ANALYZING A STOCK AS A BUSINESS: THE BUFFETT APPROACH TO SCREENING

By John Bajkowski

Most investors have little trouble understanding Warren Buffett's strategy. But its successful implementation requires a considerable amount of time, effort, and judgment in perusing a firm's financial statements, annual reports, and other information sources to thoroughly analyze the business and quality of management.

Every share of a company's common stock represents direct ownership of a business. Ownership of even a single share entitles the holder to a fractional ownership of the firm's net assets, which hopefully generate a reasonable flow of earnings and dividends. Shareholders do not normally run the company directly, but rather elect a board of directors that select the management team that actually operates the business.

Although most beginning investors understand the basic principles of company ownership, the everyday activity of the stock market tends to capture the majority of investor attention, and there is a tendency to think of the success and failure of a company through the movement of its stock price. While periods of optimism and pessimism for the market, industry or even the company may push the stock price of the company away from the value of the business, over the long term the stock price will tend to follow the economic worth of the company.

A fundamental approach to investing first begins with an understanding of the value of a business, and then determining if the current stock price presents an attractive buying opportunity.

THE QUINTESSENTIAL LONG-TERM INVESTOR

Perhaps no other investor today is associated as strongly with the basic principles of fundamental investing as is Warren Buffett. Identified by Forbes as the second richest man in the world, with a net worth of $35 billion dollars, Warren Buffett bears the distinction of having made this wealth through investing.

Buffett attracts attention, and a cottage industry has sprung up to pass on and interpret his fundamental teachings. While some critics feel that Buffett's strategy cannot be duplicated, Robert Hagstrom disagrees. He has authored three popular books that highlight Buffett's core investment principles. In his most recent work "The Essential Buffett: Timeless Principles for the New Economy" (2001, John Wiley & Sons), Hagstrom argues that it is possible to duplicate Warren Buffett's approach within your personal area of expertise. He presents the approach through an accessible series of questions that should be explored with any potential investment. The approach demands that you:

- Analyze a stock as a business,
- Demand a margin of safety for each purchase,
- Manage a focused portfolio, and
- Protect yourself from the speculative and emotional forces of the market.

Hagstrom's latest book served as the primary source for this article.

LEARNING THE TRADE

Warren Buffett was born in Omaha, Nebraska, in 1930. His father was a stockbroker and U.S. congressman. While working at his father's brokerage firm, he came across Benjamin Graham's book "The Intelligent Investor," and applied to Columbia to study under Graham. Buffett eventually joined

