

How I Analyze Net-Nets: Stocks Trading at Deep Discounts

By Jeroen Bos

Article Highlights

- Net-nets are stocks whose net current assets exceed the company's market capitalization.
- A good starting point for finding such stocks is to look at a list of stocks hitting 52-week lows.
- Check to see if the balance sheet has been stable, debt is low and that the company has been profitable in the past.



The famous investment firm Tweedy, Browne once put together an interesting publication that brought together numerous studies conducted around the world into a survey of what investing approaches have worked best over different time frames.

The publication is called “What Has Worked in Investing” (www.tweedy.com/resources/library_docs/papers/WhatHasWorkedFundVersionWeb.pdf), and it found that value investing tends to consistently outperform other investing styles, especially in the long term.

Tweedy, Browne went further and broke these studies down into five categories, making it easy to look for specific value strategies that have worked the best.

The five main categories were:

- 1. Low price in relation to asset value;
- 2. Low price in relation to earnings;
- 3. A significant pattern of purchases by one or more insiders (officers and directors);
- 4. A significant decline in a stock's price; and
- 5. Small market capitalization.

In the first category—dealing with a low price in relation to asset value—there is a study that I found particularly interesting. Conducted over the period April 30, 1970, to April 30, 1981, it is titled: “Price in relation to book value,

and stocks priced at 66% or less of net current asset value.”

Concentrating on three-year holding periods, this study found that stocks that were bought at less than 30% of book value (including those stocks that traded at 66% of net current asset value) gave on average a 87.6% return after three years, while the S&P 500 index generated a 27.7% return. The study also showed that this group generated better returns over that same time period than any other group that was trading at a smaller discount to book value or even a premium to book value.

These are eye-catching findings.

As the study's conclusion stated: “One million dollars invested on April 30, 1970, and rolled over at each subsequent April 30, into the stocks selling at less than 30% of book value would have increased to \$23,298,000 on April 30, 1982. One million dollars invested in the S&P 500 on April 30, 1970, would have been worth \$ 2,662,000 on April 30, 1982.”

The kind of returns generated by this group caught my attention when I read this study for the first time many years ago. It seemed incredible that a group of stocks could boast such outperformance while also being quite easy to identify.

After all, I think it is easier to establish the book value of a particular company than make accurate predictions about its future prospects. Book values tend to be more stable. Although they can erode over time, they are usually more resilient than the earnings of most companies over similar

Important Characteristics to Look at in Net-Net Stocks

- **1. Low levels of debt.** This is very important when considering investing in deep value situations. As these types of investments usually mean that the company in question is no longer profitable, the balance sheet will be under strain and the margin of safety will be eroded over time. Having little or no debt will put the company in a much stronger and more stable position. It will potentially give the company the possibility to add debt, as there should be headway to do this once the path to return to profitability is re-established. I like current assets to be made of stocks, debtors and cash roughly in equal parts. If it is all made up of stocks, then any valuation based on that will be much more circumspect.
- **2. Positive cash flow.** Any new potential investment must have positive cash flow for a number of years in its recent history. Even if all the conditions seem to be in place for a good deep value investment, if cash flow has been negative for a few years I will be very hesitant to invest. At the least, it will be very important to investigate such situations further before investing.
- **3. The company must have been profitable at some stage.** The business model that the company uses must have been profitable in the past. For this reason, I tend not to invest in companies with untried track records. Avoiding companies lacking this requirement and positive cash flow will protect us from an ever-eroding margin of safety where the company may well be forced to raise further capital.
- **4. The current share price is near or at all-time lows.** This indicates the sense of disappointment that the current share price has and that we may be reaching “capitulation level” where further bad news largely leaves the share price at current levels. Looking at this gives me some idea as to what levels the share price should be able to return to once the company hits higher profitability levels again.
- **5. Institutional shareholder ownership.** I like to see other institutional shareholders on the shareholder list to give me a sense of safety that other shareholders are able to engage with the company when this would be necessary. It is also good to check that the directors and officers of the company own stock, meaning they have “skin in the game.”
- **6. A stable balance sheet.** When checking the accounts of the company, I like to see a balance sheet that stays stable over a period of reporting years, with no frequent changes of accounting treatments or turnover in the accountants/auditors.

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periods. And buying stocks trading at big discounts to book value should give a certain margin of safety: Less is paid for assets than what those assets are valued at on the balance sheet.

