Twitter Thread by Shravan Venkataraman ■

Shravan Venkataraman ■
@theBuoyantMan

Interpretation of Financial Statements - preliminary filters.

1. Looking for sustainable competitive advantage:

When looking for sustainable moat, you wanna see consistency - in earnings, in having low debt, in having growing earnings, low spending in capital expenditures, etc.

The longer the company has existed, and if it sells you the same product for years (like Coca Cola), it reduces production costs and other costs (R&D, Training, marketing) slowly as the company ages.

When costs are reduced, margins and profits increase.

2. What to look for in an income statement:

Let's take a look at Apple:

i) You want to see earnings grow at a steady pace. Take a look at the net income below.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Income Statement	9/29/12	9/28/13	9/27/14	9/26/15	9/24/16	9/30/17	9/29/18	9/28/19	LTM
EBT Incl. Unusual Items	55,763.00	50,155.00	53,483.00	72,515.00	61,372.00	64,089.00	72,903.00	65,737.00	68,317.00
Income Tax Expense	(14,030.00)	(13,118.00)	(13,973.00)	(19,121.00)	(15,685.00)	(15,738.00)	(13,372.00)	(10,481.00)	(9,893.00)
Earnings From Continuing Operations	41,733.00	37,037.00	39,510.00	53,394.00	45,687.00	48,351.00	59,531.00	55,256.00	58,424.00
Net Income to Company	41,733.00	37,037.00	39,510.00	53,394.00	45,687.00	48,351.00	59,531.00	55,256.00	58,424.00
Net Income	41,733.00	37,037.00	39,510.00	53,394.00	45,687.00	48,351.00	59,531.00	55,256.00	58,424.00
Net Income to Common Incl Extra Items	41,733.00	37,037.00	39,510.00	53,394.00	45,687.00	48,351.00	59,531.00	55,256.00	58,424.00
% Net Income to Common Incl Extra Items Margins	*26.7%*	*21.7%*	*21.6%*	*22.8%*	*21.2%*	*21.1%*	*22.4%*	*21.2%*	*21.3%*
Net Income to Common Excl. Extra Items	41,733.00	37,037.00	39,510.00	53,394.00	45,687.00	48,351.00	59,531.00	55,256.00	58,424.00
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ii) Another thing that's important is a consistent and high gross margin.

As a thumb rule, Warren Buffett wants to see a gross margin of around 40% or above.

Although not quite 40%, it's around that range with respect to Apple.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Income Statement	9/29/12	9/28/13	9/27/14	9/26/15	9/24/16	9/30/17	9/29/18	9/28/19	LTM
Revenues	156,508.00	170,910.00	182,795.00	233,715.00	215,639.00	229,234.00	265,595.00	260,174.00	273,857.00
Total Revenues	**156,508.00**	**170,910.00**	**182,795.00**	**233,715.00**	**215,639.00**	**229,234.00**	**265,595.00**	**260,174.00**	**273,857.00**
% Change YoY	*44.6%*	*9.2%*	*7.0%*	*27.9%*	*(7.7%)*	*6.3%*	*15.9%*	*(2.0%)*	
Cost of Goods Sold	(87,846.00)	(106,606.00)	(112,258.00)	(140,089.00)	(131,376.00)	(141,048.00)	(163,756.00)	(161,782.00)	(169,277.00)
Gross Profit	**68,662.00**	**64,304.00**	**70,537.00**	**93,626.00**	**84,263.00**	**88,186.00**	**101,839.00**	**98,392.00**	**104,580.00**
% Change YoY	*56.7%*	*(6.3%)*	*9.7%*	*32.7%*	*(10.0%)*	*4.7%*	*15.5%*	*(3.4%)*	
% Gross Margins	*43.9%*	*37.6%*	*38.6%*	*40.1%*	*39.1%*	*38.5%*	*38.3%*	*37.8%*	*38.2%*
Selling General & Admin Expenses	(10,040.00)	(10,830.00)	(11,993.00)	(14,329.00)	(14,194.00)	(15,261.00)	(16,705.00)	(18,245.00)	(19,558.00)

Compare this to Apple's competitors.

