Chapter 2:
Basic Knowledge of Fundamental Analysis

"We have observed that the money managers who have achieved long term market beating results in this business, Walter Schloss, Warren Buffett, Bill Ruane and Rick Cunniff, Mario Gabelli and John Neff, all have an investment philosophy based on their definition of value. Our booklet, 'What has worked in investing', shows that both in the US and internationally, basic fundamental value criteria produce better than market returns over long periods of time."

Christopher Browne

Fundamental analysis is a subject studying the underlying business of a company based on the quantitative and qualitative analyses of the company's business performance, financial health, operating environments, capability of its management and its intrinsic value. The main objective of the analysis is to ascertain if the company is a suitable investment target and if it is worth our investment.

To Koon, fundamental analysis is a foundation of stock investing. Buying a stock without understanding the business of the stock is akin to gambling without reading our cards. How can we play the game with conviction if we do not look at the cards, know the odds, and deploy a suitable strategy?

A share of stock usually represents a fraction of ownership in a business. According to Peter Lynch, there is a company or business behind every stock. The stock is not a piece of lottery ticket. When we buy a stock, we become the owners of the company. Just like every business owner, we also have the right to share in the company's profits through dividend payments, and the distribution of its bonus shares if it makes money. When the company grows, we will profit from the investment through capital gains when we sell the stock. Therefore, fundamental analysis is an important work to every serious investor.

Before performing fundamental analysis, we must be able to read financial reports and annual reports, to analyse the financial health of the firm, to understand what business the company is doing, and to study the business performance of the company. If one does not know what the company is making and who its clients are, cannot read its financial reports, and has no interest to learn about the business, he or she should not risk his or her hard-earned money in the stock. Koon always says, the stock market is a dangerous place for gamblers, and it really is a jungle out there. If we enter the jungle too often we will meet a tiger.

2.1 Introduction to Quarterly Financial Statement and Annual Report

> *"I always start off my research by reading companies' annual reports and then the footnotes to their numbers. I need to be satisfied about the integrity of the numbers and the honesty of the accounting before I look further. If there is a number that is incomprehensible, I throw the report into the wastebasket and move on. If you look at Enron's footnotes in the 1990s, they were just incomprehensible. If investors had read those footnotes carefully, I don't think anyone would have invested in Enron stock."*
>
> Jean-Marie Eveillard

Quarterly financial statements are statements comprise of income statement, balance sheet, cash flow statement, statement of changes in equity and other supporting information released by a public listed company once every three months to satisfy the listing requirements of Bursa Malaysia. The main objective of issuing the statements is to disclose financial performance and important financial information of the company to shareholders and the public. This information enables potential investors make an informed judgement, whether the stock is worth their money, and enable the existing investors to decide if they should add, hold or sell the stock.

Annual report, on the other hand, is a document published by a public listed company every year to report the activities of the company in the past financial year. Unlike quarterly financial statements, the structure of annual report is more exhaustive. In addition to disclosing financial information, it also encompasses chairman's statement, top thirty shareholders list, the remuneration of the management, business prospect and etc.

2.1.1 Why You Should Read Quarterly Financial Statements and Annual Reports?

Although reading financial statements and annual reports can be time consuming, these reports provide us valuable information about a company's financial condition, and operation. In addition, they give us an insight into the business of the company, which includes, but is not limited to, its business type and structure, the industry in which it operates, the products it offers, who its clients are, its geographic market area, current developments, and etc. Sometimes, the management may also touch on their previous strategy, and discuss how it helped building on the company's success in the reports. Moreover, they disclose the short-term and long-term strategic plans and direction of the company. Indirectly they help us figure out where the company is, and the direction where it is heading. As required by the reporting rules, the management have to discuss about the current performance of the company, including significant changes in the last financial year and the future business prospect of the company. Some companies may also provide facts, including the risks, and uncertainties of the business such as legal liabilities, and lawsuits they get involved in, and the projects they are bidding for in this financial year. All this information will help us make an informed judgement about our investment in the company.

2.1.2 Understanding Quarterly Financial Statement and Annual Report

As mentioned earlier, every annual report comprises of financial statements, chairman's statement, business and financial review provided by the management, top thirty shareholders list and remuneration of the management.

- Financial statements are four reports in a set; consist of income statement, balance sheet, statement of changes in equity, and cash flow statement. They record the financial information, financial activities, and financial strength, or financial health of the company. Whilst the statement of changes in equity is also included in the financial statement set, we must pay more attention to the three main statements, viz. income statement, balance sheet, and cash flow statement. Further detail of the three statements will be covered in section 2.1.2.1, section 2.1.2.2 and section 2.1.2.3 of this chapter.

- The chairman's statement is an overview provided by the CEO of a company, in brief, about the company's current business performance, operating environment and culture, business prospect, direction, and financial strength, and the significant changes and developments in the company's operation, the changes in the board of directors' composition, and the amount of dividends declared in the financial year. Do not underestimate the importance of this summary, as it contains some essential information related to the profitability, condition, future and viability of the business. If you notice any negative tones or words used by the CEO to describe the company's financial health, you should pay a careful attention to the long-term profitability, and survivability of the business.

- Business and financial review summarises the business performance of the company, and its recent developments. Further, the explanation of the management on the changes in the company revenue, and profit trends in the last financial year can also be found in this section. Occasionally the management may use some visual aids such as graphs, charts, diagrams, and pictures to illustrate to shareholders the information of the company's evolution. We must read them in conjunction with the financial statements to get a better picture of the business performance.

- The top thirty shareholders list is a summary that illustrates the ownership structure of the company to the public. From the list, we can tell if the company ownership is dominated by local institutional funds, foreign funds, foreign companies, retail investors, superinvestors, employees or insiders. Also, we can tell from the structure if the business operating and dividend policies are influenced by any of the major shareholders. For instance, most of the foreign-owned companies listed in Malaysia such as Carlsberg Brewery Malaysia Berhad, Heineken Malaysia Berhad, Nestle (M)

Berhad, Digi.com Berhad and Panasonic Manufacturing Malaysia Berhad pay high and increasing dividends to their shareholders.

- The remuneration of the board of directors reported in the annual report is a disclosure of the salary packages received by the top management, and the directors of the company. According to some research studies, the business performance of a company is inversely correlated with management’s remuneration. This situation can be explained from the psychological point of view that the management without stakes in the company, or those who work for salary is less motivated to ensure the success of a company, and the value of the stock.

2.1.2.1 Income Statement

- An income statement (refer to Figure 2.1), also known as a profit and loss statement, reports how a company performs in the financial year or quarter. The report usually begins with the revenue or sales of the business within the reporting period. Sometimes it is called top line, as the revenue is the first figure appears in an income statement. The value of revenue alone renders not much of importance to a stock, unless the figure is compared with its profits, its revenue data over the past five or ten years, or the revenues of its competitors. Growing revenue generally implies that the company is either expanding its business lines or increasing the prices of its products. Sometimes it also reveals that the company has captured more market shares or has grabbed some market share from its competitors. Therefore, we should do some comparisons when reading a financial statement to get a better picture of the story.

- The next item we have to pay attention to is its gross profit, which is the profit netted out with after taking the cost of goods sold (or cost of sales) into account. The cost of goods sold is the total costs of producing the products which include, but are not limited to, raw material costs, utility bills, machinery maintenance costs, wages and etc. If we compare the gross profit with revenue, we will get gross profit margin. Decreasing gross margin signifies increasing raw material prices, wages and maintenance costs. In addition, it shows that the management is unable to control the cost of sales.

  Gross profit = Revenue – Cost of goods sold

  Gross profit margin = (Gross profit / Revenue) × 100%

- The second profit comes after gross profit is known as profit before tax (PBT). It is the profit obtained by subtracting operating expenses (such as depreciation and amortisation, and selling, general and administrative expenses), interest expenses, and other expenses from and adding other incomes to the gross profit. Depreciation refers to reduction in tangible asset value (i.e. car, furniture, machinery

values), whereas amortisation refers to the reduction in intangible asset value (i.e. patent, goodwill, copyrights). If we compare the profit before tax with revenue, we will get pre-tax profit margin. Decreasing margin signifies increasing operating cost, and steep falling of asset value. In addition, it shows that the management is unable to lower costs.

Whilst high profit before income tax is appealing, it should be noted that the profit is sometimes contributed by one-time-gains (or non-recurring gains) from the disposal of assets and/or other non-operating-related transactions. The gain will usually lead to a spike in profit. When we analyse a company, we must take note of the item.

Profit before tax
= Gross profit – Selling, general and administrative expenses – Depreciation and amortisation expenses – Interest expenses + Other incomes

Pre-tax profit margin = (Profit before tax / Revenue) × 100%

- The last profit is called net profit, which is also known as the bottom line, or profit net of tax. It is obtained by subtracting income tax from the profit before income tax. High net profit is although pleasing, we should not look at the figure alone. It does not tell us a complete story until we do some comparisons with the profits of the company in the past five or ten years, the profits of its competitors, and with its own revenue. An increased profit is an indicator of business growth, which will normally lift its share price up. If the net profit is higher than those of its competitors, it implies that the management is very competitive.

  Net profit = Profit before income tax - Income tax

- Earnings-per-share (EPS) is the value obtained by dividing the net profit by the number of outstanding shares. The higher the earnings per share of a stock, the higher its profitability is. Earnings-per-share is generally used together with price-to-earnings ratio to ascertain if the stock is undervalued or overvalued.

