STOCK ANALYSIS WORKSHOP

Screening for Cash-Rich Firms That Will Put Their Money to Good Use

By John Bajkowski

Investors may be tempted to scan for defensive securities considering the recent market volatility and rich valuation levels of the market compared to historical benchmarks (a current price-earnings ratio of 18.9 and dividend yield of 2.2% versus a 15.1 average price-earnings ratio and 3.7% average dividend yield since the 1960s). Many consider the ultimate safety net for a firm to be a high cash position. With a large cash hoard, a firm should be able to weather an economic storm, or so the reasoning goes. However, there are difficulties in identifying firms that have truly strong financial positions and gaining a feel for the long-term prospects of these cash-rich firms.

Strengths and Drawbacks of a High Cash Position

A healthy cash position provides important flexibility and safety to a firm. Cash-rich firms should be able to more easily meet their debt obligations, decreasing the probability of a creditor weakening the position of the equity investors or even gaining control of the firm. During an economic slow-down, cash allows a cyclical firm to continue its research and development efforts, as well as undertake capital expansion or productivity improvements, in anticipation of an economic rebound.

Firms with excess cash positions can also elect to distribute the cash to shareholders in the form of dividends—although double taxation is a weakness to the high payout strategy. The firms pay corporate taxes when they earn the money and shareholders must pay taxes at their marginal tax rate when they receive the dividend. To avoid the double tax, many firms have chosen to use excess cash to repurchase shares on the open market. This helps to boost the share price in the short term by providing demand for shares. And with fewer outstanding shares, the same level of net income boosts earnings per share.

Firms with excess cash can also attempt to use the cash strategically to broaden their product lines or diversify into new areas. This can be accomplished either through direct capital investment or the outright purchase of another firm.

Cash-rich firms can also be attractive acquisition candidates. While much more common in the leveraged buyout craze of the 1980s, the cash prize reduces the actual purchase price of the firm and the cash flow that allowed the cash hoard to be built helps to service the debt incurred acquiring the firm.

A high cash position can also be a disadvantage. Cash is generally defined as cash plus marketable securities that are readily convertible into cash. This would consist of bank deposits and short-term instruments such as Treasury bills. The cash position may reduce profitability if it earns a lower rate of return than other assets in the company. One would expect any corporate investment to earn more than the money market rate in the long run.

When finding firms with large cash balances, the critical question becomes: Why are they holding on to the cash? Often it points to a firm in a mature industry with little growth prospects. The firm may have reasonable profit margins, but little need for additional capital. For such a firm, the need for a good management team is especially important. Unlike a start-up, which must pass the tests of the capital markets to raise cash in an effort to expand into a new market, management has carte blanche to spend the firm's cash as it sees fit. Wall Street is filled with stories of firms divesting or spinning off unprofitable divisions that were acquired a few years back at rich premiums.

Measuring Cash Levels

The amount of cash per share to the market price per share provides a useful indication of the cash level of the firm. General Electric may have $3 billion in cash, but this works out to a cash level equal to about 2.5% of the stock value (cash divided by market capitalization).

Screening for firms with high proportions of cash to share price represents a reasonable starting point in tracking down cash-

