

"If you want to beat the S&P 500, here's what you do, you buy 500 stocks, and then you sell the airlines. You should do better." - Tom Gayner

A reader asks about Owners' Earnings.

According to Buffett Owners Earnings = a) Net Reporting + b) Depreciation, Amortization - c) Capex (Maintenance & Growth).

Buffett says if a+b is greater than c, then Company is earning sufficient amount for the shareholders.

My query is how do we come to a value on Capex? Not precise but on a rough basis?

Thank You.

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I suggest that you look at an average of the past 5 years of capital expenditures versus asset growth and calculate average maintenance capex. Maintenance capex (MCX) is mandatory while growth capex is not. See previous post on growth vs. maintenance capex here: <http://csinvesting.wordpress.com/2011/10/24/calculating-capex-mcx-and-growth-capex/>.

But most importantly, look at the business and its **competitive landscape**. Does the business lack barriers to entry so that much of the firm's capex goes to staying in place or fending off competition? Compare the company's capex to its competitors. A recent case study is in the Wall Street Journal today (November 17th, 2011).

Sears Suffers as It Skimps on Stores

While retail experts estimate that store chains traditionally spend \$6 to \$8 per square foot on annual maintenance, Sears is spending a fraction of that amount, said Matthew McGinley, managing director of International Strategy & Investment Group, an investor research firm.

"With roughly 250 million square feet domestically, (Sears) is spending about \$1.90 a foot, which is a *quarter* of what you need to maintain share and keep it as an acceptable place to shop." Mr. McGinley said. (Of course, this might indicate that Sear's true owner's earnings are overstated due to the lack of competitive maintenance capex.)

Also, you should break-out growth from maintenance capex. Buffett says owner's earnings are the earnings available to an owner on a steady state basis (without growth).

I included a few articles and Buffett's own words on how to calculate owner's earnings.

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Warren Buffett on Owner's Earnings (1986 Berkshire Annual Report)

Many business acquisitions require major purchase-price accounting adjustments, as prescribed by generally accepted accounting principles (GAAP). The GAAP figures, of course, are the ones used in our consolidated financial statements. But, in our view, the GAAP figures are not necessarily the most useful ones for investors or managers. Therefore, the figures shown for specific operating units are earnings before purchase-price adjustments are taken into account. In effect, these are the earnings that would have been reported by the businesses if we had not purchased them.

Analyzing Capital Expenditures

A discussion of our reasons for preferring this form of presentation is in the Appendix to this letter. This Appendix will never substitute for a steamy novel and definitely is not required reading. However, I know that among our 6,000 shareholders there are those who are thrilled by my essays on accounting - and I hope that both of you enjoy the Appendix.

February 27, 1987 Warren E. Buffett
Chairman of the Board

Appendix

Purchase-Price Accounting Adjustments and the "Cash Flow" Fallacy

First a short quiz: below are abbreviated 1986 statements of earnings for two companies. Which business is the more valuable?

	<u>Company O</u>	<u>Company N</u>	
			(000s Omitted)
Revenues.....	\$677,240	\$677,240	
Costs of Goods Sold:			
Historical costs, excluding depreciation.....	\$341,170	\$341,170	
Special non-cash inventory costs.....		4,979 ⁽¹⁾	
Depreciation of plant and equipment	8,301	13,355 ⁽²⁾	
	<u>349,471</u>	<u>359,504</u>	
	\$327,769	\$317,736	
Gross Profit			
Selling & Admin. Expense.....	\$260,286	\$260,286	
Amortization of Goodwill	_____	<u>595</u> ⁽³⁾	
		<u>260,286</u>	<u>260,881</u>
Operating Profit	\$ 67,483	\$ 56,855	
Other Income, Net	<u>4,135</u>	<u>4,135</u>	
Pre-Tax Income	\$ 71,618	\$ 60,990	
Applicable Income Tax:			
Historical deferred and current tax	\$ 31,387	\$ 31,387	
Non-Cash Inter-period Allocation Adjustment	_____	<u>998</u> ⁽⁴⁾	

Analyzing Capital Expenditures

Net Income	<u>31,387</u> \$40,231 =====	<u>32,385</u> \$28,605 =====
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(Numbers (1) through (4) designate items discussed later in this section.)