  Earnings per share = Net profit / Outstanding shares

- Remark: negative profits indicate that the business suffers losses. We should try to avoid companies with financial losses, as no one can guarantee when the businesses will become profitable. It is easier for well-managed companies to continue performing than for bad companies to turn around. Even if the companies are good companies, do not rush in to buy the stocks too early. When the companies report negative profits, their stock prices will continue to fall. Nobody can tell how low the prices can go. The best time to

buy the stocks is when the businesses return to profit, and when their profits are growing again, or if you can be very sure that the company will make more profits next year than this year.

STATEMENTS OF COMPHERENSIVE INCOME

FOR THE FINANCIAL YEAR ENDED 30 JUNE 2013

	Note	Group 2013 RM'000	Group 2012 RM'000	Company 2013 RM'000	Company 2012 RM'000
Revenue	4	493,687	517,863	16,049	20,135
Cost of sales		(422,485)	(464,346)	-	-
Gross profit		71,202	53,517	16,049	20,135
Other items of income					
Interest income from loans and receivables		594	345	6	38
Other income	5	1,944	1,427	1,626	5,069
Other items of expense					
Selling and distribution expenses		(11,602)	(11,038)	-	-
Administrative expenses		(16,464)	(14,724)	(1,278)	(589)
Other expenses		(5,547)	(7,858)	(11,708)	(6,613)
Finance costs	6	(4,469)	(4,974)	-	-
Share of results of an associate		-	(45)	-	-
Profit before tax	7	35,658	16,650	4,695	18,040
Income tax expense	10	(3,612)	(1,897)	-	-
Profit net of tax		32,046	14,753	4,695	18,040
Other comprehensive income:					
Foreign currency translation		1,209	5,901	-	-
Total comprehensive income for the year		33,255	20,654	4,695	18,040
Profit attributable to:					
Owners of the parent		24,366	9,840	4,695	18,040
Non-controlling interests		7,680	4,913	-	-
		32,046	14,753	4,695	18,040
Total comprehensive income attributable to:					
Owners of the parent		25,302	14,197	4,695	18,040
Non-controlling interests		7,953	6,457	-	-
		33,255	20,654	4,695	18,040
Earnings per share attributable to owners of the parent (sen per share)					
- Basic	11	25.07	10.12		

Figure 2.1: Income Statement of Latitude Tree Holdings Berhad for the Financial Year Ended 2013

Source: Bursa Malaysia

2.1.2.2 Balance Sheet

- Balance sheet (refer to Figure 2.2A and Figure 2.2B), also known as the statement of financial position, is a statement showing the ending balances of a company's assets, liabilities and shareholders' equity. It can be divided into two main sections. In general, current assets and non-current assets constitute the first section. Current liabilities, non-current liabilities and shareholders' equity, on the other hand, constitute the second section. The sum of components in the first section must be equal to that in the second section.

  Total assets = Total liabilities + Shareholders' equity

  Total assets = Current assets + Non-current assets

  Total liabilities = Current liabilities + Non-current liabilities

- Current assets are the assets that can be converted to cash within twelve months, which generally comprise of inventories, trade receivables, cash and cash equivalents, short-term investments, amounts due from associates, prepaid expenses, bank deposits, tax recoverable and etc.

- Non-current assets are the assets that are mostly not intended for sale, and cannot be converted to cash easily within twelve months, which include property, plant, and equipment, associate companies, or investment in subsidiaries, intangible assets, long-term investments, and etc. Intangible assets are non-physical assets but are valuable to the business, which include goodwill, brand recognition, franchises, patents, trademarks, copyrights, and other intellectual properties.

- Current liabilities are the liabilities that must be paid within twelve months; which encompass trade payables, accrued expenses, short-term borrowings, tax payable, and other current liabilities.

- Non-current liabilities are the liabilities that will only due after twelve months, which include long-term borrowings, deferred tax liabilities, and bonds.

- Shareholders' equity generally consists of share capital, preferred shares, treasury stock, reserves, and retained earnings. Note that treasury shares are the shares repurchased from the open market when the management feel that their stock is undervalued. It usually appears as a negative number in the section.

- Remark: Book value-per-share (BVPS or BV) can be obtained by dividing shareholders' equity by the number of outstanding shares. Whilst analysts always use it as a reference, please note that it is of

no use in valuing a business. No matter how high the book value of a stock is, if its profits do not grow or have no growth potential, its share price will not rise.

Book value per share = Shareholders' equity / Outstanding shares

STATEMENTS OF FINANCIAL POSITION

AS AT 30 JUNE 2013

	Note	Group 30.6.2013 RM'000	Group 30.6.2012 RM'000	Group 1.7.2011 RM'000	Company 30.6.2013 RM'000	Company 30.6.2012 RM'000	Company 1.7.2011 RM'000
Assets							
Non-current assets							
Property, plant and equipment	13	206,483	217,977	215,503	-	-	-
Investment in subsidiaries	14	-	-	-	82,368	84,382	82,189
Investment in an associate	15	-	-	1,016	-	-	-
Other investments	16	81	81	521	-	-	440
Intangible asset	17	-	-	-	-	-	-
Land use rights	18	14,405	14,828	14,496	-	-	-
Deferred tax assets	19	889	812	743	-	-	-
		221,858	233,698	232,279	82,368	84,382	82,629
Current assets							
Inventories	20	89,653	76,101	84,765	-	-	-
Trade and other receivables	21	33,530	41,578	35,368	66,843	66,999	76,866
Prepayments		925	1,431	1,280	5	-	-
Tax recoverable		897	1,101	1,771	180	227	192
Investment securities	22	204	1,196	1,018	-	-	-
Derivatives	23	-	-	655	-	-	-
Cash and bank balances	24	103,319	59,942	54,429	50	1,619	2,666
		228,528	181,349	179,286	67,078	68,845	79,724
Total assets		450,386	415,047	411,565	149,446	153,227	162,353
Equity and liabilities							
Current liabilities							
Tax payable		1,283	909	363	-	-	-
Loans and borrowings	25	85,117	93,567	99,363	-	-	13,200
Trade and other payables	26	73,551	64,187	64,639	15,795	21,355	33,377
Derivatives	23	130	307	-	-	-	-
		160,081	158,970	164,365	15,795	21,355	46,577
Net current assets		68,447	22,379	14,921	51,283	47,490	33,147

Figure 2.2A: Balance Sheet of Latitude Tree Holdings Berhad for the Financial Year Ended 2013 (Part 1)

Source: Bursa Malaysia

	Note	Group 30.6.2013 RM'000	30.6.2012 RM'000	1.7.2011 RM'000	Company 30.6.2013 RM'000	30.6.2012 RM'000	1.7.2011 RM'000
Non-current liabilities							
Loans and borrowings	25	13,416	9,184	13,939	-	-	-
Provision for severance allowance	27	474	564	612	-	-	-
Retirement benefit obligation		57	40	-	-	-	-
		13,947	9,788	14,551	-	-	-
Total liabilities		174,028	168,758	178,916	15,795	21,355	46,577
Net assets		276,358	246,289	232,649	133,651	131,872	115,776
Equity attributable to owners of the parent							
Share capital	28	97,208	97,208	97,208	97,208	97,208	97,208
Share premium	28	1,225	1,225	1,225	1,225	1,225	1,225
Retained earnings	29	128,335	106,885	97,781	35,218	33,439	17,343
Other reserves	30	5,293	4,357	-	-	-	-
		232,061	209,675	196,214	133,651	131,872	115,776
Non-controlling interests		44,297	36,614	36,435	-	-	-
Total equity		276,358	246,289	232,649	133,651	131,872	115,776
Total equity and liabilities		450,386	415,047	411,565	149,446	153,227	162,353

Figure 2.2B: Balance Sheet of Latitude Tree Holdings Berhad for the Financial Year Ended 2013 (Part 2)

Source: Bursa Malaysia

2.1.2.3 Cash Flow Statement

- Even though sales are recognised in the income statement, more often than not payments are not immediately made when goods change hands, or are shipped. As investors, we should study the cash flow statement to find out if the company has a sustainable cash flow, and if it has the ability to expand its business, and to pay dividends to investors.

- The statement of cash flows (refer to Figure 2.3A and Figure 2.3B) summarises how money is spent and brought into the company by its management. The report can be divided into three main sections, namely cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities. Note that negative cash flow indicates that the company spends more money than it generates. If the company spends more than it brings in, its cash balance at the end of the year will be decreased.

  Cash at the end of the year
  = Cash at the beginning of the year + Cash flow from operating activities + Cash flow from investing activities + Cash flow from financing activities

- Cash flow from operating activities records money spent on and received from the operation. Positive cash flow shows that the operation generates cash. By and large, it is better to have positive cash flows than negative cash flows. Nevertheless, we should not avoid some companies blindly simply because they have low, or negative cash flow from operating activities. High growth companies usually have low, or negative cash flow from operating activities as they increase their inventory, and extend credit to their customers when they get more sales.

  In general, profit before tax, decrease in inventories, decrease in accounts receivable, decrease in prepaid expenses, decrease in other current assets, increase in accounts payable, increase in accrued expenses, increase in unearned revenue, depreciation and amortisation contribute positively to cash flow from operating activities.