Samsung's gross margins are around similar range, highest being 45.7% in 2018, and Huawei had a gross margin of 38.6%.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Income Statement	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19	LTM
Revenues	206,205,987.00	200,653,482.00	201,866,745.00	239,575,376.00	243,771,415.00	230,400,881.00	230,179,55
Total Revenues	**206,205,987.00**	**200,653,482.00**	**201,866,745.00**	**239,575,376.00**	**243,771,415.00**	**230,400,881.00**	**230,179,55**
% Change YoY	*(9.8%)*	*(2.7%)*	*0.6%*	*18.7%*	*1.8%*	*(5.5%)*	
Cost of Goods Sold	(128,278,800.00)	(123,482,118.00)	(120,277,715.00)	(129,290,661.00)	(132,394,411.00)	(147,239,549.00)	(145,261,30
Gross Profit	**77,927,187.00**	**77,171,364.00**	**81,589,030.00**	**110,284,715.00**	**111,377,004.00**	**83,161,332.00**	**84,918,24**
% Change YoY	*(14.4%)*	*(1.0%)*	*5.7%*	*35.2%*	*1.0%*	*(25.3%)*	
% Gross Margins	*37.8%*	*38.5%*	*40.4%*	*46.0%*	*45.7%*	*36.1%*	*36.9%*
Selling General & Admin Expenses	(37,446,184.00)	(36,081,636.00)	(37,235,161.00)	(38,947,445.00)	(32,688,565.00)	(33,444,770.00)	(32,594,77

Having a high gross margin indicates the scalability of the business. The more the company sells, the greater the profitability becomes. Such a trait is what you want to see in a business you want to own.

iii) You also want to note the net margin.

Gross margin = (revenue - cost of goods sold) / revenue

Net margin = net income / revenue.

You want to see the company having higher net margin compared to their competitors.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Income Statement	9/29/12	9/28/13	9/27/14	9/26/15	9/24/16	9/30/17	9/29/18	9/28/19	LTM
Other Non Operating Income (Expenses)	(566.00)	(324.00)	(431.00)	(903.00)	(1,195.00)	(133.00)	(117.00)	1,237.00	234.00
EBT Excl. Unusual Items	**55,763.00**	**50,155.00**	**53,483.00**	**72,515.00**	**61,372.00**	**64,089.00**	**72,883.00**	**65,768.00**	**68,303.00**
Merger & Restructuring Charges									
Gain (Loss) On Sale Of Investments							20.00	(31.00)	14.00
EBT Incl. Unusual Items	**55,763.00**	**50,155.00**	**53,483.00**	**72,515.00**	**61,372.00**	**64,089.00**	**72,903.00**	**65,737.00**	**68,317.00**
Income Tax Expense	(14,030.00)	(13,118.00)	(13,973.00)	(19,121.00)	(15,685.00)	(15,738.00)	(13,372.00)	(10,481.00)	(9,893.00)
Earnings From Continuing Operations	**41,733.00**	**37,037.00**	**39,510.00**	**53,394.00**	**45,687.00**	**48,351.00**	**59,531.00**	**55,256.00**	**58,424.00**
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Net Income	**41,733.00**	**37,037.00**	**39,510.00**	**53,394.00**	**45,687.00**	**48,351.00**	**59,531.00**	**55,256.00**	**58,424.00**
Net Income to Common Incl Extra Items	**41,733.00**	**37,037.00**	**39,510.00**	**53,394.00**	**45,687.00**	**48,351.00**	**59,531.00**	**55,256.00**	**58,424.00**
% Net Income to Common Incl Extra Items Margins	***26.7%***	***21.7%***	***21.6%***	***22.8%***	***21.2%***	***21.1%***	***22.4%***	***21.2%***	***21.3%***
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Apple's net margin is around 22%. Samsung's net margin is around 18% and Huawei's net margin is around 8.5%.

Typically, net margin above 20% is a very strong one, indicating that we are dealing with a smoothly run business.

3) In the balance sheet:

Look at the figure - "Retained Earnings".