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Table 1.
Cash-Rich Firms

	Cash to Price (%)	Net Cash to Price (%)	Free Cash Flow to Price (%)	Dividend Yield (%)	Price-Earnings Ratio (X)	Growth Rate I/B/E/S Est. Historical EPS (%)	Growth Rate I/B/E/S Est. Long-Term (%)	Growth Rate I/B/E/S Est. Historical Sales (%)	52-Week Relative Strength (%)	Description
Large-Cap Stocks (above $1.5 billion)										
Temple-Inland (N)	179.2	na	–5.6	3.0	8.6	–9.0	9.0	8.6	–35	Holding co. in paper, pkg, & build'g prod
UAL Corp. (N)	75.4	–152.3	19.2	0.0	7.4	–44.7	10.0	7.3	49	Holding co. of United Airlines
Northwest Airlines (M)	52.1	–55.8	21.5	0.0	11.5	na	9.0	na	60	Holding co. of Northwest Airlines Inc.
Delta Air Lines (N)	34.7	–48.9	3.5	0.3	9.5	–6.8	9.0	7.3	1	Air transport for passengers, mail, freight
General Motors Corp. (N)	33.9	na	9.3	3.1	7.3	–0.5	6.0	4.1	–1	Autos, trucks, & related parts; defense prods
King World Produc'ns (N)	33.1	25.7	9.0	0.0	11.8	7.9	11.0	4.8	–11	Distribs TV programs, feature films
Foster Wheeler Corp. (N)	32.5	–35.6	–9.3	1.8	21.7	13.9	15.0	12.4	6	Design, engineer'g, construct'n, mfg operations
Apple Computer (M)	32.4	–47.3	–21.6	1.7	20.4	–1.8	15.0	14.8	–50	Personal computers & related products
PACCAR (M)	32.0	–54.9	8.5	2.1	7.5	–2.6	8.0	5.0	–17	Multinational design, mfr heavy-duty trucks
Moore Corporation Ltd. (N)	31.5	5.4	0.6	4.8	7.1	–10.7	12.0	–2.4	–19	Manufactures business forms
Canon (M)	29.8	–21.3	–0.6	0.6	49.0	–6.5	15.0	7.4	–9	Electronics; fine chemicals; & engineer'g
Novell (M)	28.9	18.8	8.0	0.0	13.5	21.5	15.0	32.6	–56	Networking and application software
National Semiconductor (N)	28.3	–4.8	–7.9	0.0	7.0	48.7	12.0	7.3	–33	Designs, manufactures semiconductor prods
General Dynamics (N)	26.3	3.6	9.6	2.5	13.0	1.8	8.0	–20.2	–2	Armored vehicles; submarines; coal mining
Liz Claiborne (N)	26.2	3.0	5.0	1.4	26.2	–10.8	12.0	8.9	57	Designs & mkts apparel, fragrances, & cosmetics
Mid-Cap Stocks ($250 million to $1.5 billion)										
Chris-Craft Indus. (N)	121.2	101.5	14.4	0.0	40.5	–33.1	na	12.5	–5	TV broadcasting; polyvinyl alcohol film
WHX Corporation (N)	105.9	32.7	16.4	0.0	5.4	–36.0	10.0	0.8	–16	Integrated steel manufacturer
Amdahl Corp. (A)	77.6	22.2	9.5	0.0	9.4	–14.7	5.0	–4.9	–39	High-perform general-purpose computer systems
VLSI Technology (M)	76.4	43.8	3.5	0.0	13.4	109.4	21.0	15.3	–40	Custom & semi-custom integrated circuits
BHC Communications (A)	66.0	56.8	6.8	0.0	44.3	–32.8	na	13.1	–5	Holding co. in TV broadcasting
LTV Corporation (N)	65.9	–9.7	37.1	0.0	7.2	–8.9	7.5	–6.6	–35	Steel & energy industries