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TABLE 1. COMPANIES PASSING THE BUFFETT SCREEN

Company (Exchange: Ticker)	ROE (TTM)* Firm (%)	ROE (TTM)* Indus. (%)	Firm 5-yr Avg. ROE* (%)	Net Profit Margin (TTM*) Firm (%)	Net Profit Margin (TTM*) Indus. (%)	Debt-to-Equity Ratio (%)	Price-to-Free-Cash-Flow (X)	P/E Ratio (X)	Price-to-Cash-Flow-to-Growth Ratio (X)	Industry
Trustmark Corp. (M: TRMK)	16.6	12.6	14.8	23.3	14.7	0.0	8.7	14.4	0.3	0727—Regional Banks
AmeriCredit Corp. (N: ACF)	26.8	8.5	20.7	28.4	3.8	34.6	13.7	13.1	0.4	0703—Consumer Fin'l Servs
Polaris Industries Inc. (N: PII)	42.5	4.8	38.5	6	–0.4	7.5	15.0	18.5	0.4	0430—Recreational Products
Barra, Inc. (M: BARZ)	59.8	–28.9	24.7	64	–30.2	0.0	19.8	31.3	0.4	1036—Software & Program'g
Hormel Foods Corp. (N: HRL)	19.6	9.4	18.0	4.5	2.2	44.3	20.4	20.1	0.5	0515—Food Processing
Robert Half Int'l Inc. (N: RHI)	15.7	–4.1	24.8	4.9	–1.9	0.3	26.3	41.2	0.7	0909—Business Services
Graco Inc. (N: GGG)	43.4	2.7	75.8	13.8	0.7	0.0	30.3	21.7	0.7	0218—Misc. Capital Goods
Pier 1 Imports, Inc. (N: PIR)	18.2	5.9	19.4	6.5	0.4	4.3	12.9	22.1	0.8	0963—Retail (Specialty Non-Apparel)
Waters Corp. (N: WAT)	21.0	0.0	34.0	13.3	–3.2	0.0	24.0	30.9	0.9	1030—Scientific & Tech Instr
Abercrombie & Fitch Co. (N: ANF)	33.3	8.9	71.6	12.4	2.1	0.0	30.3	19.3	0.9	0945—Retail (Apparel)
Fair, Isaac and Co., Inc. (N: FIC)	19.7	–4.1	19.8	15.1	–1.9	0.0	31.8	29.6	0.9	0909—Business Services
Investment Technology (N: ITG)	29.0	2.7	34.8	20.9	2.6	0.0	22.7	31.0	1.0	0718—Investment Services
Lincare Holdings Inc. (M: LNCR)	19.7	10.4	21.0	16.6	1.5	17.0	21.6	25.4	1.1	0806—Healthcare Facilities
Adobe Systems Inc. (M: ADBE)	27.9	–28.9	33.0	15.9	–30.2	0.0	28.9	52.1	1.1	1036—Software & Program'g
Automatic Data Processing (N: ADP)	21.4	–4.1	19.8	14.1	–1.9	1.9	31.8	35.6	1.2	0909—Business Services
Deluxe Corp. (N: DLX)	116.6	4.5	45.3	14.5	1.0	12.8	21.6	16.6	1.3	0518—Office Supplies
3M Company (N: MMM)	23.0	9.0	26.8	8.9	2.6	25.0	42.4	34.1	1.3	0303—Conglomerates
North Fork Bancorp. (N: NFB)	24.2	12.6	25.6	29.9	14.7	0.0	20.0	17.6	1.4	0727—Regional Banks
Pfizer Inc. (N: PFE)	42.8	26.1	35.0	24.1	14.7	14.3	58.6	32.5	1.4	0809—Major Drugs
Linear Technology Corp. (M: LLTC)	17.4	–9.6	25.9	41.7	–10.5	0.0	52.1	44.7	1.5	1033—Semiconductors

**ROE = Return on equity; TTM = Trailing 12 months*

Source: AAII's Stock Investor*/Market Guide, Inc. Data as of April 12, 2002.*

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

Graham's investment management firm, where he learned firsthand how to apply Graham's investment approach.

Eventually Buffett moved back to Omaha to form a successful investment partnership that consistently beat the market by a wide margin. Shortly after the partnership disbanded in 1969, Buffett invested $25 million of his profits from the partnership in Berkshire Hathaway, an ailing textile company. While the textile division was closed down in 1985, the cash generated by the textile group was used to invest in other firms, most notably insurance companies. Insurance companies are effectively investment vehicles that invest the premiums paid by policyholders until claims are paid out.

Today Berkshire Hathaway is best thought of as a holding company that invests in a wide range of businesses beyond insurance, including a newspaper, a candy company, an ice cream chain, a time-share private jet firm, a vacuum cleaner manufacturer, and even a couple of shoe companies.

DEVELOPING THE APPROACH

Buffett's criteria in selecting companies are straightforward:

- Simple understandable business,
- Consistent earnings power,
- Good return on equity,
- Little debt,
- Good management,
- $5 to $20 billion in size—the larger the better, and
- Avoid turnarounds and hostile takeovers.

Buffett advocates a focused, low turnover investment portfolio. Hagstrom feels that it is becoming more difficult to beat the market as investors become educated and sophisticated with their analysis. To excel in this environment, investors must be willing to make concentrated bets. Buffett argues that the only investors who need wide diversification are those who do not know what they are doing.

