Right Price Investing Checklist

Thank you for downloading the RightPriceInvesting.com Checklist! The checklist is the way I personally vet long-term investment ideas.

While the list does not lend itself to analyzing turnaround situations, catalyst driven investments or deep value speculations, it walks you through the analysis of stable businesses with a long history and good growth trends.

The list starts with business model analysis, moves onto gauging competitive advantages, evaluating management, understanding the financials, valuation and finally the buy/pass decision.

Though I hope you will not copy this work (assuming it is good enough to be copied) please send it to anyone you feel would benefit from learning how analyze a business with the methods of the greatest value investors in history.

-Mike Price

Business

Translate Business Description

In the 10k businesses are required to write a description of their business, this should usually be simple and if I can't easily translate this into Real English then the business isn't that simple and should be put into the 'too-hard' pile.

Customers, Suppliers

High return businesses can be derailed by having too few customers or too few suppliers. In both cases the lack of bargaining power will lead to higher costs and a lower selling price in the future. Check for the amount of customers and suppliers.

Risks

The Company also has to write about potential risks in the 10k, I'll go over non-generic risks and what potential they have of occurring.

Products

What differentiates the company's products from the competition? Is it a repeat purchase product? If the company sells a product that needs to be purchased over and over again (like a razor) it's easy to create revenues, but if consumers only purchase the products every few years (like a car) then they may have trouble staying consistent through normal market cycles.

Consistency

An ideal business will have several years of consistent revenue growth and margins to show they are not reaching a cyclical high. Average out five years of cash flow for one valuation, if it is materially lower than other valuations, mitigate the risk that the company is peaking and will cycle down. Be wary of companies that are too consistent 5% growth each and every quarter suggests there are financial shenanigans happening.

High Returns

Finally, if the business has a repeat purchase product, a consistent history, hundreds of suppliers and customers, no real risks, but low returns on capital there is no reason to invest in it. Look for above industry average returns on capital and margins.

Moat

Does it have a moat?

This may seem like one of the hardest things to judge in investing, but it is inherently easy to find if a company has a moat.

A moat is just something that differentiates one company's revenue source from competitors and allows it to earn higher returns selling its products or services.

Typically, consistently high returns on capital will signal a company has a moat.

What is the moat?

This is harder to find, a company may have a great moat, but what is it? Do they offer the lowest price (eg Wal-Mart), are there barriers to entry in the industry (Waste Management), high switching costs (Adobe), does it have a great brand (American Express) or does it have a better quality product (Lexus).

Many companies have other variations of the above mentioned moats and many companies have multiple moats.

How long will it last?

This is the hardest thing to judge, and is usually a crapshoot.

Most technology companies rarely have a moat for long, because someone just has to come along and recreate their model.

But, some companies, like Coke, Gillette or American Express, have had moats for half a century with no signs of anyone coming close to them.

Estimating how long a moat will last is the most important part of business analysis because it tells the analyst how to structure his DCF and if he's right he gains a huge edge against Wall St. and will probably earn high returns.

Management

I don't have any way of talking to management from any company, so my analysis will be only things that can be found online.

I believe there are three distinct things to look for when evaluating management:

Integrity
Competence
Good Communication with Shareholders

Integrity

Integrity is of the utmost necessity for good management. If a shareholder can't tell if the management of his company is telling the truth, there is no need to have anything to do with that company.

I use a number of different measures to gauge management's integrity, gleaned from different sources that will be mentioned later.

Pay

This is a big one in the news, but I don't find it as big a deal as people like to make it. That said I do believe management can be overpaid.

If I get to this point in my analysis it’s obvious management is not completely incompetent, and I believe they should make at least what the CEO of a competitor makes, maybe a little more because they run a good company, but if it’s a huge premium there's something wrong.

Also, a company should not need to issue a ton of options to motivate employees, a little is fine, but excess amounts just breed unethical decision making. I'll also monitor options granted (it should stay under 2.5% of income, at the most) as a percent of income and share growth.

Restructuring

This includes all one-time charges, restructuring charges, limitless write-downs, etc.

If a company has a one-time charge every year, it is no longer a 'one-time' charge.

Related-Party Stuff

Companies have to report any related-party transactions. Some of these are fine, and don't need to be worried about.

But, if the company is loaning excess amounts of money to the chairman's son for his business you should probably steer clear, because management obviously doesn't care about the

shareholders' best interest.

