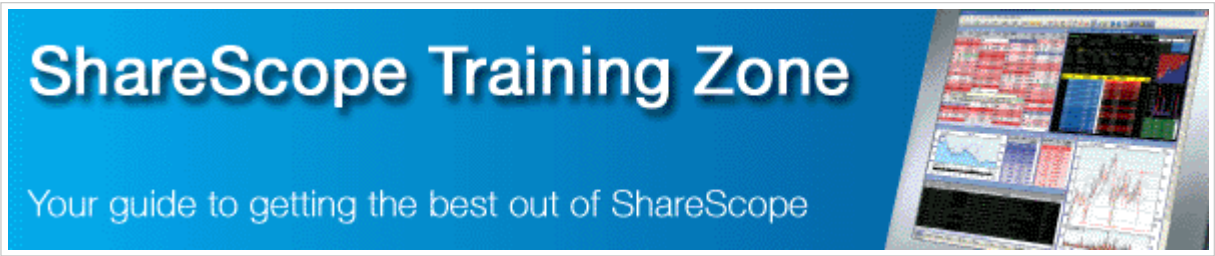

Tutorial 32 – Data Mining cash, borrowing and liquidity ratios

This week's training tutorial is written for us by Alpesh Patel. It explains key fundamental criteria related to cash, borrowing and liquidity - essential for identifying financially solid businesses in these challenging times. Alpesh gives his preferred values for each metric and provides a data mining filter at the end of the tutorial to help you find matching companies.

In this tutorial:

Introduction

Its not just in a credit crunch we should be worried about cash, credit and debt. However, it is at these times that these factors come to the most prominence. So let's look at what they mean, and how we decide what is relatively good and finally a good mix for a filter.

Cashflow

Cash flow, sometimes referred to as "net cash flow" is a measure of the amount of cash actually generated by the trading activity of the business in the accounting year. Accounting profits can be subjective: cash flow is absolute and as such is a key indicator of a company's financial health. Ordinary dividends are payable from net cash flow.

The cash flow figure is calculated from the company's Cash Flow Statement, one of the primary financial statements prepared in accordance with Financial Reporting Standard 1 "Cash flow statements". Its basis is operating profit adjusted for non-cash items like:

- Depreciation
- Movements in the value of working capital
- Actual cash revenues such as cash dividends received
- Cash costs such as tax paid.

Net cash flow excludes adjustments for capital expenditure (capex) and ordinary dividends payable.

An option is available for **cash flow per share**, which calculates the cash flow figure using a weighted average of shares in issue during the period. Many investors use this figure as a test of a company's ability to pay dividends in the future rather than EPS, which is based upon profits.

Another option is available for the **price to cash flow** ratio. This calculates the cash flow per share as a proportion of yesterday's closing share price, i.e. share price/cash flow per share. It tells you whether a company's share price is high or low in relation to its real cash generation. A low price to cash flow ratio indicates that cash flow is strong in relation to the share price and is seen by some

investors as attractive.

A company spending more cash than it receives it not necessarily a bad thing, because it may be investing for the future, however if we are being especially conservative we probably want more cash coming in than going out.

Equally, cash could inflow from borrowings and that is not necessarily a positive thing. Consequently cashflow in isolation or assumptions that positive cashflow is good or that negative cashflow is bad are too simplistic.

However, if we want to be conservative we will want to see positive cashflow (i.e. more cash coming in, than going out).

But how do we compare cashflow? I like to examine price to cash-flow as a measure of the value of the company relative to the cashflow it is generating. This at once gives us a measure of whether a company has a high or low valuation for the cashflow generated.

The period I like is the latest reported year because this is a measure of the here and now and the result. In my view a figure between 0-10 will narrow down those positive cashflow companies which are relatively well valued to their peers. For example, in the FTSE 100 that may give 30 or so companies in that range and leave out those that either have negative cashflow or are priced too high compared to their cashflow.

Cash

Price to net cash applies a similar reasoning to generate a valuation based on the net cash the companies has and the value based on it by the market. Of course the price of the share is not purely based upon its net cash position, but it tells us a relatively low valuation may be a sign the market has missed how much net cash the company has been generating.

My preference is to look for companies with a **price to net cash** of between 0 to 25. The closer to zero, all things being equal, the more undervalued the company. Anything above 25 and the company could be well valued based on its cash position at least.

Quick Ratio

It shows the quick ratio or "acid ratio" of the company at the period end. The quick ratio is a measure of a company's short-term liquidity i.e. its ability to repay its immediate creditors. The quick ratio is current assets - excluding stock and work in progress (WIP) - divided by current liabilities. It shows the number of times current liabilities are covered by assets readily convertible into cash. Generally speaking, a value greater than 1.00 indicates short term debts are fully covered, so the ratio can be a useful indicator of a company's immediate financial health. However, typical quick ratios vary by sector: retailing is a good example.