Hangstom identifies 12 basic principles that a company should possess to be considered for purchase. Not all of Buffett's purchases displayed all of these tenets, but as a group the principles help to establish a reasonable approach toward selecting stocks. The tenets cover both qualitative and quantitative business elements, which we used to help create a stock screen using AAII's fundamental stock screening program, *Stock Investor Pro*.

BUFFETT'S BUSINESS TENETS

1. Is the business simple and understandable?

Knowledge helps to increase

investment return and decrease risk. Buffett warns that if you buy a company for superficial reasons, then there is a tendency to dump the stock at the first sign of weakness. Investors need to be able to understand company factors such as cash flow, labor issues, pricing flexibility, capital needs, revenue growth, and cost control. The only way to gain this knowledge is to limit your investments to areas of your expertise.

We did not include or exclude any specific industries in our screen, but to be true to the Buffett methodology, you would be wise to focus on industries in which you possess expertise. We did, however, filter out small-cap firms by requiring a market capitalization of at least $1 billion. This filter cut the starting universe of 8,888 companies down to 1,355 firms.

2. Does the business have a consistent operating history?

Buffett avoids companies that are either solving difficult business problems or fundamentally changing their direction because previous plans were unsuccessful. Turnarounds rarely succeed in their turn. Buffett feels that the best returns come from companies that have been producing the same product or service for years.

While this tenet is primarily a qualitative element, one can screen for positive operating profit over each of the last seven years as a basic test for consistent performance. This filter cut the universe of companies down to 812 stocks.

3. Does the business have favorable long-term prospects?

Buffett feels that the economic world is divided into a small group of "franchise" companies and a large group of commodity businesses. Companies with a "franchise" produce a good or service that is needed or desired, has no close substitute, and is not strongly regulated. Companies should have a strong, sustainable business advantage that protects sales and profits from competitors.

While this a qualitative screen, many of the other financial tenets below help to identify franchise companies.

MANAGEMENT TENETS

4. Is management rational?

When considering a company, Buffett evaluates managers for their rationality, candor, and independent thinking. Much insight can be gained from reading a few years' worth of annual reports.

Buffett looks for companies whose managers behave like business owners and act in a rational way, especially in treatment of retained earnings and investment of company profits. This issue becomes critical as companies mature and generate excess cash flow that cannot be reinvested in the primary business line at high rates of return. While Buffett has used these cash flows to acquire strong companies, he favors companies that use excess cash to repurchase shares. The share repurchase helps to shore up the stock price through rising demand and increases the proportional claim toward income for the remaining shares.

5. Is management candid with its shareholders?

Buffett holds in high regard managers who fully disclose company performance, equally reporting mistakes and successes. This is very much a qualitative screen that must be analyzed once your search is narrowed.

6. Does management resist the institutional imperative?

Buffett looks for companies run by managers willing to think independently. Most managers follow the "institutional imperative" to imitate the behavior of other managers because they are afraid to stand out and look foolish. Most managers cannot control their lust for activity and have an exaggerated sense of their own abilities.

FINANCIAL TENETS

7. Focus on return on equity, not earnings per share.

Buffett does not take quarterly or yearly results too seriously when studying company financials. He finds it better to focus on three- to five-year averages to gain a feel for the financial strengths of a company.

While Wall Street typically measures company performance by studying earnings per share, Buffett looks for strong and consistent return on equity that is achieved without excess leverage or accounting gimmickry.

The screen looks for return on equity above 15% over the last four quarters and for each of the last three fiscal years. This filter reduced the number of passing stocks to 234.

Companies can increase return on equity by increasing asset turnover, widening profit margins, or increasing financial leverage. Buffett is not against the use of debt—financial leverage—but warns against excessive use of debt. Acceptable levels of debt vary from industry to industry, so a filter was added that requires debt-to-equity ratios to be below the respective industry norm. This filter further reduced the number of passing companies to 94 stocks.

8. Calculate "owner earnings."

Buffett looks beyond earnings and even cash flow to measure company performance. Buffett judges performance using "owner earnings," which Hagstrom defines as net income plus non-cash charges of depreciation and amortization less capital expenditures—the basic calculation for free cash flow. Free cash flow and free cash flow growth are used later in the screen to help value the company.