Board of Directors

Look at who is sitting on the board of directors, if there are more than ten members or if many of them are politicians, members of the founding family or others with no business background you should probably pass.

Also, if the Chairman of the board is also the CEO it is unlikely the board will ask him any challenging questions.

Pension Fund Stuff

Michelle Leder calls this the best way to easily find if a company reports trustworthy numbers.

There are two things to look for regarding pension funds are they overfunded or underfunded and the expected return rate.

In the pension fund footnote the company reports their pension fund obligations and assets. If the assets are more than the obligations, they have an overfunded account, if the assets are less it is underfunded.

Both can be troublesome, if the fund is overfunded it could be inflating earnings, so look hard at earnings to find if it is. If it is underfunded it creates a drag on net income (look at General Motors, who has had possibly the worst pension fund management in history).

Companies also report the rate at which they expect their pension fund to grow. If this rate is too high (Robert Olstein says 6% should be the highest rate, because it includes fixed income and stock investments) it shows the company has too aggressive accounting and adds to the net income amount, without adding cash.

Revenue

This part of the analysis is two-pronged: recognition and receivables.

How companies recognize revenue says a lot about how they do business. If they sell a product they may record revenue when the contract is signed to sell the product, when it would be better to record it when the cash is received after they ship the product. Find the revenue recognition footnote and if you don’t understand it, pass.

Also, if revenue is growing fast, but when you check accounts receivables they are growing just as fast there might be future trouble if the company is unable to collect the money it is owed.

Earnings

Look at the past ten years of earnings, if there is never a drop in growth or if they always meet

the target (you can find this on Yahoo Finance) be suspicious and look into how much of their earnings each year are actually cash.

Compare free cash flow with the actual net income, if it varies (in either direction) by a lot the company is reporting income that it hasn't earned in actual cash.

Ownership

This is a very arguable criterion. A lot of people base their investment decisions on inside ownership, others claim it does not matter.

I believe a healthy amount of insider ownership aligns management's interest with that of the shareholders.

I also believe that when management owns part of a huge company it is hard to own a huge percent of the shares. So I look at the absolute amount of a company management owns. If the CEO owns $100 million worth of stock, but he runs a multi-billion dollar company, it won't show up as huge inside ownership, but he obviously has the shareholder's interest on his mind.

I also don't care much for insider buying or selling, no one knows the reasoning behind insider buys and sells, and in my mind it is a waste of time to try to figure them out.

Auditing

The last part of the integrity analysis is to check the auditing firm, if they are a no-name firm that doesn't seem likely to ask hard questions, one should view the financial statement with a grain of salt.

Competence

Expenses

I have a page in my spreadsheet that does a percent analysis for the income statement. It breaks down what percent of Revenue each expense accounts for.

If a company has lower margins than competition identifying the expense causing this is crucial to turn-around, if management seems ignorant of this, pass on the company.

Debt

If a company is focusing all its interest on how it will pay off its debt, it has no time left to figure out how to grow.

Look to see how debt a company has, and also find what percent it is paying on that debt in interest, if the interest payments alone account for a huge percent of income it is time to pass.

It is important to not put mark down a company too strongly for holding debt. Companies with consistent cash flow generation and/or strong capital allocators at the helm can create value by earning higher returns on capital than they pay in interest and potentially buying back shares or paying out big dividends when possible.

Returns

I repeat this over and over, but it is necessary, when analyzing each facet of a company. The amount of income a company can produce using its equity (or assets) is the best gauge for determining the validity of the company.

If management is unable to allocate its capital efficiently there is nothing else it can do correctly to make up for this and you should pass on the company.

Also, coinciding with the last criteria I like to look at Return on Capital (income over equity plus long-term debt) and Return on Assets (income over assets) to find how much of a company's return on equity is produced using leverage.

Retained Earnings Contrasted to Market Cap

This is from Buffett's letters.

Basically, for every dollar in retained earnings a company's market value should increase at least one dollar.

It is true that a company needs a long history for this to be applicable, but I believe that could be five years.

That concludes the competence part, which is not very long, but management's competence should be obvious if it has a moat and good returns.

Shareholder Communication

This part is the one the I think is the least necessary. It's important for CEOs to be honest and let shareholders know what is going on.

But, I can also understand if management doesn't necessarily care about what Wall St. thinks so they report the bare minimum. For this reason I don't put as much weight on this part as the former two.

Earnings Reports

A lot can be found from a company's press release announcing their earnings.