Some investors prefer the quick ratio to the current ratio because it excludes stocks and WIP from current assets in the calculation and so is a more accurate indicator of a company's immediate ability to repay its debts. For banks and insurance companies, the current ratio does not apply and is shown as zero.

My preferred settings: A quick ratio above 1 is what to look for safety.

Current Ratio

It shows the current ratio of the company at the period end. The current ratio is a measure of a company's near-term liquidity and its ability to repay its short-term creditors out of current assets.

The current ratio is the result of dividing total current assets by current liabilities, and shows the number of times current liabilities are covered by current assets. Some investors look for a value greater than 2.00 as an indicator of financial health. Similarly, a value under 1.25 can indicate short term financial weakness. These numbers are only a guide: current ratios can be very sector specific. In addition, a high current ratio can indicate high levels of unsold stock, which could be an early warning that the company has problems. For banks and insurance companies, the current ratio does not apply and is shown as zero.

My preferred settings: A ratio above 2.

Net Borrowing

It shows the net borrowing by the company at the period end. Net borrowing is gross borrowing minus cash and cash equivalents. A negative value for net borrowing indicates a net cash position.

Gross borrowing incorporates all loan capital, including loan stock and debenture stock, convertibles, bank loans and overdrafts. Cash equivalents are current assets of a liquid nature which can readily be converted to cash, for example cash on overnight or short-term deposit, treasury bills or Certificates of Deposit. Price-sensitive marketable securities and hedging instruments such as corporate bonds, options or futures are not classed as cash equivalents.

My preferred settings: A negative value is positive of course! Remember, debt is not bad, it can be useful. But if in a credit crunch you are looking for safety then you may want to limit the size of net borrowing you find acceptable.

Net Gearing

It shows the net gearing of the company at the period end date. It gives a measure of a company's borrowings less cash.

Net gearing is defined as net borrowing divided by shareholders' funds. Any preference capital redeemable within 12 months is classed as borrowings.

For this calculation, an option is available to use either shareholders' funds including or excluding intangibles. Some investors prefer to exclude intangibles as their valuation can be subjective.

More generally, gearing is a percentage measure of a company's debt to equity ratio. It can be used as a measure of a company's indebtedness. A little gearing can be tax efficient for a company but too much debt can be of concern. Acceptable levels of gearing can also be very sector specific. For example, house builders are typically highly geared because of the levels of mortgage debt that they take on. There are many ways of calculating gearing (ShareScope offers 8 different ways).

My preference: Most recent net gearing including intangibles. I like to see a little net gearing, but of course not too much – say 50% or below.

Net Current Assets

It shows the net current assets of the company at the period end. Net current assets are current assets less current liabilities. A negative value for net current assets is possible and simply indicates that a company has net current liabilities. Current assets include stocks and work-in-progress, debtors, short-term investments and cash. Current liabilities include short-term borrowings, creditors, dividends, taxation payable, and accruals.

My preference: a positive value of course is best, but a small negative may not be a major problem.

Book Value

Shows the accounting book value or net asset value of the company at the period end. Book value is sometimes referred to as "Shareholder Funds".

It is the sum of ordinary share capital plus equity reserves (e.g. retained profit and loss and revaluation reserves). Intangibles are not excluded so some investors prefer to use the tangible book value instead.

An option is available for book value per share, sometimes referred to as net asset value per share (NAV) which calculates the book value at year-end using a weighted average of shares in issue during the period. Many investors use this figure to see how much of a share's price has asset backing.

Another option is available for the price to book value (PBV), used by some investors as a measure of value in the share price. This calculates net asset value per share as a proportion of yesterday's closing share price, i.e. share price/net asset per share. The effectiveness of PBV as an investor ratio really depends upon the quality of the underlying assets.

My preference: For most recent price to book value up to say 4, anything higher than that might suggest too great a valuation placed on the book value.

Free Data Mining Filter

I've put together a Data Mining filter based on the criteria I have discussed above and also included two additional criteria - profits and positive broker consensus.

These are my personal settings - although of course feel free to edit, add and remove criteria to suit your preferred style.

You may also like to add the criteria as columns in the Data Mining list screen to see the filter in action.

Download filter:

Click here to download filter.

Before importing this filter into ShareScope, you first need to download the file to your desktop. To do this, simply click on the above link and select the option **Save to Desktop**. You will then need to unzip the file.

To import the filter:

- Open the Data Mining screen
- Click on the **File** menu and select **Import**. From the sub menu select **Import a filter...**
- This will display the **Import a filter file dialog**. Locate the file and click **Open**.
- A dialog will appear notifying you that the filter has been imported successfully.

The next time you click on the **Select Filter** button on the Data Mining screen, you will notice that a new filter, *Solid Financials*, now appears in the list of available filters to view.

Remember, if you have any trouble finding or using any of these features, please don't hesitate to call our Customer Support team. They will be delighted to help.

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