9. Look for companies with consistent and high profit margins.

Buffett seeks franchise companies selling goods or services in which there is no effective competitor,

either due to a patent or brand name or similar intangible that makes the product unique. These companies typically have high profit margins because of their unique niche; however, simple screens for high margins may only highlight firms within industries with traditionally high margins. The Buffett screen looks for companies with operating margins and net profit margins above their industry norms. The operating margin concerns itself with the costs directly associated with production of the goods and services, while the net margin takes all of the company activities and actions into account. Follow-up examinations should include a detailed study of the firm's position in the industry and how it might change over time. This filter reduced the number of passing companies from 94 to 88.

10. For every dollar retained, make sure the company has created at least one dollar of market value.

The market recognizes companies that use retained earnings unproductively through weak price performance. Buffett feels companies with good long-term prospects run by shareholder-oriented managers will gain market attention, which results in a higher market price. The screen required at least a dollar-for-dollar share price increase for each dollar of increase in retained earnings over the last five years. This necessitated the use of custom fields in *Stock Investor,* and when the filter was applied, the number of passing companies dropped to 77.

VALUING A STOCK

11. What is the value of the business?

Even if you have identified a good company, it does not necessarily represent a good investment unless it can be purchased at a reasonable price. Buffett uses a discounted free cash flow model, which totals future free cash flows and then discounts this figure by an appropriate discount rate. The discount rate is based upon the long-term government bond rate adjusted upward by as much as three percentage points to provide an added margin of safety.

This is a process that involves careful and thorough analysis—something not easily suited to preliminary screening.

12. Purchase stock if it can be acquired at a significant discount to its valuation.

Many investors turn to simple multiples, such as price-earnings ratios, to help establish a preliminary hurdle before an in-depth analysis is performed. Since Buffett likes to focus on free cash flow, the price-to-free-cash-flow ratio is used in the screen. The price-earnings ratio is presented in the table of passing stocks as a point of comparison.

However, a company with higher growth deserves to trade at a higher multiple than a slower growing firm. To adjust for varying growth rates, the price-to-free-cash-flow ratio was divided by the free-cash-flow growth rate to help equate value to growth. The companies with the lowest ratios of free cash flow multiple to growth rate ratio are presented in Table 1. Like all screens, this represents a starting point for in-depth analysis.

The table of passing companies includes a diverse set of companies operating in a wide range of industries. Deluxe Corp. presents an interesting case study. It is the largest printer of checks and related forms in the country with a commanding 51% market share. Its return on equity is surging, not so much because of earnings increases, but more because of an aggressive share buyback program that has reduced the number of outstanding shares by nearly 20% over the last five years. In 2001, every dollar of sales generated 14 cents of profit and 10 cents of free cash flow, which the company has also used to pay a hefty dividend (3.3%). Deluxe is a mature company and growth in its core business is due to the overall rate of economic growth and its ability to take additional market share. Deluxe has some pricing flexibility, as exhibited by a recent 4% price increase, but expansion in the use of electronic payments helps to explain why the company is trading at a below market multiple.

CONCLUSION

Warren Buffett's approach identifies "excellent" businesses based on the prospects for the industry and the ability of management to exploit opportunities for the ultimate benefit of shareholders. He then waits for the share price to reach a level that would provide him with a desired long-term rate of return.

Most investors have little trouble understanding Buffett's philosophy. The approach encompasses many widely held investment principles. Its successful implementation is dependent upon the dedication of the investor to learn and follow the principles.

Duplicating the process requires a considerable amount of time, effort, and judgment in perusing a firm's financial statements, annual reports, and other information sources to thoroughly analyze the business and quality of management.

It also requires patience, waiting for the right price once a prospective business has been identified, and the ability to stick to the approach during times of market volatility. But for individual investors willing to do the considerable homework involved, the Buffett approach offers a proven path to investment value. ✦