Using retained earnings, you can find out if a company is reinvesting its income or not. A steady growth in this number means the business is profitable, and that it's identifying good investing opportunities.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Balance Sheet	9/29/12	9/28/13	9/27/14	9/26/15	9/24/16	9/30/17	9/29/18	9/28/19	LTM
Other Current Liabilities	1,638.00	2,967.00	81.00	1,999.00	163.00	30,551.00	33,327.00	37,720.00	33,632.00
Total Current Liabilities	**38,542.00**	**43,658.00**	**63,448.00**	**80,610.00**	**79,006.00**	**100,814.00**	**115,929.00**	**105,718.00**	**95,318.00**
Long-Term Debt		16,960.00	28,987.00	53,329.00	75,427.00	97,207.00	93,735.00	91,807.00	94,048.00
Capital Leases									8,090.00
Unearned Revenue Non Current	2,648.00	2,625.00	3,031.00	3,624.00	2,930.00	2,836.00			
Deferred Tax Liability Non Current	13,847.00	16,489.00	20,259.00	24,062.00	26,019.00	31,504.00			
Other Non Current Liabilities	2,817.00	3,719.00	4,567.00	9,365.00	10,055.00	8,911.00	48,914.00	50,503.00	47,606.00
Total Liabilities	**57,854.00**	**83,451.00**	**120,292.00**	**170,990.00**	**193,437.00**	**241,272.00**	**258,578.00**	**248,028.00**	**245,062.00**
Common Stock	16,422.00	19,764.00	23,313.00	27,416.00	31,251.00	35,867.00	40,201.00	45,174.00	48,696.00
Retained Earnings	101,289.00	104,256.00	87,152.00	92,284.00	96,364.00	98,330.00	70,400.00	45,898.00	24,136.00
Comprehensive Income and Other	499.00	(471.00)	1,082.00	(345.00)	634.00	(150.00)	(3,454.00)	(584.00)	(550.00)
Total Common Equity	**118,210.00**	**123,549.00**	**111,547.00**	**119,355.00**	**128,249.00**	**134,047.00**	**107,147.00**	**90,488.00**	**72,282.00**
Total Equity	**118,210.00**	**123,549.00**	**111,547.00**	**119,355.00**	**128,249.00**	**134,047.00**	**107,147.00**	**90,488.00**	**72,282.00**
Total Liabilities And Equity	**176,064.00**	**207,000.00**	**231,839.00**	**290,345.00**	**321,686.00**	**375,319.00**	**365,725.00**	**338,516.00**	**317,344.00**

Apple doesn't fulfill the criteria regarding retained earnings. But that's because in 2013, Apple started a rigorous dividends and share repurchase program.

To measure how efficiently a company is using these retained earnings, Return on Equity (ROE) is used.

To calculate ROE, compare Net income to the Total Equity of the company.

Apple looks quite strong in this aspect. It's partly an effect of distributing a lot of their earnings to shareholders. It also signifies the sustainable competitive moat.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Ratios	9/29/12	9/28/13	9/27/14	9/26/15	9/24/16	9/30/17	9/29/18	9/28/19	LTM
Return Ratios:									
Return on Assets %	23.6%	16.0%	15.0%	17.1%	12.3%	11.0%	12.0%	11.3%	13.1%
Return on Capital %	41.8%	31.2%	31.4%	34.3%	24.9%	21.8%	32.0%	32.2%	34.5%
Return On Equity %	42.8%	30.6%	33.6%	46.2%	36.9%	36.9%	49.4%	55.9%	69.2%
Return on Common Equity %	42.8%	30.6%	33.6%	46.2%	36.9%	36.9%	49.4%	55.9%	69.2%

Compare this with Samsung (ROE:18.3%) and Huawei (ROE:25.3%), Apple shows significant strength.

4) Exceptional businesses seldom require a lot of debt to expand (except maybe banks/NBFCs). Instead, they can just use the strong cashflow from the business.

So, look for businesses with little to no long term debt. If a company can pay off with all its long term debt with less than 4 years of earnings, it signifies a good position for the company. Apple fulfills this criterion. Samsung and Huawei do too.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW STATEMENT | RATIOS

