

## The balance sheet: Telling a balanced story

The balance sheet often lives in the shadow of its better-known brother, the income statement.

While the income statement portrays operating performance, the asset and liability metrics found on the balance sheet are better known as windows to a company's financial health. But the balance sheet also measures operating performance, albeit in a different way.

Commonly cited statistics like sales and profit growth, profit margins, and the price/earnings ratio consider only the income statement. But data from the balance sheet can be used to measure growth, operating efficiency, profitability, and valuation, as well as financial strength:

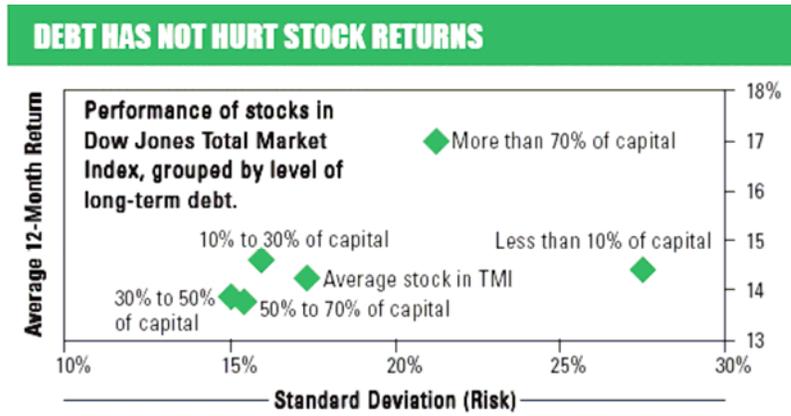
- **Equity growth:** Equity, also known as book value, equals assets minus liabilities. Book value, a proxy for the value of stockholders' investment in a company, will increase when equity investments are made or when earnings exceed dividends.
- **Price/book value:** Just as the price/earnings ratio measures the value of a company relative to its earnings, the price/book ratio measures the value of a company relative to its equity. Price/book serves as a useful check on the price/earnings ratio.
- **Turnover:** Such ratios as fixed-asset turnover and inventory turnover measure how efficiently a company uses assets. For example: If a company's cost of goods sold was \$100 million last year and inventory averaged \$20 million, the inventory turnover ratio is 5, meaning that inventory turns over five times a year.
- **Returns on assets, investment:** Return on assets (ROA) and return on investment (ROI) show how well companies squeeze profits out of their assets and capital. To calculate ROA or ROI, divide net income by total assets or invested capital (long-term debt plus equity).
- **Changes in long-term debt:** As shown in the chart below, carrying debt is not inherently better or worse than carrying no debt. A capital structure that includes debt offers both advantages and disadvantages. But many investors view paying down debt as a sign of financial strength.

The following paragraphs offer some suggestions on how you can use the balance sheet to assess financial strength, growth, operating efficiency, and profitability.

### Financial strength

Investors like companies that pay off debt — it makes intuitive sense to individuals, on whom debt is a drain. However, businesses take on debt for a variety of reasons. Debt financing is cheaper than equity financing, partly because interest payments are tax-deductible. The market also tends to punish companies for issuing equity.

By using debt, companies can leverage their profits. The higher the debt level, the riskier the profit stream. If operating profits rise or fall 15%, a company completely financed by equity will tend to see per-share profits rise or fall 15%. But what if a company borrows to buy back some of its shares, and its interest expense jumps? Fixed interest costs represent a smaller proportion of operating profits in times of rising profits, and a larger proportion when profits are falling. Thus, a change in operating profits will result in a larger change in per-share earnings for the company using debt. Rather than avoiding companies with debt, investors should consider how well a company manages that debt.



While paying down debt is often viewed as a sign of financial strength, companies with moderate debt levels averaged returns similar to those of companies with little or no debt, based on a back-test of rolling 12-month returns for stocks in the Dow Jones Total Market Index from January 1992 through April 2005.

All else equal, debt tends to increase the volatility of stocks. As shown above, companies with long-term debt/capital ratios of more than 70% have delivered superior returns since 1992 at the cost of above-average volatility. However, returns have also been quite volatile for shares of companies with debt of less than 10% of capital, largely because the volatile technology group is heavily represented among such stocks.

### Growth

Most growth in equity (book value) comes from two sources. Companies can issue new shares of stock, or they can increase retained earnings. The second type of growth is better for shareholders than the first. Retained earnings quite literally reflect earnings retained by the business for internal use. The portion of net income used to reinvest in the business or pay off debt increases retained earnings.

### Profitability

ROA and ROI illustrate whether a firm makes good use of its operating and financial resources. At first blush, 50% profit growth sounds good. But what if a company funds that growth by doubling the number of shares outstanding? ROI would decline. ROI measures profitability relative to the capital invested in the business, a useful way to assess companies with a capitalization structure that includes debt. ROI is less useful

when dealing with financial institutions that borrow to fund their lending, because debt levels can be misleading. ROA is a better indicator for such companies.

### **Operating efficiency**

Turnover ratios and the cash-conversion cycle offer another take on how efficiently a company uses its assets. Turnover is particularly important to manufacturers and retailers, which tend to have a lot of inventory and such long-term assets as factories, distribution centers, and warehouses. Inventory costs money to acquire, create, and store — but does not earn a return until it is sold. Fixed assets require expenditures for upkeep. Turnover ratios reflect how effectively a company turns those assets into products that generate cash.

Another measure of operating efficiency is the cash-conversion cycle, which measures the length of time a company's cash is tied up during the process of making and selling products and paying bills.