  Cash flow from operating activities
  = Profit before tax + Decrease in inventories + Decrease in receivables + Increase in payables + Depreciation + Amortisation

- Cash flow from investing activities records the money received from the disposal of assets or investments and money spent on the acquisition of plant, property, and equipment.

In general, capital expenditures, long-term investments, and cash outflow from investing activities contribute negatively to the cash flow from investing activities.

Whilst conservative investors avoid companies with a sudden surge in capital expenditure, spending money to acquire property, plant, and equipment may not necessarily be a bad sign. When a company expands its business operation, having a high capital expenditure in a particular year is inevitable. If we shun the company blindly without ascertaining if the investment is an excellent one, we will probably kick ourselves later for missing out on the golden opportunity.

Cash flow from investing activities
= Cash received from asset disposal – Capital expenditures – Long-term investments

- Cash flow from financing activities records the amount of money received from and repaid to lenders, money received from the issuance of stocks, money used for stock repurchased and money paid to investors as dividends.

  In general, repayment of debt, the repurchase of shares, and dividends paid contribute negatively to the cash flow from financing activities, as they are outflows of cash.

  Cash flow from financing activities
  = Debt issued + Issuance of stocks – Repayments of Debt – Dividend paid – Share buyback

STATEMENTS OF CASH FLOWS
FOR THE FINANCIAL YEAR ENDED 30 JUNE 2013

	Note	Group		Company	
		2013 RM'000	2012 RM'000	2013 RM'000	2012 RM'000
Operating activities					
Profit before tax		35,658	16,650	4,695	18,040
Adjustments for:					
Reversal of allowance for impairment of other receivables	5	-	-	(1,623)	(4,962)
Gain on disposal of an associate	5	(524)	-	-	-
Loss/(gain) on disposal of property, plant and equipment	5, 7	30	(21)	-	-
Fair value (gain)/loss on derivatives	5, 7	(177)	962	-	-
Net unrealised foreign exchange loss/(gain)	5,7	14	(871)	1	158
Finance costs	6	4,469	4,974	-	-
Amortisation of land use rights	7	413	414	-	-
Depreciation of property, plant and equipment	7	16,354	16,703	-	-
Impairment loss on investment in an associate	7	-	971	-	-
Impairment loss on investment in subsidiaries	7	-	-	2,014	338
Impairment loss on other investments	7	-	440	-	440
Impairment loss on other receivables	7	63	103	9,691	5,666
Impairment loss on trade receivables	7	143	61	-	-
Property, plant and equipment written off	7	2	25	-	-
Provision for severance allowance	7	130	216	-	-
Retirement benefit expense	7	17	40	-	-
Interest income on loans and receivables		(594)	(345)	(6)	(38)
Share of loss of an associate		-	45	-	-
Total adjustments		20,340	23,717	10,077	1,602
Operating cash flows before changes in working capital		55,998	40,367	14,772	19,642

Figure 2.3A: Cash Flow Statement of Latitude Tree Holdings Berhad for the Financial Year Ended 2013 (Part 1)

Source: Bursa Malaysia

	Note	Group 2013 RM'000	Group 2012 RM'000	Company 2013 RM'000	Company 2012 RM'000
Operating activities (cont'd)					
Changes in working capital					
(Increase)/decrease in inventories		(13,552)	8,664	-	-
Decrease/(increase) in trade and other receivables		7,828	(6,401)	(7,912)	9,161
Decrease/(increase) in prepayments		506	(151)	(5)	-
Increase/(decrease) in trade and other payables		9,364	(452)	(5,560)	(12,022)
Decrease in provision for severance allowance		(217)	(294)	-	-
Total changes in working capital		3,929	1,366	(13,477)	(2,861)
Cash flows from operations		59,927	41,733	1,295	16,781
Interest paid		(4,469)	(4,974)	-	-
Interest received		594	345	6	38
Taxes refunded		295	969	81	-
Taxes paid		(3,468)	(1,704)	(34)	(35)
Net cash flows from operating activities		52,879	36,369	1,348	16,784
Investing activities					
Purchase of property, plant and equipment	13	(5,285)	(13,431)	-	-
Proceeds from disposal of property, plant and equipment		557	27	-	-
Acquisition of non-controlling interests		-	(2,531)	-	-
Additional investment in a subsidiary		-	-	-	(2,531)
Proceeds from disposal of investment in an associate		524	-	-	-
Purchase of investment securities		(8)	(2,178)	-	-
Proceeds from investment securities		1,000	2,000	-	-
Net cash flows used in investing activities		(3,212)	(16,113)	-	(2,531)
Financing activities					
Repayment of obligations under finance lease		(24)	(18)	-	-
Repayment of loans and borrowings		(250,081)	(265,478)	-	(13,200)
Proceeds from loans and borrowings		246,299	251,876	-	-
Deposits uplifted from/(placed as) security for bank borrowings		1,032	(481)	1,409	(38)
Dividends paid to minority shareholders		(270)	(2,539)	-	-
Dividends paid on ordinary shares	12	(2,916)	(1,944)	(2,916)	(1,944)
Net cash flows used in financing activities		(5,960)	(18,584)	(1,507)	(15,182)
Exchange differences in translation of financial statements of foreign subsidiaries		49	793	-	-
Net increase/(decrease) in cash and cash equivalents		43,756	2,465	(159)	(929)
Effect of exchange rate changes on cash and cash equivalents		974	3,379	(1)	(156)
Cash and cash equivalents at 1 July		51,361	45,517	210	1,295
Cash and cash equivalents at 30 June	24	96,091	51,361	50	210

Figure 2.3B: Cash Flow Statement of Latitude Tree Holdings Berhad for the Financial Year Ended 2013 (Part 2)

Source: Bursa Malaysia

2.2 Assessing the Financial Health and Performance of a Business

"The important thing to remember is that purchasing the common stock of bankrupt companies is rarely a profitable investment strategy."

Joel Greenblatt

Whilst having the ability to read financial statements is important, it is not enough to ascertain if the financial health of a company is in good shape, if the business is performing well and if the company is worth our investment, we need to gather more information and to perform a thorough analysis through calculation and comparison so as to make an informed judgement.

Just like a human's wellbeing, a business will not be thriving if its finance is in chaos. Likewise, our chance of winning a bet would be very slim if we invest in a company in deep financial trouble or a company with no earning growth potential. Avoiding this type of companies will help protecting our hard-earned money, and will smoothen our path to achieving financial freedom.

Below are some useful metrics, which we can use to determine if the financial health of a company is in a favourable condition, and if the business is performing well prior to making judgement.

2.2.1 Profitability

As we know, profit is the lifeline of every business. The operation of a company is not sustainable if the business has no ability to generate profits. We should therefore look for companies with positive earnings, and with bright profit growth prospects, and avoid stocks with massive financial losses.

2.2.1.1 Net Profit Margin

Net profit margin (NPM) is an important indicator of a company's financial health. It measures the amount of net profit a company earns from every ringgit of its sales or revenue. The higher its net profit margin, the more profitable the business is.

Whilst high net profit margin business is more appealing to investors, it should be noted that not all types of business share the same range of net profit margin. In fact, it varies from industry to industry. Thus, we should compare the net profit margins of companies with that of the industry average.

In general, companies that provide legal advice, machinery and equipment rental, accounting, tax and payroll services, specialised design, real-estate, management consulting and medical services enjoy higher net profit margins than electronics and appliance stores, wholesalers, petrol stations, trading and manufacturing companies.

Net profit margin = Net profit / Sales

2.2.1.2 Profit Growth

According to Koon's study, high profit growth (earnings growth or EPS growth) is the most important trait of a winning-stock. A company with deteriorating profits does not only suffer business setbacks, and sluggish growth, it may also force the management to cut its dividends. As a result, the share price of the stock will descend. To protect our capital, we must make sure that the company can earn more profits next year than this year, and increasing profits years after next year before placing our wager. In other words, we must make sure that the company has a good profit growth prospect.

There are two types of profit growth rate. The first type is called year-over-year profit growth rate, or profit growth rate (YoY), which measures the growth rate of profits from one year to another. This type of profit growth is important in moving short-term stock price. The second type, on the other hand, is called the compound annual growth rate of profit, or profit growth rate (N-year CAGR), which measures the constant growth rate of profits over a specific number of years. The latter is important in increasing long-term shareholders' value.

$$\text{Profit growth rate (YoY)} \\ = [(\text{Profit in Year 1} / \text{Profit in Year 0}) - 1] \times 100\%$$

$$\text{Profit growth rate (N-year CAGR)} \\ = \{[(\text{Profit in Year N} / \text{Profit in Year 0})^{1/N}] - 1\} \times 100\%$$

Remark: when we notice a surge in the recent profit growth rate, we must find out if it is attributed by any non-recurring incomes (i.e. one-time gains from the disposal of property or assets, or from currency exchange gain).

2.2.1.3 Return on Equity

Return on equity (ROE) measures the amount of profit a business produces from the shareholders' equity. The higher the return, the more efficient the management is in utilising shareholders' investment. Companies with sustainable competitive advantage usually enjoy high return on equity.

Some gurus particularly fond of businesses with high return on equity, as profits generated from the business can be reinvested to fund its growth without having the need to inject more capitals. The compounding effect also allows a high return on equity business to grow much faster than its peers.