Balance Sheet	9/29/12	9/28/13	9/27/14	9/26/15	9/24/16	9/30/17	9/29/18	9/28/19	LTM
Net Property Plant And Equipment	**15,452.00**	**16,597.00**	**20,624.00**	**22,471.00**	**27,010.00**	**33,783.00**	**41,304.00**	**37,378.00**	**43,851.00**
Long-term Investments	92,122.00	106,215.00	130,162.00	164,065.00	170,430.00	194,714.00	170,799.00	105,341.00	100,592.00
Goodwill	1,135.00	1,577.00	4,616.00	5,116.00	5,414.00				
Other Intangibles	4,224.00	4,179.00	4,142.00	3,893.00	3,206.00				
Deferred Tax Assets Long-Term									
Deferred Charges Long-Term									
Other Long-Term Assets	5,478.00	5,146.00	3,764.00	5,422.00	8,757.00	18,177.00	22,283.00	32,978.00	32,836.00
Total Assets	**176,064.00**	**207,000.00**	**231,839.00**	**290,345.00**	**321,686.00**	**375,319.00**	**365,725.00**	**338,516.00**	**317,344.00**
Accounts Payable	21,175.00	22,367.00	30,196.00	35,490.00	37,294.00	44,242.00	55,888.00	46,236.00	35,325.00
Accrued Expenses	6,749.00	8,427.00	18,372.00	23,169.00	21,864.00				
Short-term Borrowings			6,308.00	8,499.00	8,105.00	11,977.00	11,964.00	5,980.00	11,166.00
Current Portion of Long-Term Debt				2,513.00	3,500.00	6,496.00	8,784.00	10,260.00	7,509.00
Current Portion of Capital Lease Obligations									1,373.00
Current Income Taxes Payable	1,535.00	1,200.00							
Unearned Revenue Current	7,445.00	8,697.00	8,491.00	8,940.00	8,080.00	7,548.00	5,966.00	5,522.00	6,313.00
Other Current Liabilities	1,638.00	2,967.00	81.00	1,999.00	163.00	30,551.00	33,327.00	37,720.00	33,632.00
Total Current Liabilities	**38,542.00**	**43,658.00**	**63,448.00**	**80,610.00**	**79,006.00**	**100,814.00**	**115,929.00**	**105,718.00**	**95,318.00**
Long-Term Debt		16,960.00	28,987.00	53,329.00	75,427.00	97,207.00	93,735.00	91,807.00	94,048.00
Capital Leases									8,090.00

5) In a cashflow statement:

This is where you see the actual in's and out's of money.

Look at "Capital Expenditures" on the cashflow statement.

This is the money being spent on properties, plant, and equipment.

Look at what percentage of net income the capital expenditures are. You want it to be as low as possible, lower than 25% over a period of time is considered very good. Less than 50% is okay-ish.

Exceptions: One time payment to grow the business in some capex activity.

Look at Apple's CAPEX spendings. Compare that with their net income, and you can see that their average capex spending is less than 25% of their net income. Samsung (around 65%) and Huawei (around 45%) aren't even close.

Capital Expenditure	(8,295.00)	(8,165.00)	(9,571.00)	(11,247.00)	(12,734.00)	(12,451.00)	(13,313.00)	(10,495.00)	(8,302.00)

Also, in Apple's cash flow statement, we can see the reasons why the retained earnings from the balance sheet haven't been growing from 2012. Apple has been distributing a lot of cash to its shareholders.

Apple's Augmented Payout Ratio (includes share buybacks and dividends) has been higher than 100% in some years. This basically means Apple's distributing more money than it earns.

5) When to sell?

3 instances when you could consider selling the stock.

i) You need money for a better investments. This is more so applicable in a bear market, for you to switch from something great to something exceptional.

ii) When a company loses its competitive advantage. Times change, and once monopolistic companies are constantly being disrupted. If your investment faces such a risk, cut it loose.

iii) During crazy raging bull market. Even if a company runs a fantastic business, it could be a bad investment if you have to pay insane price. At such times, at such price, you could selling a fantastic business if you already have held onto it for a long time.

At a PE of 40 or higher, you should start considering selling your stocks, even if you believe in the underlying economics of the company.

This may not always apply to all markets, all stocks. But with anything above 40PE, tread carefully and cautiously.

So, key takeaways:

- Competitive advantage and scale
- Consistently high net income, return on equity
- Requires very little debt
- Retained earnings has steady growth

- Capital expenditures should be < 25%
- Sell a company if prices are crazy, or a better opportunity comes up.

The Swedish Investor YT channel has some interesting playlists on financial statements. Check it out. These insights I gathered are from one of his videos.

https://t.co/nbKA5Bzpi6

For learning Valuation, nothing better than Aswath Damodaran's course. Find his courses here:

https://t.co/MbmUKsE968