First, you should look at the headline, if it is announcing the company's brilliant quarter and its strong growth, be cautious, but if it just says, "X Company reports Q4 earnings," be happy.

Next, is pro forma income check into how a company determines pro forma income, if it is excluding expenses that need to be included in the running of the business or adding non-cash measures ignore the pro-forma earnings and be suspicious of everything else management says.

Also, if management reports their huge growth check to which numbers they are referring. If they are using pro-forma income as their growth measure and their net income didn't grow, or fell, they are most likely dishonest.

What they say and What they do

It is a very informative exercise to read over a bunch of years of annual reports and conference call transcripts and record all of management's promises and predictions to find what actually happened.

Financials

Analyzing the financials of a business is necessary to find how cash runs through a business and measure how a company's assets compare to its debt.

Income Statement

Margins

High margins are one of the best ways to judge how efficient a company is. They also help show who has the better competitive advantage, either by a better cost system or the ability to price their goods higher.

I like to look a gross margins, operating margins (which are usually the best way to compare competitors so different tax rates don't skew the results), profit margins and cash flow margins.

Expenses

After looking at margins it is a necessity that one use a percentage analysis, this is done by dividing each expense by revenue to find where revenue is spent before it falls down to income. It's also beneficial to find how expenses may change. Companies like Overstock have artificially low income numbers because their variable expenses can be leveraged in the future to allow more money to fall to the bottom line.

Growth

Growth fuels investor's returns. If a company can grow its earnings in double digits for multiple years it is likely to be undervalued.

I first like to focus on revenue growth, if a company will be growing income in the future based on more products sales, or if it grows income by reducing expenses anticipating revenue growth will allow you to find income growth.

Also, when evaluating past growth, if you expect growth to stay at its current level, make sure the growth rate is climbing.

Balance Sheet

Cash

I like to start with the assets and cash is the first thing I check.

First, check to make sure cash is growing, and also that it is a good percent of current assets.

Other Current Assets

As before mentioned check to make sure a company isn't growing its revenue on accounts receivables, if accounts receivables are growing faster than revenue you may want to pass.

A lot of inventory can be good or bad. If the company has a lot of finished goods inventory it can mean a drop in sales is near, but if the company has a lot works-in-progress inventory it can signal more revenue growth soon.

Watch for a lot of deferred tax assets, these only last so long.

Intangibles

These can also be positive or negative. Intangibles assets can provide a competitive advantage, but should probably not be included in any valuation.

PP&E

PP&E is hard to judge and can be good if real estate was purchased a long-time ago, but equipment and other property can erode sometimes faster than management expects.

Debt

Debt is one of the hardest things to analyze. Great capital allocators can use leverage to amplify returns in good times and set themselves up to dominate during down markets.

Of course, even great capital allocators can be sunk if their cash flow dries up when all the debt comes due. Make sure the company has more than enough EBITDA to make its interest payments and look for debt that is spaced out and due in a long time – at favorable rates.

Cash Flow

There are innumerable amounts of ways to measure cash flow and almost every entry can be taken out or added into income to come up with a different amount, I will only go over four kinds here, but recommend reading non-stop to learn all the ways.

The four I will go over are:

Free Cash Flow
Owner's Earnings
Free Cash Flow to the Firm
Maintenance Vs Growth CapEx

Free Cash Flow

Free cash flow is simply Operating Cash Flow minus Capital Expenditures. This is good to use for quick comparisons to other company's valuations or to income.

Owner's Earnings

A more clean way to find cash flow, and Warren Buffett's method, is to add back non-cash charges like deprecation and then subtract the actual expense: capital expenditures.

This method helps more than free cash flow, but it does not take into account any changes in working capital. When a company increases accounts receivables its sales go up while it does not collect the cash, conversely they may account for expenses that they have yet to pay with accounts payables.

Free Cash Flow to the Firm

To account for these working capital changes you can use this method. It's the same as owner's earnings, but the change in working capital is applied.

It is important to point out that when using net income to find real cash flow, you are using relatively unpredictable items, like interest, that are not related to the operations of the company. A way to correct this is to apply the tax rate to operating income and then add back noncash charges and subtract CapEx and investment in working capital.

Also, companies can't grow cash flow based totally on working capital changes forever so it is important to compare free cash flow to the firm with owner's earnings.

Maintenance Vs. Growth CapEx

Capital Expenditures is the cash paid out to invest in the company. It buys PP&E and other things to help the company sustain its growth.