Note that not all industries share the same range of return on equity, as some businesses require only little assets, whilst others require large infrastructure investment. Therefore, we need to compare the return on equity of the company with that of the industry average to get a better picture on how it fares against its competitors. Also, we must look at the trend of the company's return on equity over the past ten years. Down-trending return on equity may point to the inability of the management to sustain its past performance.

Return on equity = Net profit / Shareholders' equity

2.2.2 Solvency

Loan is an important source of finance for a business. It does not only help the company meet the financial need of the business operation, it is also useful for funding the company's growth, and for increasing the wealth of its owners, as it does not dilute the stakes of the existing shareholders. Therefore, Koon always says, being investors, we should not be disheartened when a company takes loan to do more business.

However, debt is a double-edged sword. Taking an excessive amount of loan to support the growth of a business, especially buying unproductive assets, will put the company in a vulnerable position. Therefore, we must monitor the type of business assets acquired and the debt level of the company to ensure the solvency of the business so it can meet its long-term financial obligations.

Below are two useful metrics, namely Debt-to-EBITDA ratio and Debt-to-equity ratio, which we can use to assess the solvency level of the business.

2.2.2.1 Debt-to-EBITDA Ratio

Debt-to-EBITDA ratio is one of the most important metrics used to determine the ability of a company to service its debt. The higher the ratio, the longer the company needs to pay off its debt. Whilst some investors prefer to look for companies with the debt-to-EBITDA ratio lesser than three, it should be noted that some businesses are more capital intensive than other businesses. Peer-to-peer comparison is therefore a better approach to ascertaining the solvency of a firm.

Debt-to-EBITDA ratio = Debt / EBITDA

EBITDA
= Net Profit + Interest + Taxes + Depreciation and Amortisation

2.2.2.2 Debt-to-Equity Ratio

Debt-to-equity ratio (D/E) measures the debt of a business relative to its shareholders' equity. Similarly, capital-intensive businesses

tend to have higher debt-to-equity ratios than other businesses. During industry boom, or when catalysts kick in, highly-leveraged companies will enjoy higher earnings than their conservative peers. Conversely, the stocks' prices may take a hit when the companies suffer huge losses during an industry recession. Therefore, we must sell the stocks as soon as they report losses or when the industry bust begins.

Debt-to-equity ratio = Debt / Equity

2.2.3 Liquidity

Meeting the short-term financial obligations of a business is equally important to, if not more important than, meeting its long-term financial obligations. Failure to cover the short-term liabilities will risk the business going into a distressed state. One of the indicators we can use to judge the ability of the company in meeting its obligations is its liquidity. Liquidity measures the amount of liquid assets, such as cash and cash equivalent, accounts receivable and marketable securities, which can be converted to cash rather quickly and easily. Low liquidity will usually result in financial health deterioration to a company.

Two of the financial ratios investors usually use to assess the liquidity of a company are current ratio, and quick ratio.

2.2.3.1 *Current Ratio*

Current ratio, also known as working capital ratio, measures the proportion of current assets in relation to the liabilities of the business. Current assets are the assets that can be converted into cash in a year. Current liabilities, on the other hand, are the debts that must be repaid in a year. The higher the current ratio, the higher the ability of a company is in serving its short-term financial obligations. Nonetheless, the value should not be too high. Unreasonably high current ratio signifies the inability of the company in managing its cash, or working capital efficiently. Further, it is wasteful, as some inventories may become obsolete, or the quality of the stocks may be deteriorating, or the management may be too lax in collecting back the money owed to the company.

Whilst some finance books suggest using 2 to 1 as the rule of thumb, it should be noted that not all industries share the same value of ideal current ratio. The value varies from industry to industry. We should, in this case, compare the company's current ratio to the industry average ratio to find out how it fares against its competitors.

Current ratio = Current assets / Current liabilities

2.2.3.2 Quick Ratio

Quick ratio is also known as an acid-test ratio. Just like current ratio, quick ratio measures the ability of a company to meet its short-term financial liabilities. However, inventories are omitted in quick ratio calculation, as inventory could not be readily converted into cash.

Even though the general rule of thumb for quick ratio is 1 to 1, we should also compare the company's quick ratio with that of the industry average to find out how it fares, as not all industries share the same value of ideal quick ratio.

Quick ratio = (Current assets – Inventories) / Current liabilities

2.2.4 Activity Ratios

Activity ratios are the metrics used to ascertain the effectiveness of a management in converting their resources such as assets, receivables, and inventories into cash or sales. Three of the most commonly used activity ratios are total asset turnover, accounts receivable turnover, and inventory turnover ratios.

2.2.4.1 Total Asset Turnover Ratio

Total asset turnover measures the amount of revenue a company generates in relation to its total assets. It indicates the efficiency of a management in deploying assets to produce sales. The higher the turnover, the better the management is compared to their competitors in asset management.

Total asset turnover ratio = Sales / Average total assets

2.2.4.2 Inventory Turnover Ratio

Inventory turnover measures how fast inventory is sold. In addition, it indicates how long cash is being tied up to inventory asset.

The higher the turnover, the higher the number of times inventory is sold in a year, the higher the efficiency of a company is in managing its resources. However, unreasonably high turnover is not good for a company as it implies insufficient inventory, which may result in a loss in business.

Low inventory turnover, on the other hand, may suggest that the company is overstocking, suffering from obsolescence or deficiency in the finished goods. Nonetheless, a sudden drop in the turnover is not always bad. At times a company may increase its inventory if the management anticipates market shortages or rapidly rising prices of certain goods. As investors, we should read the comments of the management provided in the financial reports in conjunction with

the inventory turnover ratio to get a better picture of the situation. At the same time, we should compare the figure with the turnovers of its peers.

Inventory turnover ratio = Sales / Average inventory

or

Inventory turnover ratio = Cost of goods sold / Average inventory

Remark: to find out the number of days cash is tied up to inventory asset, or the number of days inventory is in stock; simply divide 365 by the calculated inventory turnover.

2.2.4.3 Receivables Turnover Ratio

Receivables turnover measures the number of times receivables are collected in a year. The higher the turnover, the more efficient the management is. On the other hand, low receivables turnover points to the problem that the management has some difficulties in collecting the credit it extends to customers in time. In addition, it may suggest that the company has a loose credit policy or a massive amount of bad debt.

Notwithstanding that, it should be noted that not all industries share the same average receivable turnover ratio. Some companies such as construction, consumer discretionary, and basic material, and manufacturing companies tend to have higher receivables turnovers than the others (i.e. large retailers, consumer, casino and gaming, and transportation companies) due to their business natures. Therefore, we should, as investors, compare the company's receivable turnover with the average turnover of the industry.

Receivables turnover ratio
= Net credit sales / Average accounts receivable

Remark: to find out the number of days a firm's credit is collected; simply divide 365 by the calculated receivable turnover.

2.2.5 Cash Flow

Cash flow is an important element of a business. It shows the amount of cash flowing into and out of a business. Very often a company goes bankrupt due to its inability to pay liabilities, not because the business is not profitable. Therefore, positive cash flow is not only important for dividend payment, and for future business expansion; it also ensures the solvency of a business. Note that cash flow does not take non-cash items (i.e. credit sales and payables) into account, as cash is not involved in the transactions.

2.2.5.1 Free Cash Flow

Free cash flow measures the amount of cash generated by a business from its operation after netting out capital expenditures. Free cash flow is an important indicator to ascertain if a company has an ability to pay dividends and the amount of dividends it can afford to distribute to its shareholders. In addition, it shows the ability of a company to weather hard times, especially during the industry recession, and to fund its business expansion internally.

Companies consistently produce positive, or high free cash flow is normally called cash cow. In other words, to find a cash cow, we should pay attention to the free cash flow of companies when we are searching for high quality investment.

Free cash flow = Operating cash flow – Capital expenditures

2.2.5.2 Operating Cash Flow-to-Sales Ratio

Operating cash flow-to-sales ratio measures the amount of cash produced by a business from its sales. The higher the ratio, the better the management is in managing its cash flow. That being said, not all companies have the same range of ratio. In fact, the range varies widely from industry to industry. Being investors, we should compare the latest operating cash flow-to-sales ratio with those of its peers and with its historical performance over the past few years to make an informed judgement.

Operating cash flow to sales ratio = Operating cash flow / Sales

2.3 Do Not Forget the Details of Financial and Annual Reports and Company Announcements

"The best advice I ever got was on an airplane. It was in my early days on Wall Street. I was flying to Chicago, and I sat next to an older guy. Anyway, I remember him as being an old guy, which means he may have been 40. He told me to read everything. If you get interested in a company and you read the annual report, he said, you will have done more than 98% of the people on Wall Street. And if you read the footnotes in the annual report you will have done more than 100% of the people on Wall Street. I realized right away that if I just literally read a company's annual report and the notes -- or better yet, two or three years of reports -- that I would know much more than others. Professional investors used to sort of be dazzled. Everyone seemed to think I was smart. I later realized that I had to do more than just that. I learned that I had to read the annual reports of those I am investing in and their competitors' annual reports, the trade journals, and everything that I could get my hands on. But I realized that most people don't bother even doing the basic homework. And if I did even more, I'd be so far ahead that I'd probably be able to find successful investments."