Net-Net Stocks

Among this group of stocks in the Tweedy, Browne study was a subgroup of stocks trading at 66% or less of net current asset value. When stocks traded at this level, no value was ascribed to any fixed assets the companies might have had. To put this a different way, these companies could be bought at very low valuations and the fixed assets were free. They were not yet “bargain stocks” or “net-nets,” which can be even cheaper, but if we ever come across shares like this we know we are dealing with stocks that are trading at the very margin of

their book values.

So-called net-nets are at the most extreme end of this subgroup. Net-nets are stocks whose net current assets—defined as current assets after subtracting all liabilities (i.e., short and long-term liabilities)—exceed the company’s market capitalization. In other words, a “net-net” exists when working capital divided by the number of shares outstanding has a higher value than the company’s share price in the equity market.

When we find a stock at these valuations, we have a situation where the liquid assets alone are worth more than we need to pay to buy the entire company. The company could be bought and put into liquidation and the investor should expect to get back more than what he or she paid for it. The fixed assets come for free, potentially raising the total returns on his or her investment if they can also

be disposed of profitably.

Basing one’s investment around such companies still strikes me as exciting: It maximizes the upside and minimizes the downside in a very simple way and requires little more than public information and patience. It is the investing approach I have followed throughout my career and which I explore in my recent book, “Deep Value Investing” (Harriman House, 2013).

It may seem incredible that situations like this can exist in equity markets, with owners of some stocks willing to sell their holdings for less than their liquidation value. But there are many reasons why such situations arise. They usually involve a lengthy period of severe underperformance in the equity market, bringing disillusionment and exhaustion from those who perhaps once held the shares at a higher value. Such stocks

also often come with a certain amount of “baggage” and the outlook for them may seem dubious at best.

As a group, though, their performance clearly stands out if you can buy the right ones at the right time—and it would seem that this should be a very rewarding hunting ground for the value investor.

I have found that identifying these stocks is easiest in those sectors or markets that have had a pretty miserable time, and where substantial share price contraction has been experienced. A good starting point for this is to keep a close eye on stocks that hit new 52-week lows and see if any of them have interesting balance sheets.

Working Capital Should Exceed Current Share Price

My initial aim is to see if I can find any stocks that are trading at such levels where the net-net working capital position (the current assets minus all liabilities) divided by the number of shares is worth more than the current share price.

This may sound like quite a mouthful, but it is actually a very simple calculation to make. If a company’s balance sheet has \$10 million in current assets and \$4 million in total liabilities (i.e., current and long-term liabilities), then the net-net working capital position is \$6 million. If this company has five million shares outstanding, then the net-net working capital position per share is \$1.20. Comparing this with a current share price of, say, \$0.90, we can say that we have found a stock that is trading at a discount to its net-net working capital.

You might have noticed that fixed assets have not been treated as crucial to such investments. When buying a net-net we are getting the fixed assets, whatever they are, for free. They could be quite substantial and it is nice to have them, but they are usually problematic to value so I do not think it is wise to rely on them.

In particular, you will often see that fixed assets include goodwill, an asset that I tend to ignore in my calculation of

the worth of a company. I am certainly not saying that goodwill has no value, but the types of companies that we look at when dealing with net-nets will almost always either be realizing losses or be marginally profitable. As a consequence, the goodwill valuation in the balance sheet will often be at a too-optimistic valuation. The other components of the fixed assets, such as buildings and land, should show a more durable quality in terms of volatility in values.

By establishing that we have found a stock that is trading at a discount to the net-net working capital position, we can say that we have found one that on a statistical basis is cheap. The next thing I do is establish if this particular company has ever made a return on capital and if it is realistic to expect it to ever return to being profitable again.

The statements released by the company over the last few years are the primary source to delve into here. They will also help us to see how the current situation has developed. It is very important to look at the balance sheet over a number of years; I don’t like to see great movements in assets unless they are clearly explained. There are many reasons why stocks will trade at these extremely low valuations: changes in technology, legal issues, mismanagement, and the cyclicity of the industry sector they operate in, among others.

I prefer stocks that have been profitable in the past, that have been in business for a reasonably extended period of time and have “clean” balance sheets that carry little debt. This last point is important. As previously stated, these firms are usually realizing losses or are just marginally profitable. Though not a disaster at this stage, having a lot of debt on the balance sheet certainly complicates matters.