National Presto Indus (N)	65.3	51.3	–2.4	4.8	13.7	–5.6	6.0	0.1	–26	Electrical appliances and housewares
Seaboard Corp. (A)	61.9	20.1	–44.7	0.4	10.8	13.5	na	13.7	10	Poultry & pork process'g;
Navistar International (N)	57.6	na	33.1	0.0	5.5	25.8	5.5	10.5	–46	Holding co. of diesel truck manfacturer
Alaska Air Group (N)	48.2	–100.3	13.1	0.0	23.7	–9.1	9.0	7.5	13	Holding co. for Alaska Airlines & Horizon Air
Mercer International (M)	47.8	7.1	3.9	0.0	4.7	43.1	20.0	55.3	0	Pulp & paper indus; financial services
Silicon Valley Group (M)	45.9	22.3	–3.7	0.0	13.4	30.5	22.0	20.2	–31	Automated wafer process'g equip
Continental Airlines (N)	45.4	–75.1	16.2	0.0	7.2	16.2	10.0	–1.3	338	Air transport of passengers, cargo, mail
FSI International (M)	41.0	19.2	–8.9	0.0	10.4	48.3	25.0	28.5	–43	Equip used in fabrication of integrated circuits
Farmer Brothers Co. (M)	38.3	30.5	8.4	1.6	12.6	–0.3	na	3.5	–14	Coffee, spices, & allied food prod for food serv
Shadow Stocks (small-cap firms with low institutional interest)										
Astrosystems (M)	97.9	93.0	14.6	0.0	55.8	33.4	na	4.1	5	Electronic measure & control devices
Daxor Corp. (A)	97.5	80.2	1.4	0.0	27.2	43.8	na	17.4	–13	Cryopreservation tech for human semen & blood
Wilshire Oil Co. of Texas (N)	62.4	51.1	–7.7	1.2	19.0	73.3	na	9.9	–29	Explore & prod oil & gas in U.S. and Canada
Salem Corp. (A)	48.8	–36.8	–7.7	2.6	13.1	13.8	na	1.2	–21	Industrial equip for furnaces, metal process'g
Sevenson Environmental (M)	47.6	30.5	–4.3	1.3	9.7	5.3	15.0	8.3	–22	Field serv for remediation of hazard materials
Intrav (M)	45.4	–50.3	–4.8	6.3	9.6	na	na	na	na	Escorted international travel programs
Thermo Voltek Corp. (A)	42.5	29.7	0.1	0.0	38.6	19.8	20.0	27.7	49	Instruments to test electronic & elec'l systems
National Beverage Corp. (A)	39.3	–46.6	5.4	0.0	8.0	72.6	na	3.0	–22	Holding co. for branded soft drinks
Detroit & Canada Tunnel (M)	32.3	25.4	–10.4	1.6	10.4	0.1	na	–8.7	–8	Operates tunnel connecting Detriot & Windsor
Align-Rite International (M)	32.2	17.9	0.8	0.0	11.4	na	na	na	na	Manufactures photomasks for integrated circuits
Lynch Corp. (A)	32.0	–57.3	–8.8	0.0	19.1	8.2	na	16.4	20	Holding co. for multimedia, serv & manufac'g
American Filtrona Corp. (M)	27.5	8.5	2.6	3.0	13.2	0.0	na	0.4	–7	Fiber filters for tobacco prods
New Mexico & Arizona Land (A)	26.6	23.8	7.1	0.0	6.3	21.9	na	15.9	49	Real estate sales, exchanges, & devlp
FDP Corporation (M)	25.9	16.7	0.9	0.0	23.6	52.7	na	5.0	–8	Application software for life insurance indus
Industrial Scientific (M)	24.7	18.6	5.7	0.0	15.6	29.3	11.0	24.9	–26	Portable instruments for measuring gases