As you've probably guessed, Companies O and N are the **same** business - Scott Fetzer. In the "O" (for "old") column we have shown what the company's 1986 GAAP earnings would have been if we had not purchased it; in the "N" (for "new") column we have shown Scott Fetzer's GAAP earnings as actually reported by Berkshire.

It should be emphasized that the two columns depict identical economics - i.e., the same sales, wages, taxes, etc. And both "companies" generate the same amount of cash for owners. Only the accounting is different.

So, fellow philosophers, which column presents truth? Upon which set of numbers should managers and investors focus?

Before we tackle those questions, let's look at what produces the disparity between O and N. We will simplify our discussion in some respects, but the simplification should not produce any inaccuracies in analysis or conclusions.

The contrast between O and N comes about because we paid an amount for Scott Fetzer that was different from its stated net worth. Under GAAP, such differences - such premiums or discounts - must be accounted for by "purchase-price adjustments." In Scott Fetzer's case, we paid \$315 million for net assets that were carried on its books at \$172.4 million. So we paid a premium of \$142.6 million.

The first step in accounting for any premium paid is to adjust the carrying value of current assets to current values. In practice, this requirement usually does not affect receivables, which are routinely carried at current value, but often affects inventories. Because of a \$22.9 million LIFO reserve¹ and other accounting intricacies, Scott Fetzer's inventory account was carried at a \$37.3 million discount from current value. So, making our first accounting move, we used \$37.3 million of our \$142.6 million premium to increase the carrying value of the inventory.

Assuming any premium is left after current assets are adjusted, the next step is to adjust fixed assets to current value. In our case, this adjustment also required a few accounting acrobatics relating to deferred taxes. Since this has been billed as a simplified discussion, I will skip the details and give you the bottom line: \$68.0 million was added to fixed assets and \$13.0 million was eliminated from deferred tax liabilities. After making this \$81.0 million adjustment, we were left with \$24.3 million of premium to allocate.

Had our situation called for them two steps would next have been required: the adjustment of intangible assets other than Goodwill to current fair values, and the restatement of liabilities to current fair values, a requirement that typically affects only long-term debt and unfunded pension liabilities. In Scott Fetzer's case, however, neither of these steps was necessary.

The final accounting adjustment we needed to make, after recording fair market values for all assets and liabilities, was the assignment of the residual premium to Goodwill (technically known as "excess of cost over the fair value of net assets acquired"). This residual amounted to \$24.3 million. Thus, the balance sheet of Scott Fetzer immediately before the acquisition, which is summarized below in column O, was transformed by the

¹ A LIFO reserve is the difference between the current cost to replace inventory and the amount shown as the cost of inventory on a balance sheet. This difference can grow significantly, especially during inflationary periods.

Analyzing Capital Expenditures

purchase into the balance sheet shown in column N. In real terms, both balance sheets depict the same assets and liabilities - but, as you can see, certain figures differ significantly.

	<u>Company O</u>	<u>Company N</u>
(000s Omitted)		
Assets		
Cash and Cash Equivalents.....	\$ 3,593	\$ 3,593
Receivables,net.....	90,919	90,919
Inventories	77,489	114,764
Other	<u>5,954</u>	<u>5,954</u>
Total Current Assets.....	177,955	215,230
Property, Plant, and Equipment, net	80,967	148,960
Investments in and Advances to Unconsolidated Subsidiaries and Joint Ventures.....	93,589	93,589
Other Assets, including Goodwill.....	<u>9,836</u>	<u>34,210</u>
	<u>\$362,347</u>	<u>\$491,989</u>
Liabilities		
Notes Payable and Current Portion of LT Debt.....	\$ 4,650	\$ 4,650
Accounts Payable	39,003	39,003
Accrued Liabilities	<u>84,939</u>	<u>84,939</u>
Total Current Liabilities	128,592	128,592
Long-term Debt and Capitalized Leases	34,669	34,669
Deferred Income Taxes	17,052	4,075
Other Deferred Credits	<u>9,657</u>	<u>9,657</u>
Total Liabilities	189,970	176,993
Shareholders' Equity	<u>172,377</u>	<u>314,996</u>
	\$362,347	\$491,989

