How retail investors can avoid short-sellers' targets

Such stocks generally show signs of basic problems which diligent investors can recognise.

By : BOBBY JAYARAMAN

OVER the past few months, many Singapore companies have come under the spotlight of short-sellers and have been sold aggressively. Even companies such as Noble and Olam which were thought of as high-quality growth companies with wide institutional ownership have not been spared. Retail investors must have been dismayed by the level of complexity and detail in the back-and-forth exchanges between the target company and the short-seller. Let alone small investors, even equity analysts who are supposed to know the ins and outs of the company they cover were mostly silent except to make empty statements such as "there is nothing new in the report" or "we are waiting for more information from the management".

Short-seller accusations mostly revolve around common themes. A diligent investor can save himself a lot of grief by avoiding companies that show signs of making a short-seller's shortlist. What are those signs? While these are not exhaustive, I believe answering the five questions below is a good start to picking companies that will stay out of a short-seller's crosshairs.

1. How does the company really make money?

One would think that anyone who invests in stocks would be able to answer such a basic question. The reality is that even fund managers are likely to be stumped by this question for some of the stocks they own. Most people when asked how their neighbourhood cafe makes money would be able to say something like: they make money by selling drinks, sweets and sandwiches to customers. Their costs are the raw material for their food and drinks such as milk, meat and sugar, staff costs, shop rental, depreciation for furniture/fitouts, utilities and transport. Any money they make after covering these costs is their profit. Their profits would depend on the number of customers, the amount each customer spends, and on how well they control their costs.

Can you describe with similar clarity how the various businesses you bought (a stock represents a part ownership in a business) make money? Try this for Noble or any major Wall Street bank! If you are unable to answer this clearly, try learning more about the industry or simply put the stock in the "too hard" bucket and move on.

Short-sellers are attracted to complex business models like bees to honey. They know that such businesses offer plenty of opportunities for crooked managers to cook the books. Till Enron's plunge into bankruptcy, very few people understood how it actually made money. Of course, that did not stop analysts from issuing rosy price targets!

2. Do the sales and profit numbers look and feel real?

In September 2014, an anonymous short- seller launched an attack against SGX-listed Sino Grandness claiming that its revenues and profits were grossly inflated. It did indeed seem strange that a new entrant in the fiercely competitive market for fruit juices in China could snatch market share away from the major players and that too at much higher margins. Apparently, not many investors had questioned this before as Sino Grandness's share price took a severe beating post the short-seller's report.

Most investors make the mistake of immediately extrapolating earnings into the future without critically examining the business. Sudden changes in revenues and earnings should always be viewed sceptically as incumbents fight tooth and nail for every dollar. Operating margins generally do not differ much among peers. If indeed a new entrant manages to post strong numbers in the face of high entrenched competition, then the source of that advantage should be clearly understood to build conviction in the company's business model.

Despite diligent research, if an investor is unable to build conviction in the company's business model, it is best to give it a miss.

3. Does the company generate healthy operating cash flows?

One of the first things a doctor does when a patient comes to see him is to take his temperature. Why? Because a fever immediately tells the doctor that something is wrong with the patient.

Similarly, a business reporting consistent negative operating cash flows while reporting strong accounting profits flashes a clear "something is wrong" signal to the smart investor. Lack of operating cash flows is a common factor in virtually all short-seller target companies.

Operating cash flows are the lifeblood of every business and signify the cash generating power of the business. It is through operating cash flows that companies finance all or part of their capital expenditures, service debt and pay dividends to shareholders.

High operating cash flows and low investing requirements lead to the blissful situation of a business generating free cash flows which form the foundation of long-term sustainable growth. Every successful company and shareholder wealth creator over the years has thrown off ample cash, be it Microsoft, Walmart, Visa, Nike or Infosys.

The reasons for poor operating cash flows can be many. The company may have a long receivable collection period or, worse, is simply unable to collect. Inventory turnover may be very low. The income statement may include non-cash accounting gains such as negative goodwill, writeback of provisions and fair value gains. The company may be using mark-to-market accounting or booking profits through release of various reserves.

Just as some fevers are easy to diagnose and some test even the best of doctors, so it is with operating cash flows. While even beginner investors will be able to spot weak operating cash flows - say, due to seasonal inventory stocking - others such as mark-to-market accounting are far more complicated to understand.

This is where the investor has a big advantage over the doctor. Unlike a doctor who has no choice but to diagnose and treat the patient, the investor can simply move on to the next company. Why risk your capital on companies with questionable cash flows when there are plenty of businesses available with strong cash flows?

CEOs are well aware that investors like to see profit growth and thus focus most of their attention on showing EPS (earnings per share) growth. Analysts play along by valuing companies mostly on price-to-earnings ratio. All of this influences investors to quickly pluck the EPS or net profit number from the income statement to get an idea of the health of their companies.

This approach is majorly flawed as the net profit number is the one that can be most easily manipulated and reveals little about the true state of the business. Serious investors always scrutinise the cash flow statements thoroughly as this is where the red flags show up first.

4. Does the company depend on large and frequent acquisitions to deliver growth?

In June 2014, a little-known short-seller, Prescience Point, published a damning report on Chicago Bridge & Iron (CB&I), a multinational oil and gas engineering, procurement and construction company with a 10 per cent stakeholding by no less than Warren Buffet's Berkshire Hathaway.

The report charged that CB&I was inflating earnings by releasing income from a merger reserve created during a large 2013 acquisition of a competitor. Notwithstanding Berkshire Hathaway's tacit approval, the stock took a severe beating.

Merger accounting with creation of all sorts of reserves is complicated to decipher even for professionals. While small bolt-on acquisitions to strengthen specific areas of a company are fine, it is best to stay clear of companies that seem dependent on large mergers and acquisitions to deliver growth. One can never be sure whether real value is being created or whether it is just a smoke screen to cover up something else.

Incidentally, analysing the cash flow statement would have helped here too. For CB&I, there had been a growing divergence between earnings and cash flow since the 2013 acquisition.

5. Are the company's assets real and verifiable?

Book value or net asset value (NAV) is a commonly used valuation measure. Companies regularly report NAV per share in their financial statements. This number, however, is only as real as the assets and liabilities on the company's books. In 2010, short-selling firm Muddy Waters alleged that Sino Forest, a Chinese logging company listed in Canada, had grossly exaggerated its timber assets. Similar charges were made against Oriental Paper, a US-listed Chinese paper products manufacturer.

There is a big difference between a balance sheet that has mostly cash and prominent assets such as a CBD office building in a major city versus one that has a land bank in the Canadian wilderness, a shrimp farm, or a mine in Angola. Investors need to understand the genuineness and value of the actual assets before ascribing any importance to NAV. Valuations can seriously crumble if the assets are found to be non-existent or of much lower value than previously thought.

To sum up, stocks targeted by short- sellers generally show signs of fundamental problems which can be recognised early by diligent investors. Some have fiendishly complex business models that no one understands while others are simply unable to generate operating cash flows despite showing healthy accounting profits. As investors, the biggest advantage we have is simply passing over such investments irrespective of glowing analyst forecasts or blue-chip institutional ownership.

The writer is a private investor and author of the book "Building Wealth Through REITS". He can be reached at jbobby@frunzeinvestments.com