Jim Rogers

One of the reasons why most retail investors lose money in the stock market is that they are reluctant to read the announcements, financial statements, and annual reports of the stocks in which they have interests. Most of them buy and sell stocks based on rumours. As a result, they lose their hard-earned money for punting on news with low reliability. Even if they are willing to read the financial statements, most of them do not have the patience to read the entire reports, and all announcements. Skimming through the documents does not only hinder investors capturing the essence of the reports, and companies' progress, many of the hidden gems will also be missing out.

Like it or not, keeping track of companies' business developments is a duty of every investor. We would miss out on many golden opportunities if we do not keep track of their developments. The detailed information of the developments can always be found in the announcements, explanatory notes, and footnotes of their reports. Moreover, the resources can be freely accessed by investors from any part of Malaysia through the website of Bursa Malaysia and they are always free.

Below are some important details, which we can obtain from the reports, and announcements if we are willing to spend time going through the documents.

2.3.1 Prospect of the Business or Company

Every management team is required to provide their view on the performance and outlook of their business periodically -- quarterly and yearly. This statement does not only contain some information about the current operation of the firm, it also provides investors an insight into the business and reveals how the business will perform in the near future.

Negative tone projected by the management usually points to a deteriorating business outlook. Similarly, when the management focus more on industry development than the company's earnings prospect, or when they paint a challenging business environment, it reveals that the business prospect of the firm will be gloomy in the near future. We should avoid this type of companies until their fundamentals and business outlooks show some improvement.

Positive comments and optimistic opinions provided by the management, on the other hand, reveal that the business outlook is improving, or the business is growing. However, it should be noted that not all positive comments are good news. Sometimes the management may paint a false picture of the reality to protect the reputation of the company even if the business performance has sunk into the red. As investors, we should take the comments, and explanation of the management with a pinch of salt when reading their reports.

2.3.2 Latest Development

Latest developments of a business, such as the invention of a new product, the discovery of a new oil well, winning a concession contract, or award for infrastructure development, receiving a casino operating license, mergers and acquisitions, the formation of a joint venture for a new project, and the incorporation of a new subsidiary for new business opportunities, must all be reported in annual reports, and quarterly financial statements, and be announced on Bursa Malaysia website.

Every piece of information provides us an opportunity to buy a potential winning horse before the race starts if we know how to interpret the information when the share price is just about to rise. If you are willing to do some homework, to find out the new developments, the additional revenues and profits contributed by the projects or awards, you would find yourselves surrounded by plenty of gold.

2.3.3 Segmental Business Performance

Many of the listed companies in Malaysia are either diversified companies, or vertically integrated companies. A diversified company is a firm involves in multiple businesses, whilst a vertically integrated company is a firm providing several different services along the supply chain. Under the requirements of Financial Reporting Standards in Malaysia, the revenues, costs and profits of these businesses (if the segmental assets, revenue or profit is 10% or above) must be disclosed separately in the segmental reporting section.

By scrutinising the section, we can tell how the firm's profits are derived, the type of products the firm sells, the geographical market of the firm, and the impact of the strategy the management have implemented. Also, we will be able to identify the high-performing businesses within the firm, and to make a better prediction on the revenues and profits for the next few quarters.

2.3.4 Number of Shares Owned by the Management Team and the Thirty Largest Shareholders

Studies show that the managerial ownership of a firm is directly correlated with the value of a firm. When the management possess high stakes in the company, naturally they will align their interest with that of the other shareholders, thus a better team performance, and a higher firm value. In addition, the ownership level of the management reveals their confidence in the company. When we read an annual report, we should not ignore the number of shares owned by the top executive in the company, as the data tells us more than just a number.

Similarly, the number of shares owned by the thirty largest shareholders should not be overlooked as it tells us the maximum percentage of shares left floating in the market currently. The lesser number of shares

circulating in the market, the faster the share price soars when the business performs better in future. Further, we would be rewarded handsomely if we spot any super investors or gurus owning the stock, and if we buy it below its intrinsic value.

2.3.5 Other Details of the Annual Reports

2.3.5.1 Risks and Uncertainties

In some annual reports, risks and uncertainties are also provided by the management so that investors can take them into consideration in their analysis and valuation, and can prepare for the worst, or take immediate actions if, unfortunately, any mishap occurs to the firm. Pay no heed to the possibility of this calamity, you will find yourself in a panic state if the firm's operation is suspended or comes to a halt abruptly one day.

2.3.5.2 Auditor's Reports

Auditor's opinion on the company's financial statements is important that the report reveals the conformity of the information presented by the management with GAAP or FRS, and its fairness. Four types of opinion usually provided by auditors are unqualified opinion, qualified opinion, adverse opinion and disclaimer of opinion reports. Out of the four opinions, unqualified opinion is the best opinion, and is the most commonly issued opinion. The remaining three types of opinion are undesirable opinions, which show that the statements, either, do not comply with GAAP or FRS, or are lack of fairness, violate accounting principles, or cannot be audited impartially. We should be careful when studying the business performance of the company with these three types of opinion. Also, if the company changes auditors, we should take the numbers with a grain of salt.

2.3.6 Other Important Announcements You Should Not Miss Out

2.3.6.1 Bonus, Warrant and Treasury Shares Distribution Announcement

Koon will be delighted whenever the companies he has stake in distributing bonus, warrant, and bonus shares to their shareholders. According to him, the issuance of warrants and bonus, and the distribution of treasury shares are amongst the powerful catalysts that can lift the price of a stock up. Distributing warrants or treasury shares to shareholders is like giving 'Ang Pow' to all shareholders. Naturally the price of the stock will rise after the announcement of the news. Distributing bonus shares to shareholders, on the other hand, reveals that the company is in good financial health. The news will have positive effects on the share price, as investors' confidence in the company will be greatly elevated. In addition, the issuance of

bonus shares and convertible warrants will increase the liquidity of the stock.

2.3.6.2 Dividend Announcement

The declaration of dividends too has a great impact on the share price of a stock, as it increases the wealth of its investors. Further, it indicates the success of the business and helps growing the confidence of investors. As the confidence of investors boosted, the demand and share price of the stock will follow along. If we pay attention to this type of announcements and dividend distribution pattern, our chance of missing out on winning stocks in Bursa Malaysia would be very slim.

2.3.6.3 Share Buyback Announcement

Share repurchase indicates that a stock is cheap, and the company possesses plenty of cash. These two factors will attract the attentions of many investors who are constantly looking for undervalued stocks and will elevate the share price of the stock. Investors who always keep track of the company strategy and activities will be benefited from the announcement.

2.4 Stock Valuation

"The price of any particular security can be pictured as something resembling a captive balloon attached, not to the ground but to a wide line travelling through space. That line represents "intrinsic" value. As time goes on, if a company's earning power and true prospects improve, the line climbs higher and higher. If these or other basic ingredients of intrinsic value get worse, the line declines correspondingly. At any one time, the psychological influences (i.e., how the financial community is appraising these more fundamental matters of intrinsic value) will cause the price of the particular stock to be anywhere from well above this line to well below it. However, while momentary mass enthusiasm or unwarranted pessimism will cause the stock price to be far above or well below intrinsic value, it, like our captive balloon, can never get completely away from the line of true value and will always be pulled back toward that line sooner or later."

Philip Fisher

After analysing the business performance of a company and adding the stock in our shortlist, we must perform stock valuation prior to placing an order. This is to prevent us from paying an extortionate price for the stock. No matter how good the company is, our investment return will be greatly reduced if we pay an unreasonably high price for the stock. Therefore, stock valuation acts as the second defence line to protect our lifetime savings.

That being said, it does not mean that we should use a very complex model in our valuation work. According to Benjamin Graham, "*in 44 years of Wall Street*

experience and study I have never seen dependable calculations made about common stock values, or related investment policies that went beyond simple arithmetic or the most elementary algebra. Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience." When we use a multi-variable model with Greek symbols in your analysis, the likelihood of making mistakes will be higher. Instead of focusing on the economic moat of a business and its performance, we will just be concentrating on the precision of variables used for valuation. As a result, our attention will be diverted to the wrong direction and our investment thesis will be jeopardised. After all, stock valuation only helps us find an approximate value of the business, gives our rational side a chance to guard our investment and allows us to buy a stock at a price less than what it is worth. Hence, the process should not be made too complicated.

2.4.1 Simple Valuation and Common Sense Judgement

When we plan to start a business, we will usually begin our planning work by determining the income we can expect from the business. After that, we will calculate the number of years it takes for us to get back the capital we invest in the business. Similarly, when it comes to stock valuation, we should, first of all, find out the company's current earnings, current earnings per share and future earnings and future earnings per share. Using the data, we should subsequently find out how long the company needs to earn you back the price you pay for the stock. If the duration is too long, it is highly likely that the stock is overvalued.

2.4.1.1 Price-to-Earnings Ratio (and Forward Price-to-Earnings Ratio)

To calculate the duration, we can use price-to-earnings ratio (P/E or PER) equation, which measures the current share price of the stock in relation to its annual earnings per share. The higher the value, the longer it takes for the company to earn us the amount of money we pay for the stock.

However, you must note that price-to-earnings ratio is calculated using the current earnings per share, which does not indicate the direction towards where its stock price will be heading next year. The price will rise if its earnings grow the following year. If we avoid stocks with marginally higher P/E but with excellent profit growth prospects, we will probably miss out on the growth stories. In addition, professional fund managers always shun stocks with poor current earnings even though the companies have tremendous profit growth prospect. Since the fund managers are not interested in these stocks, they are sold at low prices. If we use the current earnings to calculate their P/E, we would also miss out on the rewards.

