Investment Focus:
The changing nature of balance sheets

BLUEALPHA
INVESTMENT MANAGEMENT

This quarter we look at the how reporting on balance sheets has changed dramatically and how this has affected the Price to Book (P/B) valuation metric.

Before we get into the details:

$$\frac{P}{B} = \frac{\textit{Market Cap}}{\textit{Book Value}} = \frac{\textit{Share Price}}{\textit{Book Value per share}}$$

$$\textit{Book Value (Shareholder's Equity)} = \textit{Assets} - \textit{Liabilities}$$

While Book Value intuitively seems like a good place to start when considering a company's value, recently it has been one of the most poorly performing metrics. In fact, the entire "Value" bucket has underperformed - for numerous reasons, including high leverage and slow growth, but of these reasons, the changing nature of Book Value is often overlooked.

Generally, companies' Balance Sheets are made up of Physical Assets, Goodwill and Working Capital on the asset side. On the liability side there is long- and short-term debt, and future obligations. The difference between these is the Shareholders Equity (Book Value). For our purposes, we will only focus on the asset side.

To examine this, we will compare four companies (Sasol, Datatec, Pick n Pay and Microsoft) in trying to understand how different their respective Balance Sheets look, and what these differences mean for valuations.

First, we look at companies whose assets are mainly plant and machinery – like Sasol (80% in fact). Sasol has some working capital - roughly 15% of total assets, and a very small 5% balance in Goodwill.

Figure 1: Sasol's Assets

Source: Bloomberg

Accounting standards allow companies to capitalise the costs of plant, property and equipment as an asset on the Balance Sheet, which flows through the Cash Flow Statement, rather than being expensed through the Income Statement (remember this mechanism when we discuss Microsoft). Companies with similar asset bases include Nampak and Mondi. Given that the asset side is fairly straightforward, the P/B of Sasol reflects the market's assessment of return on capital and future prospects. Forty years ago, almost all companies' Balance Sheets looked like this.

The advent of middlemen led to the creation of companies like Datatec. Datatec distributes products on behalf of other companies. It uses financing to secure inventories and then hopes to sell them at a higher price, receiving payment at a later date. The asset side of the balance sheet looks like this: fixed assets 10%, goodwill 10% and working capital assets making up 80%. Working Capital is made up of inventory and receivables. Receivables in this case is some 40% of total assets.

Figure 2: Datatec's Assets

Source: Bloomberg

The owners of African Bank will tell you the dangers of paying a high multiple for receivables. As for inventory, it may or may not be sold for more than what is on the Balance Sheet. For this reason, Datatec will very rarely trade above a multiple of one. Most distributor models look like this. In general, at BlueAlpha we rarely buy these types of companies.

You will notice that we haven't included cash as part of assets. In general, this cash can't be accessed, so mostly we assume it is trapped. Steinhoff spoke glowingly about their cash balances.

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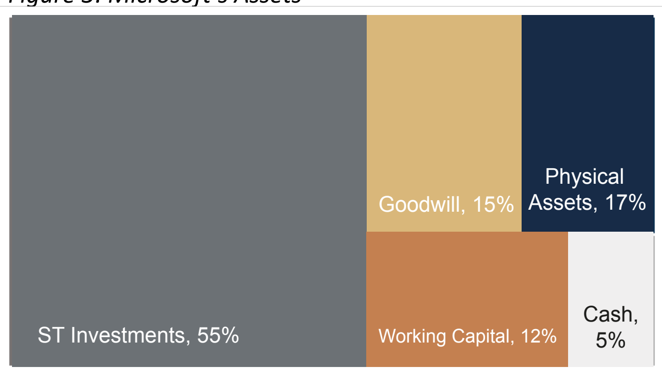
In our next example, Pick n Pay is a bit of a hybrid. Physical long-term assets are some 50% of total assets. Inventories and receivables are split both 20% and intangibles only 10%. We've done this exercise using 2019 statements so as not to introduce leased assets. Like many companies with strong consumer brands, Pick n Pay has spent a considerable amount on building their brand. However, while its brand may be a considerable asset, it never appears on the Balance Sheet – rather it is expensed through the Income Statement. Not all expenses on advertising pay off, but in the case of Pick n Pay it has. So much so, that suppliers are willing to fund the inventory of Pick n Pay. This internally generated Goodwill also doesn't appear on the Balance Sheet.

Lastly, we look at Microsoft, which has even fewer physical assets. Plant and property assets are only 13% of total assets. Inventory is a measly 2% and receivables 10%. The balance is intangibles – mainly from acquisitions of 15%, and the rest is cash and short term investments (de-facto cash) at 60% of assets (this is one of the few companies where cash is not trapped). It generates so much cash and spends so little on capex that it really does have a surplus.

Figure 3: Microsoft's Assets



Source: Bloomberg

So the question is how Microsoft can spend so little on capex but still make money? As it happens, Microsoft spends a lot on Research and Development (R&D), which according to accounting standards has to be expensed through the Income Statement (i.e. it doesn't reflect as an asset on the Balance Sheet like typical capex would). In fact, R&D spend will only reach the Balance Sheet via retained earnings if that research leads to a successful product. In a way this, Microsoft has a very conservatively struck Balance Sheet. It has no recognition for all the R&D it has done over many years.

Remember how Sasol spend mainly goes through the Cash Flow Statement?

As a reminder, figure 3 depicts each company's P/B ratios and asset breakdowns, which highlights the stark differences between them – most notably between Sasol (typical Industrial) and Microsoft ("new" economy). The more tech companies grow, the more this difference in Balance Sheet structure will matter in understanding the value of different businesses.

Figure 4: Balance Sheet asset breakdown 2019

	Sasol	Datatec	Pick n Pay	Microsoft
P / B	***0.37***	***0.55***	***8.16***	***13.67***
Cash	3.4%	12.7%	4.7%	46.7%
Receivables	5.0%	46.5%	0.0%	10.3%
Inventories	6.3%	12.2%	17.7%	0.7%
Other S-T Assets	2.0%	12.6%	14.2%	3.5%
CURRENT ASSETS	**16.6%**	**83.9%**	**36.6%**	**61.3%**
Property, Plant& Equip	76.9%	2.2%	50.7%	15.3%
L-T Investments/receivables	1.6%	0.8%	0.7%	0.9%
Other L-T Assets	4.9%	13.0%	12.0%	22.5%
NON-CURRENT ASSETS	**83.4%**	**16.1%**	**63.4%**	**38.7%**

Source: Bloomberg

Simplistically, the more a company expenses its business through the Cash Flow Statement (capitalising that spending on its Balance Sheet), the more the business will reflect Sasol and Nampak. When instead, your expenses are borne through the Income Statement, like advertising, salaries for highly skilled employees (human capital) and R&D, the less relevant Book Value becomes.