflow to pay Woolworths

JB Hi-Fi has been around for years

Centralised. Stock on hand. Developed national store network, strong brand, customer loyalty. Cemented itself as a category killer similar to Bunnings.

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Profit & Loss Statement

Is the company making a profit? How much is it making for every share on issue (EPS)? Are sales increasing?

JBH

		2015	2014
Profit for the year		136,511	128,447
Earnings per share			
Basic (cents per share)	23	137.91	128.39
Diluted (cents per share)	23	136.46	126.89

DSH

		2015	2014
Net profit for the year		**37,905**	**19,826**
Earnings per share			
Basic	13	$0.16	$0.08
Diluted	13	$0.16	$0.08

- Is the company making a net profit?
- Compare P&Ls for two separate years, and analyse the variance between figures.
- Look out for unusual costs.
- **Gross profit =** sales revenue – COGS. Good indicator of overall profit.
- **Net profit** is the bottom line. It is the total amount earned.

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Case Study

Cash flow example

•Dick Smith turn to page – 55

•JB Hi-Fi turn to page - 67

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Cash Flow Statement

A healthy business generates positive net cash flow from operating activities. Outside financing used to prop up cash flow will not sustain a business.

JBH

Net cash inflow from operating activities	32	179,896	41,326
Cash flows from financing activities			
Proceeds from issues of equity securities	21	3,125	21,523
Proceeds / (repayment) of borrowings		(40,113)	54,063
Payments for debt issue costs		(484)	(64)
Payment for shares bought back	21	(4,970)	(25,830)
Share issue and buy-back costs		(24)	(118)
Dividends paid to owners of the Company	24	(87,174)	(77,183)
Net cash (outflow) from financing activities		(129,640)	(27,609)
Cash and cash equivalents at end of year		49,131	43,445

DSH

Net cash (used in)/provided by operating activities	15(a)	(3,940)	52,177
Cash flows from financing activities			
Proceeds from issue of shares		-	343,611
Payment in relation to corporate reorganisation		-	(358,611)
Proceeds from borrowings		122,500	57,598
Repayment of borrowings		(52,000)	(57,598)
Dividend paid		(35,476)	-
Net cash provided by/(used in) financing activities		35,024	(15,000)
Cash and cash equivalents at the end of the year		29,511	29,944

JBH is repaying debt and is still cash flow positive

Dick smith is borrowing to be cash flow positive

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Balance Sheet (Assets = Liabilities + Equity)

How to spot a weak Balance Sheet - Negative or deficit retained earnings, Negative equity, Negative net tangible assets and Low current ratio.

JBH

	Notes	2015 $'000	2014 $'000
ASSETS			
Current assets			
Cash and cash equivalents		49,131	43,445
Trade and other receivables	9	81,480	70,745
Inventories	10	478,871	458,625
Total liabilities		551,534	565,208
Net assets		343,479	294,633

	Notes	2014 $'000	2013 $'000
ASSETS			
Current assets			
Cash and cash equivalents	10	43,445	67,368
Trade and other receivables	11	70,745	64,246
Inventories	12	458,625	426,000
Reserves	22	17,636	16,265

12% increase since 2013

DSH

	Note	As at 28 June 2015 $'000	As at 29 June 2014 $'000
Current assets			
Cash and cash equivalents	15	29,511	29,944
Trade and other receivables	6	53,323	46,688
Current tax receivables		10,460	2,021
Inventories		293,044	253,814
Total liabilities		**339,374**	**284,231**
Net assets		**169,147**	**166,940**

	Note	As at 29 June 2014 $'000	As at 30 June 2013 $'000
Current assets			
Cash and cash equivalents	15	29,944	46,538
Trade and other receivables	6	46,688	10,404
Inventories		253,814	170,796
Reserves	12	(339,409)	(339,187)

72% increase since 2013

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Auditor's Report

- Provides an opinion on the validity and reliability of a company's financial statements.

- But don't always trust it.

- Deloitte found nothing wrong with Dick Smith's Annual Report.

- Slater & Gordon – EY's British firm did due diligence on the Quindell transaction and signed off on it.

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Smell Test

- What is the general smell of the company?
- Does everything smell right?
- Is there anything that smells bad?

Comparison

- JBH – Smells right. Stores are packed. Heaps of customers. Buzz.
- DSH – Empty. Massive discounts. No customers. Doesn't smell right.

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Check list

Warning signs to watch out for:

- ✓ Management / board resignations and departures.
- ✓ Negotiations bankers or financiers.
- ✓ Proposals to raise further capital that’s not
- ✓ Underwritten
- ✓ Share sales by members of the management / board.
- ✓ Late lodgement of financial statements.
- ✓ Auditors not signing the financial statements.
- ✓ Negative returns on equity.
- ✓ Negative cash flows at operating level.
- ✓ High gearing.
- ✓ Low or negative NTA (net tangible assets).

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THIS IS WHAT WE DO

- Analysing an annual report takes time and patience, but the pay back time is very quick.
- As either a DIY or Self directed investor you need to put time aside, even 15 minutes once per year to do this excise.
- If you have more Pink and Yellow than Green and Oranges seek help asap or sell the stock asap.
- Suggest you take your reviewed annual report to you investment adviser once per year to talk them through. If you adviser refuses then find another adviser.

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Q & A

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