As a businessman, Koon prefers to focus on the future earnings, and forward price-to-earnings ratio. If it is accurately estimated, we would be highly rewarded. Forward price-to-earnings ratio measures

the current stock price in relation to the expected earnings per share. To determine the forward price-to-earnings ratio, we must be able to make an educated guess, or prediction about the future earnings of the business. Again, it can only be accurately predicted if we understand the business.

In general, Koon always looks for financially healthy companies with P/E, and forward P/E lesser than ten (P/E < 10). This will prevent him from overpaying for the stocks, and will increase his chance of winning the bet.

Having said that, research studies show that investors who buy only low P/E stocks are not always ended up winning. Stock prices seldom drop without a cause. As investors, we should figure it out why the price, and P/E of the stock are so low. If we pay attention to the company's announcements, and read its financial statements, and annual report closely, we should be able to find out the reason. If, indeed, the share price falls without a valid reason, the demand for its products is high and the company's earnings are on an uptrend, then we should not be afraid to buy the stock.

Price-to-earnings ratio = Share price / Earnings-per-share

Forward price-to-earnings ratio
= Share price / Forecasted earnings-per-share

2.4.1.2 Dividend Yield

Another approach to determine the duration we need to get back the money we invest in a stock is by examining the stock's dividend yield (D/Y), which measures the percentage of dividend we can expect from our investment. The higher the yield, the shorter it takes for us to get back the money we invest in the stock.

High dividend yield stocks are appealing to passive investors, and are always in high demand. Therefore, the prices of high dividend stocks are not cheap. If you can find a stock with a dividend yield higher than 7%, with high earnings predictability, and its earnings are on an uptrend, you should consider adding the stock in your portfolio.

Note that not all high dividend stock investments will be your winning bets. Since dividend yield is calculated based on the dividends paid last year, the yield tends to go up when the stock price falls during industry downturn. Being investors, we should find out if the dividend payment is sustainable by looking at the current earnings, earning potential, and cash flow of the firm. The yield will fall, and its price may drop further if the company is unable to maintain its dividend payment.

Stocks that pay very little or no dividend may not necessarily be a bad investment. Young companies usually do not pay dividend to shareholders, as they need to preserve the cash for business expansion. If we avoid high growth companies with profitable, and promising businesses that pay no dividend to shareholders without finding out the reason of doing so, a lot of golden opportunities will be slipping through our fingers.

Dividend yield = Dividend per share / Share price

2.4.2 Relative Valuation

After calculating the price-to-earnings ratio, we can re-value the stock again using relative valuation. The objective of this valuation is to find out if the stock is fairly priced compared to its competitors with comparable assets in the same industry. In relative valuation, it is assumed that the market is efficient on all stocks in the same industry except the stock to be analysed. In other words, the market is right on average but is wrong on an individual stock.

2.4.2.1 Methodology of Performing Relative Valuation

i. To perform relative valuation, first of all, we need to select a multiple that we would like to use for comparison. The most commonly used multiples for relative valuation are price-to-earnings ratio (P/E), enterprise value-to-earnings before interest, tax, depreciation and amortisation ratio (EV/EBITDA), enterprise value-to-earnings before interest and taxes ratio (EV/EBIT), price-to-book ratio (P/B), price-to-sales ratio (P/S) and etc. Since we have learned how to calculate the P/E of a stock earlier on, let’s use P/E for relative valuation.
ii. Subsequently, we need to list down the stock we are valuing, and its peers on a piece of paper.
iii. Calculate the P/E of each stock.
iv. Calculate the average P/E of the stocks.
Remark: the stock we are valuing currently, and the stocks with negative P/E should not be included in the average P/E calculation.
v. Multiply the average P/E by the earnings-per-share (EPS) of the stock we are valuing to find out the value of the stock.
vi. If the stock’s market price is lower than its value, it is undervalued. The higher stock price (compared to its value), conversely, implies that the stock is overvalued.

2.4.2.2 Use the Method Wisely

As much as the method helps ascertaining if a stock is undervalued or overvalued against its peers, it cannot tell us if the stock market,

in general, is undervalued or overvalued. Moreover, it does not indicate if the industry is entering a recession.

Take Plenitude Berhad, a property stock listed on the Main Board, as an example, it looked undervalued at the end of 2014 when the property market was taking a turn for the worse. Its P/E was below 10, and lower than the industry average. As the property market rolling down the hill, so was the share price of Plenitude Berhad. If anyone bought the stock at the end of 2014, and if he or she held onto it until 2019, his or her portfolio performance would be adversely affected by its price dip.

As investors, prior to placing our wager, we must study the business of the company, analyse the financial health of the company, and only safeguard our investment with stock valuation. Ask ourselves if the business can make more profits next year than this year, and make increasing profits years after next year. If the answer is “no”, we should move on to the next stock.

2.5 Example: Latitude Tree Holding Bhd.

"You must thoroughly analyze a company, and the soundness of its underlying businesses, before you buy its stock; you must deliberately protect yourself against serious losses."

Benjamin Graham

Latitude Tree Holdings Berhad is one of the multi-bagger stocks in which Koon previously invested, and it constituted a substantial chunk of his portfolio in 2013, 2014 and 2015. When he initially shared his investment thesis on Latitude with people, it was not well received, as they did not understand the business of the company, and did not bother to know about its financial performance. Most of them took punts on either stock market rock stars, or stocks in hot sectors. After two years, it was proved that Latitude was a better investment. Its stock price soared alongside the increasing profits, and stronger business performance. It still makes people wondering how Latitude provided such a spectacular return to its shareholders.

In this section, let us study why Latitude was a good investment in 2013, 2014, and 2015, and how Koon assessed Latitude. I hope this simple, yet practical method will help you discover multi-baggers stocks in Bursa Malaysia in future, and help us achieve financial freedom sooner after learning about it.

2.5.1 Understanding the Business of Latitude Tree Holding Bhd.

Latitude is one of the largest publicly traded furniture manufacturers in Malaysia by revenue. Despite its position in the industry, the company was not closely followed by any analysts in 2013. The market capitalisation of Latitude was only about 156 million in November 2013.

The company principally involved in wooden and rubber-wood furniture production. Being an integrated furniture manufacturer, the company has more control over the value chain, production expenses and transaction costs, and is able to offer a wide range of furniture products to clients at very low prices. As furniture order grows, the management increase their investment in the automated system and advanced technology machinery to reduce their long-term manufacturing costs.

In addition, it has a research and development team, comprises of professional designers, technicians and developers, designing furniture to cater for the tastes of different markets, to increase the range of innovative, and attractive products, and to adapt to the fast-changing customer needs. This investment gives the company an opportunity to distinguish itself from its competitors.

The group operates mainly in Southeast Asia such as Vietnam, Malaysia, and Thailand. In total, the company owns seven factories with the manufacturing area of 7.8 million square feet. Most of its products are exported overseas to the United States, Europe, Canada, Australia, and

Middle East countries. The United States, being the largest market of Latitude, accounted for 92% of its revenue in 2013.

Remark: one of the advices of Koon is to look for businesses that we can understand because we have to be able to make an educated guess about their future earnings. The more complex a business is, the more uncertain our projections will be. Moreover, it is harder for an incompetent management to make big mistake to affect the bottom line of a simple business.

2.5.2 Assessing the Financial Performance of Latitude Tree Holding Bhd.

Having a good understanding of the business, and its outlook is not enough, we must also analyse the financial health of the company, and buy it below its fair price. To judge the financial status of Latitude, we need to study the profitability, solvency, liquidity, and activity ratio of its business.

- **Profitability**

First of all, we must make sure that the business made more profits this year than last year, and will earn more profits next few years than this year before placing our bet.

Profit growth rate (YoY)
= [(Net profit in 2013 / Net profit in 2012) – 1] × 100%
= [(Rm 32,046,000 / Rm 14,753,000) – 1] × 100%
= 117.22%

Profit growth rate (4-yr CAGR)
= {[(Net profit in 2013 / Net profit in 2009) 1/4] – 1} × 100%
= [(Rm 32,046,000 / Rm 13,213,000) 1/4] – 1 × 100%
= 24.79%

It can be clearly seen from the calculation above that the net profit of Latitude in 2013 had increased by 117.22% from Rm 14.753 million to Rm 32.046 million. The figure was higher than that of its 4-year CAGR profit growth rate, 24.79%, and that of the industry average, 26.62%. The surge was an early indicator showing that the company’s net profit had started to grow rapidly in 2013, and had grown faster than the profit growth of its competitors.

Net profit margin (NPM)
= Net profit / Sales
= (Rm 32,045,000 / Rm 493,687,000) × 100%
= 6.49%

In addition, its net profit margin showed an improvement from 2.85% in 2012 to 6.49% in 2013, which was higher than that of the industry average, 5.66% in 2013. This implied that the business's profitability was improving, and was better than that of its peers.

Return on equity
= Net profit attributable to shareholders / Shareholders' equity
= (Rm 24,366,000 / Rm 232,061,000) × 100%
= 10.50%

Further, its return on equity demonstrated an improvement from 4.69% in 2012 to 10.50% in 2013, which was higher than that of the industry average, 8.19% in 2013. This figure suggested that the management is efficient in utilising the available resources to generate profits for the company despite the growing shareholders' equity, and decreasing debt level.