Definitions of Screens and Terms

The following is a short description of the screens and terms used for this month's Shadow Stock listing.

Cash to Price per Share: Cash and cash equivalents per share divided by the market price per share. Indicates what percentage of the stock price is equal to cash per share. The higher the percentage, the more cash on hand relative to share price.

Net Cash to Price per Share: Cash and cash equivalents per share less current liabilities per share divided by market price. Indicates percentage of stock price equal to net cash per share, a more conservative measure than cash to price per share. A higher percentage indicates a higher level of cash per share relative to share price.

Free Cash Flow to Price per Share: Free cash flow per share divided by price per share. Free cash flow per share is defined as cash from operations minus capital expenditures and dividends paid. Positive ratios indicate that the firm has positive free cash flow and is able to meet the needs of its capital expenditures and dividend payouts from internal operations. The higher the percentage, the greater the free cash flow relative to share price.

Dividend Yield: Annual dividends per share divided by price per share. An indication of the income generated by a share of stock.

Price-Earnings Ratio: Market price per share divided by the firm's earnings per share. A measure of how the market currently values the firm's earnings growth and risk prospects. High price-earnings ratios indicate high expectations of future earnings growth.

Historical EPS Growth Rate: Annual growth in earnings per share over the last five years. A measure of how successful the firm has been in generating the bottom line, net profit.

I/B/E/S Est. Long-Term Growth Rate: The median growth rate in earnings per share in continuing operations expected over the next five years that is being forecasted by analysts tracked by I/B/E/S. An indication of the growth expectations for the firm.

Historical Sales Growth Rate: Annual growth in sales over the last five fiscal years. Used to provide a confirmation of the quality of historical earnings per share growth rate.

52-Week Relative Strength: Price performance of the stock during the last year relative to the price performance of the S&P 500 index. A figure of 0 indicates the stock had the same percentage price performance as the market. A figure of 5 indicates that the stock outperformed the market by 5%.

rich firms. When performing such a screen, it is important to exclude financials, because by the nature of their business they are required to hold large cash positions. Utilities were also excluded because of their regulated nature and overall low growth potential.

To perform this screen, AAII's *Stock Investor* program was used. In addition to excluding financials and utilities, a filter requiring positive earnings from continuing operations for the last 12 months was specified as a minimum current profitability requirement, along with a minimum share price requirement of five dollars. Without the minimum share price requirements, bankrupt firms with a share price of a few pennies would dominate. The securities were broken into three groups—large-capitalization, mid-cap, and Shadow Stocks. (Shadow Stocks are defined by AAII as stocks of small nonfinancial companies with low institutional interest, and that have had positive earnings for the last two years.) The 15 stocks with the highest percentage of cash to price are listed for each group in Table 1.

As important as it is to look at cash, it is equally important to look at the financial obligations of the firm. In the mid-cap group, WHX Corporation's cash position is equal to 105.9% of its share price, compared to 121.2% for Chris-Craft Industries. A quick look at balance sheets of the firms reveals large differences. WHX is the ninth largest domestic integrated steel manufacturer and has emerged from a chapter 11 reorganization. Its $12.32 per share in cash is quickly reduced when one considers the firm's short-term liabilities and long-term debt. Some firms build up a cash reserve to ensure that they can meet the required payments of their short-term debt and current portion of long-term debt. When borrowing money, they may be required to hold compensating balances as terms of the loan. In the case of WHX, its annual 10-K filing indicates that it intends to retain any future earnings for working capital needs and to finance capital improvements, and it does not intend to pay cash dividends on the common stock for the foreseeable future. In addition, the terms of the company's senior debt places certain limitations on WHX's ability to pay cash dividends.

A useful modification to the gross cash to price per share ratio is to subtract the short-term liabilities from cash to establish a net cash per share figure, which provides a better measure of the excess cash on hand. Dividing the net cash per share by the share price indicates how much of this "excess cash" is available on a per share basis. In the case of WHX, considering short-term liabilities drops the ratio of cash to price from 105.9% to 32.7%. While this is still a significant number, it paints a different picture than that for Chris-Craft Industries, which manages to maintain a net cash to share price per share ratio of 101.5%.

While the mention of the name Chris-Craft may bring the image of boats to mind, the company has reinvented itself into primarily a television broadcaster through its majority owned subsidiary, BHC Communications, which also made the screen as a separate entity—highlighting the problem of double counting when screening.

Many of the firms with positive ratios of cash to price per share have negative ratios once short-term liabilities are considered. The effect is especially pronounced with the many airline stocks that passed the initial screen. These firms have heavy capital expenditure requirements and are heavy users of cash in operations. While these companies have made a recent turnaround and the industry is turning profitable after a number of years of running in the red, the high gross cash positions are not significant when screening for cash-rich firms.

Three firms, Temple-Inland, General Motors, and Navistar, do not show a net cash to price per share ratio calculation because they do not maintain clear-cut divisions between current and long-term assets and liabilities.

Beyond looking at the static cash positions of these firms, an examination of the actual cash the firm is providing is even more important for a long-term investor. Free cash flow is calculated by taking the cash flow from operations as reported on the firm's statement of cash flow and subtracting capital expenditures and dividends. This measure attempts to capture whether the firm is generating enough cash to help fund any necessary internal capital expenditures. Apple, which has a positive cash to price ratio, has a negative ratio of free cash flow per share to market price. It is not generating enough cash from its operations to cover its currently required capital expenditures. Its current position points out the need for the company to determine whether it should jettison some of its product development ideas and focus on those that show the greatest potential.