In the example of the stock trading at \$0.90 with a net-net working capital position of \$1.20 per share, we have a margin of safety of approximately \$0.30 (ignoring any fixed assets the company may have). If this particular company is marginally profitable and debt-free, then we have a pretty good position. The debt is not eroding the working capital. Plus,

the marginal profitability will protect the margin of safety and, we hope, will give the management enough time to make the assets more productive again and increase profitability going forward.

Another attraction of companies trading in these kind of circumstances is that they could be potential takeover candidates, with the working capital position potentially financing the takeover. It is my experience that this actually happens quite often. Unfortunately, a takeover offer is not always good news, because once a net-net company hits its stride again on its own, the earnings could grow quite some way and push the share price up to a multiple of what we paid for it. The potential return from a company hitting its stride could be higher than the gain from a company bought by someone else at a modest premium to its net asset value.

An Example of a Net-Net Stock

Although equity markets have had a pretty good run since the financial crisis, there are still examples of companies trading at low valuations that can be bought at working capital levels. A recent example I found was Gencor Industries (GENC), a U.S. company trading on the NASDAQ exchange that was a net-net, was profitable and had a very strong and liquid balance sheet.

At the time I looked at the company in early 2014, it traded at \$9.45. (Tables 1 and 2 show the balance sheet and the income statement.) The most recent company balance sheet looked like this:

- Total current assets: \$107.7 million
- Total liabilities: \$4.9 million
- Net-net position: \$102.8 million

The number of shares outstanding was 9.5180 million, giving a net-net working capital position of \$10.80 per share. Adding the fixed assets, the net asset value would work out at \$11.64 per share.

When looking at the actual balance sheet, it became immediately apparent that this balance sheet was extremely liquid. The net-net working capital position was basically all-cash or near-cash assets and the total liabilities position

Table 1. Gencor Industries Balance Sheet

Assets		12/31/13	9/30/13	6/30/13	3/31/13	12/31/12	9/30/12	6/30/12	3/31/12
Cash	\$M	5	9.6	8.5	6.4	4.3	3.4	10.8	13.5
Short-Term Investments	\$M	84.6	83.1	82	81.4	79.5	81.4	76.2	76.9
Accounts Receivable	\$M	1	1.2	1.1	1.3	1.1	1.2	1.4	1.5
Inventory	\$M	14	14.1	11.9	13.5	15.1	11.9	12	14.7
Other Current Assets	\$M	3.1	0.8	4.9	5.3	3.1	4.2	5.6	1.6
Total Current Assets	\$M	107.7	108.8	108.5	107.9	103.1	102.1	106	108.3
Net Property, Plant, Equip.	\$M	8	8.1	8.4	8.2	7.9	8.1	8.3	8.6
Long-Term Investments	\$M	0	0	0	0	0	0	0	0
Goodwill/Intangibles	\$M	0	0	0	0	0	0	0	0
Other Long-Term Assets	\$M	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total Assets	\$M	115.8	116.9	116.9	116.1	111	110.3	114.4	117
Liabilities		12/31/13	9/30/13	6/30/13	3/31/13	12/31/12	9/30/12	6/30/12	3/31/12
Accounts Payable	\$M	1	1.3	1.7	2.3	1.5	1.9	3.4	2.8
Short-Term Debt	\$M	0	0	0	0	0	0	0	0
Total Current Liabilities	\$M	4.2	6	6.1	8.9	8.4	5.9	10.4	13.9
Long-Term Debt	\$M	0	0	0	0	0	0	0	0
Other Long-Term Liabilities	\$M	0.7	0.5	2.7	1.6	0.1	1	0.2	0.5
Total Liabilities	\$M	4.9	6.5	8.8	10.6	8.5	6.9	10.6	14.4
Preferred Stock	\$M	0	0	0	0	0	0	0	0
Common Stock Equity	\$M	110.9	110.4	108.1	105.6	102.5	103.5	103.8	102.5
Total Liabilities and Equity	\$M	115.8	116.9	116.9	116.2	111	110.4	114.4	116.9

Source: AAI's Stock Investor Pro/Thomson Reuters.