Some companies have huge CapEx because they are trying to fund huge growth. Some analysts say that this high CapEx number punishes the company when its maintenance (what it would take to sustain the current earnings) CapEx would be lower.

They then advocate separating maintenance CapEx from growth CapEx to find the real cash flow.

Here's my position on this: If a company needs to spend money to grow, that's cash going out the door, regardless of whether or not its funding growth the company will not need in five or ten years.

So if you're going to separate the two to apply to numbers in the future more power to you, but if you separate them and then apply it to a multiple today I believe it is the inverse of what the initial goal was, to find the actual amount of cash a company made in the year. This is because even though a company could sustain its current operations with a lower CapEx number, it has chosen to grow instead and pretending it didn't spend that money to grow is an easy way to get mediocre returns.

Valuation

Valuing a business is how a successful investor can decide when to buy and when to sell great companies.

Before I start, I'd like to add that when doing my analysis I like to keep any valuation out of my head until the end, to keep myself from becoming biased, I don't even look at the stock price.

The methods of valuations I will use are:

Comparable Companies and Precedent Transactions
DCF
Reverse DCF
Liquidation Value

Comparable Companies and Precedent Transactions

Using comparable company multiples and the multiples of precedent transactions are typically two different research processes, but both end in the same result – finding a target price for your subject company and using it as a valuation.

Research the companies closest competitors and create a table in excel with several valuation ratios, P/E, P/CF, EV/FCF, EV/EBITDA, P/B, etc. and then calculate the mean, high and low of these ratios. Typically, you would then apply the mean to the subject's current numbers, or a forecast, however, if you're dealing with a company that is of substantially better or worse quality than its competitors apply a premium or discount to this multiple when finding your value.

Do the same for any precedent transactions in the industry over the past 2 or 3 years to get a feel for what valuation is being used in mergers.

DCF

The basic theory of a DCF is to forecast out several years (usually 5, of if you're feeling frisky, 10) of cash flows, discount back this sum to the present and then add a terminal value to the calculation. The terminal value is either the sixth year's cash flow over the discount rate minus a terminal growth rate or the value the company would have in an acquisition which is typically computed with precedent transaction multiples.

DCFs are very theoretically sound and can be useful in valuations. Unfortunately DCFs tend to have a garbage in garbage out problem. Even management cannot forecast cash flows one year into the future with any sort of reliability. No matter how good your spreadsheet is, building 3 statement models to forecast ten years of cash flow and then discount it back is a crapshoot.

I recommend using DCF models, but I don't base my entire valuation on them.

Reverse DCF

In a reverse DCF the current market value is inputted and the method shows what earnings growth is needed to support the current market value, this does not give a specific market value, but does give a general view on whether or not the stock is undervalued.

Liquidation Value

Liquidation value is computed to find the floor value of your subject company. This method is mostly useless for any company that is not capital intensive – If you need to liquidate Facebook and sell all of the furniture the investment is well past failure.

The following table present pretty good rules of thumb for evaluating the liquidation value of each asset.

Asset	Percent%
Cash	100%
Marketable Securities	100%
Accounts Receivables	85%
Inventories	50%
PP&E	45%
Goodwill	0%
Deferred taxes	0%

I'd like to add to this that if a company owns its own real estate this should be taken 100% and if the market has gone up a conservative appreciation should be added.

Conclusion

I believe there are three crucial factors to apply in your conclusion:

Margin of Safety
Why it undervalued?
Catalyst

Margin of Safety

Margin of Safety is at the top of any value investing strategy.

It's a very easy to understand concept: when buying shares in a company make sure they are worth more than you are paying.

The thing most debatable about margin of safety is how much of is needed. To guarantee future profits I like to look for companies that possess a 40% margin of safety between the current price and value, but for truly great companies I'd pay up to 80%, with the intention of holding them for a very long time.

Why is it Undervalued?

This question is usually found in the investigation of the company, but it needs to be restated in words, so an analyst can easily find how it will be changed.

Catalyst

Many value investors choose to ignore this. I think it is one of the most important parts of investing, and making sure you haven't found a value trap.

These are usually easy to find, what will make the stock price reach the company's value? This can be as easy as continuing earnings growth, or more complex like a competitor raising its prices.

Buy or Sell

The last decision is when an analyst sums up all his research and decides whether to buy or sell.

To run a truly concentrated portfolio, I would suggest not buying a company unless the business is great and can be proved so by the financials, the management can run the business and allocate capital without the need of debt and there is a high margin of safety between the stock price and value.