According to Koon, when he delved further into the business detail, and the financial reports of Latitude, he noticed a few near-term catalysts that would contribute positively to its bottom line, and would stimulate its revenue and earnings growth despite operating in a challenging economic environment. Some of the main catalysts include

- higher orders,
- increased production capacity in Vietnam,
- higher production output,
- improved productivity,
- lower material costs,
- lower tax rate, attributed to the tax incentive provided by the government of Vietnam
- strengthening of USD against MYR (refer to Figure 2.4),
- decrease in finance costs,
- upward revision of its selling prices for some products.

Figure 2.4: USD-MYR Currency Exchange Rate Chart from 2012 to 2017

Source: Yahoo Finance

Koon started buying Latitude after performing some analysis at the price of Rm 1.60, at the end of 2013. His judgement on the profit growth of Latitude was proved right when its net profit continued to increase in 2014 and 2015 (refer to Figure 2.5). In addition, its return on equity continued to show positive growth (refer to Figure 2.6) and so as its share price (refer to Figure 2.7). He added more shares to his winning position as the share price, and earnings of Latitude continued to go up. After holding the stock for about three years, he started to sell it at Rm 8.00 when the company reported reduced earnings in 2016.

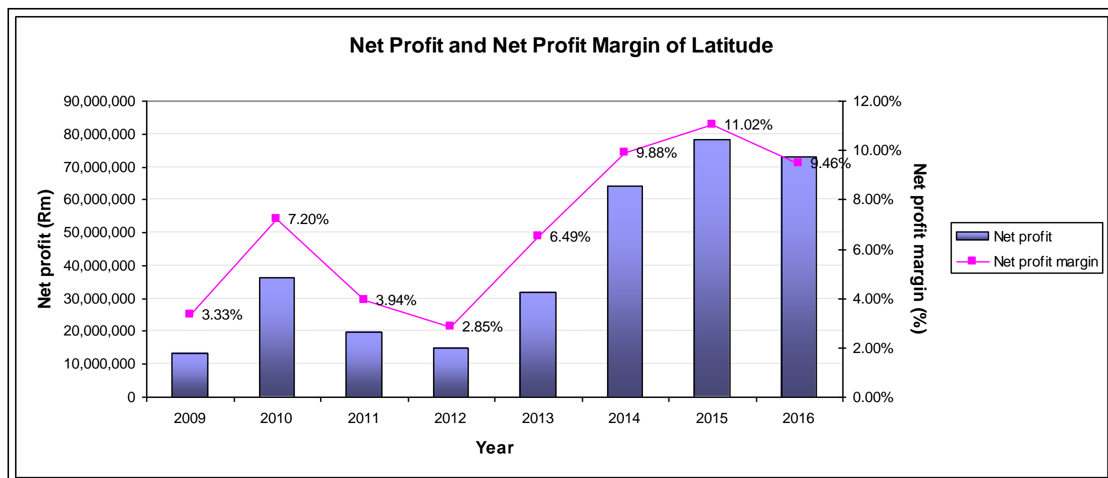

Figure 2.5: Net Profit and Net Profit Margin of Latitude from 2009 to 2016

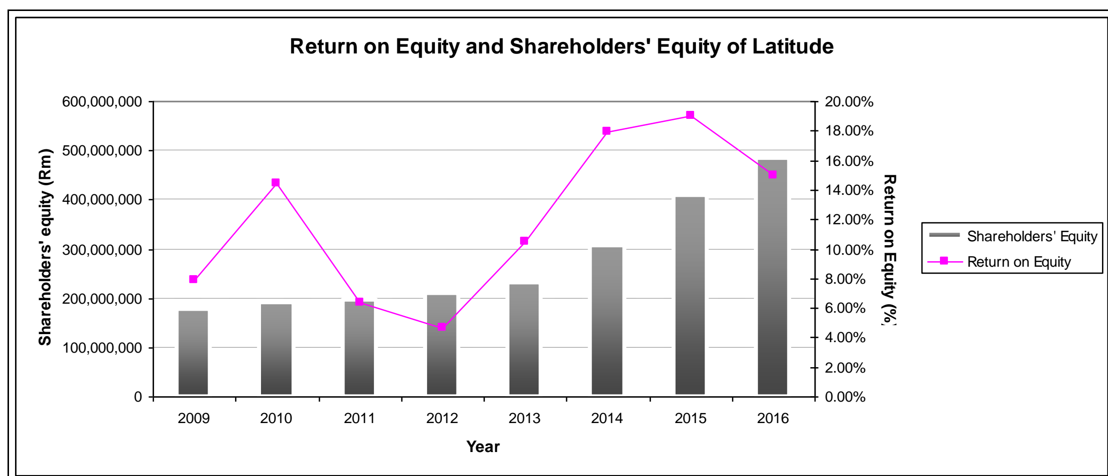

Figure 2.6: Return on Equity and Shareholders' Equity of Latitude from 2009 to 2016

Figure 2.7: Stock Price Chart of Latitude from 2012 to 2017

Source: Yahoo Finance

Reminder: betting your money on a profitable stock with growing profits, and good profit growth prospect will give you a higher chance of winning the game than on a money-losing business. The latter is more likely to continue suffering setbacks, so as its share price. You must avoid the company, unless you can be sure that its business has turned the corner, and will be profitable next year.

- **Solvency**

Subsequently, we have to ascertain the solvency of the company to ensure that the company has the ability to meet its long-term financial commitments. It can be done by analysing the debt-to-EBITDA ratio, and debt-to-equity ratios of the firm.

Debt-to-EBITDA ratio
= Debt / EBITDA
= Rm 98,533,000 / Rm 56,894,000
= 1.73

Debt-to-Equity ratio
= Debt / Shareholders' Equity
= Rm 98,533,000 / Rm 232,061,000
= 0.42

The debt-to-EBITDA ratio, and debt-to-equity ratio of Latitude in 2013 were at 1.73 and 0.42, respectively, and were still on down trend (refer to Figure 2.8). Although the figures were slightly higher than those of the industry averages, 1.42 and 0.17, respectively, they were controlled at acceptable levels. If we shun stocks with higher debt-to-EBITDA, and debt-to-equity blindly without trying to understand their reasons of taking loans, we will probably miss out on this type of glowing gems.

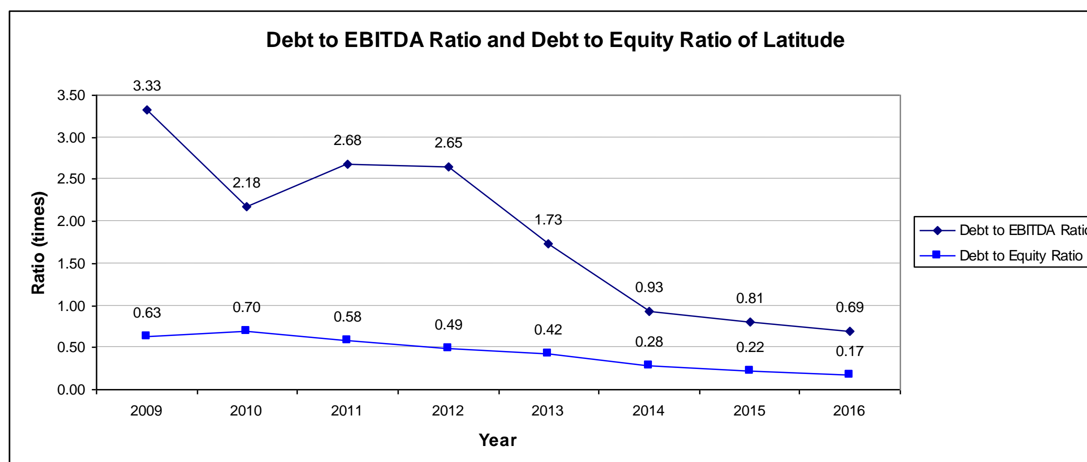

Figure 2.8: Debt-to-EBITDA Ratio and Debt-to-Equity Ratio of Latitude

- **Liquidity**

Also, we must not forget to assess the company's ability to pay its short-term obligations. It can be done by determining the current ratio and quick ratio of the stock.

Current ratio
= Current assets / Current liabilities
= Rm 228,528,000 / Rm 160,081,000
= 1.43

Quick ratio
= (Current assets – Inventories) / Current liabilities
= (Rm 228,528,000 – Rm 89,653,000) / Rm 160,081,000
= 0.87

As can be seen in Figure 2.10, the current ratio and quick ratio of Latitude were lower than those of the industry averages. The current ratio and quick ratio of Latitude in 2013 were at 1.43 and 0.87, respectively. The current ratio and quick ratio of the industry averages, on the other hand, were at 1.83 and 1.20, respectively. As the management continued to pay back its debts, and continued to build up its cash level, the current ratio and quick ratio of Latitude improved significantly (refer to Figure 2.9), which reached the levels of 2.62 and 1.78, respectively, in 2016.