Table 2. Gencor Industries Income Statement

		12/31/13	9/30/13	6/30/13	3/31/13	12/31/12	9/30/12	6/30/12	3/31/12
Sales	\$M	10	7.6	18.7	17.7	4.9	14	23	19.3
Cost of Goods Sold	\$M	8.5	6.3	13.7	13.4	4.5	12.5	17.2	15.3
Gross Income	\$M	1.5	1.3	5	4.3	0.4	1.5	5.8	4
Depreciation & Amortization	\$M	NA	NA	NA	NA	NA	NA	NA	NA
Research/Development	\$M	0.4	0.4	0.4	0.5	0.4	0.6	0.7	0.6
Interest Expense	\$M	NA	NA	NA	NA	NA	NA	NA	NA
Unusual Expenses/(Income)	\$M	0	0	0	0	0	0	0	0
Total Operating Expenses	\$M	10.6	7.6	16	15.8	6.9	15.4	20.6	18.4
Operating Income	\$M	-0.6	0	2.7	1.9	-2	-1.4	2.4	0.9
Interest Expense - non-op.	\$M	0	0	0	0	0	0	0	0
Other Expenses/(Income)	\$M	-1.5	-1.1	-0.7	-1.8	-0.2	-1.2	0.7	-3.3
Pretax Income	\$M	0.9	1.1	3.4	3.7	-1.8	-0.2	1.7	4.2
Income Taxes	\$M	0.4	-1.2	0.9	0.7	-0.8	0.1	0.5	1.4
Income After Taxes	\$M	0.4	2.2	2.5	3	-1	-0.4	1.2	2.8
Adjustments to Income	\$M	0	0	0	0	0	0	0	0
Income for Primary EPS	\$M	0.4	2.2	2.5	3	-1	-0.4	1.2	2.8
Nonrecurring Items	\$M	0	0	0	0	0	0	0	0
Net Income	\$M	0.4	2.2	2.5	3	-1	-0.4	1.2	2.8
Shares Outstanding	M	9.52	9.52	9.52	9.52	9.52	9.52	9.52	9.52
EPS - Diluted Continuing	\$/Shr	0.05	0.23	0.26	0.31	-0.1	-0.04	0.13	0.29
Dividends per Share	\$/Shr	0	0	0	0	0	0	0	0

Source: AAI's Stock Investor Pro/Thomson Reuters.

was very small when compared to the current assets, which made the margin of safety look very healthy.

The company had also been in business for a number of years and was profitable. Less attractive was the fact that it operated in a cyclical industry and suffered from client concentration, but that would explain the low valuation of this stock to a certain extent.

This is how I find and analyze a potential net-net. I do not intend to recommend you buy this Gencor Industries, or for this to act as investment advice; it is simply an example of a stock trading at net-net working capital levels and one that seems to fit the bill of the kind of stock I look for.

Why Net-Net Isn't Used by Every Investor

If the results are so clearly in the favor of net-net stocks, why isn't every equity investor following this approach?

One reason may be that in order to trade at these extreme valuations, this particular category of value stocks are typically small caps—their share prices (and market capitalization) have shrunk, in many cases by 80% or more. This makes them unattractive for large portfolio managers and unprofitable for brokerage firms to research.

Another argument is that such extreme valuations—especially net-nets—are difficult to find in today's

equity markets. But in my experience there are usually over 200 individual stocks worldwide trading as net-nets at any one time. Besides, the studies that Tweedy, Browne have collected over the years show that the approach works equally well around the world, in all the main equity markets.

In other words, there are always plenty of places to look.

They are out there and with a little bit of effort can be quite easily identified. The strategy continues to work as well as when it was first articulated by Benjamin Graham in the 1930s, whose wonderful book "The Intelligent Investor" features timeless material on what he called "bargain issues." ▲

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Trading Strategies

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nualized). In more aggressive call writing using options with a strike of \$38.00, the potential gain would be 14.0% (18.7% annualized). The covered option position should only be established if the investor finds each of these calculated numbers attractive.

Outcomes

In a portfolio approach to covered writing, the objective would be a set of

outcomes that were not only generally positive, but provided a relatively steady and attractive return.

In periods when the market rises rapidly, returns from the strategy, while attractive, might lag the market and leave a significant amount of the long stock positions' upside on the table.

On the other hand, in a declining market, the income generated by option writing coupled with the type of solid dividend-paying stocks selected for the

portfolio would generally cushion the impact of the weak market such that the overall portfolio return would be significantly above the market averages.

Finally, in a directionless market, the strategy should generally outperform the market averages, as the proceeds from option writing would add to the returns on the long stock positions without leaving much money on the table from those few stocks that did well in a market moving sideways. ▲

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