In contrast, another technology firm, Novell, has a lower cash to price ratio, yet has positive net cash to price per share and positive free cash flow to price per share. Novell dominates the network operating systems marketplace for personal computers, but is facing increased competition from vendors such as Microsoft. In the past, Novell has used its built-up cash hoard and excess cash flow to acquire products in an attempt to diversify its product line. It acquired UNIX System Laboratories in 1993, merged with WordPerfect in 1994 and purchased Quattro Pro from Borland in 1994. As is too often the case, things did not go as well as planned. Novell just sold off its WordPerfect and Quattro product lines to Corel and its UnixWare product line to the Santa Cruz Operation, so that it could focus on its primary business unit.

The price-earnings ratio is the traditional measure of value and market expectations. The price-earnings ratio is computed by dividing a stock's price by its most recent 12 months' earnings per share. The price-earnings ratio is closely followed because it embodies the market's expectation of future company performance; companies with high price earnings ratios have greater expectation of future performance than those with low ratios. A value investor would typically search for stocks with low price-earnings, with the belief that the market has mispriced the stock.

The price-earnings ratios for this group ranges from a low of 4.7 for Mercer International to a high of 55.8 for Astrosystems. Many of the cyclical companies such as Navistar are currently carrying low price-earnings ratios because the market feels that the economy's growth potential is limited and these firms would suffer if the economy topped out. So while Navistar currently has a positive free cash flow per share and has a very high earnings growth rate of 25.8% annually over the past five years, its growth potential is limited. The I/B/E/S consensus long-term earnings growth estimate of 5.5% confirms this market view. It is common for cyclicals to carry low price-earnings ratios late into the economic cycle.

Many of the companies that passed our initial screen are capital-intensive firms that benefited from operating leverage, in which a small boost in sales translates to a larger boost in earnings. Sales growth rates are often used to confirm the strength of earnings per share.

The final data element presented in Table 1 shows the 52-week relative strength versus the S&P 500 index; positive figures indicate the percentage that the stock outperformed the S&P 500, and negative numbers indicate the percentage that the stock underperformed the S&P 500. As a whole, this group has performed poorly on a relative basis, with the airline group being the notable exception. The few firms with an "na" designation have gone public in the last year.

Conclusion

Screening for cash-rich stocks is not a simple process. Preliminary filters should screen for companies that have not only a high level of cash per share, but also a strong balance sheet, the potential for future earnings growth, and positive free cash flow per share. Much of the final analysis rests on your belief in management's ability to use any cash hoard wisely.

Screening Criteria
For use with AAII *Stock Investor* program

Found in the Company Information Group:	
IND_2_DIG <> 07	Sector is not equal to Financial
IND_2_DIG <> 12	Sector is not equal to Utility
IND_3_DIG <> 0933	Industry is not equal to Real Estate Operations
Found in the Price and Share Data Group:	
MKTCAP > 20	Market capitalization in the last quarter is greater than $20 million
PRICE > 5	Price is greater than $5 per share
Found in the Income Statement—Annual Group:	
EPSCON_12M > 0	Earnings per share from continuing operations for the last 12 months is greater than 0.

User Defined

Cash to Price per Share or Net Cash to Price per Share is Greater than 20%

Cash per Share:

Cash_Q1 / Shr_AQ1

Cash to Price per Share:

((Cash_Q1 / Shr_AQ1) / Price) * 100

Net Cash per Share:

(Cash_Q1 - CL_Q1)/SHR_AQ1

Net Cash to Price per Share:

(((Cash_Q1 - CL_Q1)/SHR_AQ1) / Price) * 100

Found in Balance Sheet—Quarterly:

Cash

Current libilities Q1

Found in Price & Share Data:

Shares average Q1

Price