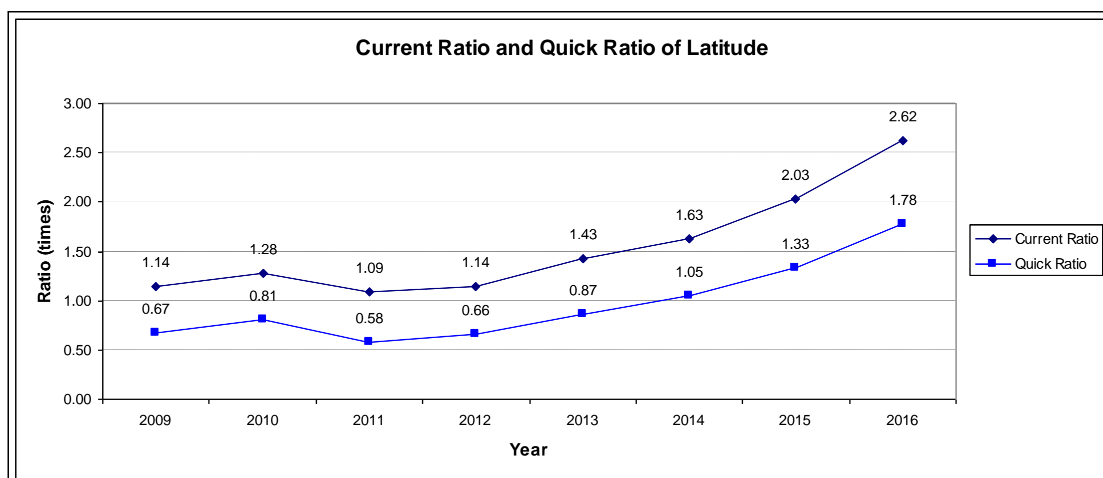

Figure 2.9: Current Ratio and Quick Ratio of Latitude from 2009 to 2016

- **Activity Ratio**

To prevent investing in a poorly-managed company (of which the management cannot utilise their resources effectively), we have to compare the total asset turnover ratio, inventory turnover ratio, and receivable turnover ratio of the company with those of its peers.

Total asset turnover ratio
= Sales / Average total assets
= Rm 493,687,000 / Rm 450,386,000
= 1.10

Inventory turnover ratio
= Sales / Average inventory
= Rm 493,687,000 / Rm 89,653,000
= 5.51 (66 days of inventory on hand)

Receivables turnover ratio
= Net credit sales / Average accounts receivable
= Rm 493,687,000 / Rm 33,530,000
= 14.72 (25 days of credit)

In comparison, the asset turnover ratio of Latitude in 2013 was similar to that of the industry average, 1.10. This figure implied that the company was as efficient as its competitors in utilising their assets to generate sales.

However, its inventory turnover ratio, 5.51, was slightly lower than that of the industry average, 6.10. Given the increasing orders in 2013, it was sensible that the management kept more inventories so they could fill the new orders quickly once they received them, and to prevent shortage of stock due to unforeseen circumstances.

Moreover, sixty six days of inventory on hand signified that the inventory moved fairly quickly. Therefore, it did not worry Koon much about the inventory level.

Compared to its peers, its receivables turnover ratio, 14.72, was far higher than that of the industry average, 6.92. This was a good sign showing that the management were efficient in collecting its credit.

- **Cash Flow**

Just like managing our personal finances, we must make sure that the company can continue its operation without running out of cash. Therefore, we must analyse the free cash flow and operating cash flow to sales ratio of the firm.

Free cash flow
= Operating cash flow – Capital expenditures
= Rm 52,879,000 – Rm 5,285,000
= Rm 47,594,000

Operating cash flow to sales ratio
= Operating cash flow / Sales
= Rm 52,879,000 / Rm 493,687,000
= 0.11

The free cash flow of Latitude, Rm 47,594,000, was in surplus in 2013, and was higher than its net profit, Rm 32,046,000, and was also higher than the dividend paid to shareholders, Rm 6,124,000. This was a positive sign showing that the company was in a healthy financial state. After paying dividend to shareholders, the company could still fund its business expansion, using the cash generated from operation, without taking more loans.

In addition, the operating cash flow to sales ratio of Latitude, 0.11, was higher than that of the industry average, 0.08. This indicated that the management was more capable than their competitors in turning sales into cash in their day-to-day operation.

Description	2009	2010	2011	2012	2013	Industry Average (in 2013)
Revenue (Rm)	397,378,000	506,866,000	500,664,000	517,863,000	493,687,000	163,715,000
Net profit (Rm)	13,213,000	36,483,000	19,741,000	14,753,000	32,046,000	9,259,000
Net profit attributable to shareholders (Rm)	14,009,000	27,730,000	12,471,000	9,840,000	24,366,000	8,958,000
Adjusted earnings per share (Rm)	0.1441	0.2853	0.1283	0.1012	0.2507	0.1041
Net profit margin (%)	3.33%	7.20%	3.94%	2.85%	6.49%	5.66%
Profit growth (year over year, %)	0.00%	176.11%	-45.89%	-25.27%	117.22%	26.62%
Return on equity (%)	7.89%	14.45%	6.36%	4.69%	10.50%	8.19%
Debt-to-EBITDA ratio (times)	3.33	2.18	2.68	2.65	1.73	1.42
Debt-to-equity ratio (times)	0.63	0.70	0.58	0.49	0.42	0.17
Current ratio (times)	1.14	1.28	1.09	1.14	1.43	1.83
Quick ratio (times)	0.67	0.81	0.58	0.66	0.87	1.20
Total asset turnover ratio (times)	1.09	1.17	1.22	1.25	1.10	1.12
Inventory turnover ratio (times)	6.65	6.61	5.91	6.80	5.51	6.10
Receivables turnover ratio (times)	12.82	13.56	14.16	12.46	14.72	6.92
Free cash flow (Rm)	37,467,000	8,781,000	-11,990,000	22,938,000	47,594,000	9,194,000
Operating cash flow to sales ratio (times)	0.11	0.08	0.05	0.07	0.11	0.08
Adjusted dividend per share (Rm)	0.0387	0.0667	0.0200	0.0300	0.0630	0.0275
Price to earnings ratio (P/E)					6.40	9.31
Dividend yield (%)					3.94	2.84

Figure 2.10: Summary of Latitude Tree Holdings Berhad’s Financial Performance

2.5.3 *Valuing the Business of Latitude Tree Holding Bhd.*

To avoid paying too much for sellers, and avoid overpaying for what the business is worth, Koon always makes sure that the Price-to-Earnings ratio or forward Price-to-Earnings ratio of his stock does not exceed 10, and does not exceed that of the industry average.

Price-to-Earnings ratio
= Share price / Earnings-per-share
= Rm 1.60 / Rm 0.25
= 6.40

Forward Price-to-Earnings ratio
= Share price / Estimated earnings-per-share
= Rm 1.60 / Rm 0.50
= 3.20

Predicted share price of Latitude in 2015
= Industry average P/E ratio × Predicted earnings-per-share
= 9.31 × Rm 0.50
= Rm 4.65

The Price-to-Earnings ratio and forward Price-to-Earnings ratio of the stock were only about 6.40 and 3.20, respectively, when Koon started to accumulate the shares of Latitude at the end of 2013. Both ratios were lower than 10, and were below the industry average P/E -- 9.31. Based on prediction, its stock price could go up to Rm 4.65 when Mr. Market re-valued it using the industry average P/E the following year. It was proved right as the share price went up to Rm 4.65 in early 2015, and the price continued its dash towards the level of Rm 8.00 at the end of 2015. Had anyone followed Koon to buy it at Rm 1.60 and sold it at Rm 8.00, he or she would have earned about 400% gain, equivalent to 124% per year, in the investment!

Chapter Summary

- Fundamental analysis is about finding the intrinsic value of a company
- What do we need to excel in fundamental analysis
  - ✓ Interest to understand the business of a stock
  - ✓ Rudimentary accounting and finance knowledge
  - ✓ Effort to study financial statements, annual reports, and announcements of a company
- The three main financial statements we should read
  - ✓ Income statement: gross profit, pre-tax profit, and net profit
  - ✓ Balance sheet: assets, liabilities, and equity
  - ✓ Cash flow statement: cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities
- How to analyse the value of a company
  - ✓ Step 1: know its business
    - What kind of products it offers?
    - Who the customers are?
    - How its profits are derived?
  - ✓ Step 2: assess the financial health of the company
    - i. Profitability:
Profit growth rate, net profit margin, return on equity
    - ii. Solvency:
Debt-to-EBITDA ratio, and debt-to-equity ratio
    - iii. Liquidity:
Current ratio, and quick ratio
    - iv. Activity ratio:
Asset turnover ratio, inventory turnover ratio, and receivables turnover ratio

Chapter Summary (Continued)

v. Cash flow:
Free cash flow, and operating cash flow to sales ratio

- ✓ Step 3: value the stock
  - Using Price-to-Earnings ratio, and forward Price-to-Earnings ratio
  - Using dividend yield
  - Using relative valuation

- ➢ Do not ignore the details of financial and annual reports, and important announcements
  - ✓ Prospect of the business
  - ✓ Latest development
  - ✓ Segmental business performance
  - ✓ Number of shares owned by the management, and major shareholders
  - ✓ Other nitty-gritty of annual reports: risk and uncertainties, and auditor's reports
  - ✓ Essential announcements: warrants, bonus and treasury shares distribution, dividend, and share buyback announcements

- ➢ Before buying a stock, we must make sure that
  - ✓ The company makes increasing profits
  - ✓ The company is financially stable
  - ✓ Its share price is below what the business is worth