The higher balance sheet figures shown in column N produce the lower income figures shown in column N of the earnings statement presented earlier. This is the result of the asset write-ups and of the fact that some of the written-up assets must be depreciated or amortized. The higher the asset figure, the higher the annual depreciation

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or amortization charge to earnings must be. The charges that flowed to the earnings statement because of the balance sheet write-ups were numbered in the statement of earnings shown earlier:

1. \$4,979,000 for non-cash inventory costs resulting, primarily, from reductions that Scott Fetzer made in its inventories during 1986; charges of this kind are apt to be small or non-existent in future years.
2. \$5,054,000 for extra depreciation attributable to the write-up of fixed assets; a charge approximating this amount will probably be made annually for 12 more years.
3. \$595,000 for amortization of Goodwill; this charge will be made annually for 39 more years in a slightly larger amount because our purchase was made on January 6 and, therefore, the 1986 figure applies to only 98% of the year.
4. \$998,000 for deferred-tax acrobatics that are beyond my ability to explain briefly (or perhaps even non-briefly); a charge approximating this amount will probably be made annually for 12 more years.

It is important to understand that none of these newly-created accounting costs, totaling \$11.6 million, are deductible for income tax purposes. The "new" Scott Fetzer pays exactly the same tax as the "old" Scott Fetzer would have, even though the GAAP earnings of the two entities differ greatly. And, in respect to operating earnings, that would be true in the future also. However, in the unlikely event that Scott Fetzer sells one of its businesses, the tax consequences to the "old" and "new" company might differ widely.

By the end of 1986 the difference between the net worth of the "old" and "new" Scott Fetzer had been reduced from \$142.6 million to \$131.0 million by means of the extra \$11.6 million that was charged to earnings of the new entity. As the years go by, similar charges to earnings will cause most of the premium to disappear, and the two balance sheets will converge. However, the higher land values and most of the higher inventory values that were established on the new balance sheet will remain unless land is disposed of or inventory levels are further reduced.

* * *

What does all this mean for owners? Did the shareholders of Berkshire buy a business that earned \$40.2 million in 1986 or did they buy one earning \$28.6 million? Were those \$11.6 million of new charges a real economic cost to us? Should investors pay more for the stock of Company O than of Company N? And, if a business is worth some given multiple of earnings, was Scott Fetzer worth considerably more the day before we bought it than it was worth the following day?

If we think through these questions, we can gain some insights about what may be called "owner earnings." These represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges such as Company N's items (1) and (4) less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume. (If the business requires additional working capital to maintain its competitive position and unit volume, the increment also should be included in (c). However, businesses following the LIFO inventory method usually do not require additional working capital if unit volume does not change.)

Our owner-earnings equation does not yield the deceptively precise figures provided by GAAP, since (c) must be a guess - and one sometimes very difficult to make. Despite this problem, **we consider the owner earnings figure, not the GAAP figure, to be the relevant item for valuation purposes - both for investors in buying stocks and for managers in buying entire businesses.** We agree with Keynes's observation: **"I would rather be vaguely right than precisely wrong."**

The approach we have outlined produces "owner earnings" for Company O and Company N that are identical, which means valuations are also identical, just as common sense would tell you should be the case. This result is reached because the sum of (a) and (b) is the same in both columns O and N, and because (c) is necessarily the same in both cases.

And what do Charlie and I, as owners and managers, believe is the correct figure for the owner earnings of Scott Fetzer? Under current circumstances, we believe (c) is very close to the "old" company's (b) number of \$8.3 million and much below the "new" company's (b) number of \$19.9 million. Therefore, we believe that owner earnings are far better depicted by the reported earnings in the O column than by those in the N column. In other words, we feel owner earnings of Scott Fetzer are considerably larger than the GAAP figures that we report.

That is obviously a happy state of affairs. But calculations of this sort usually do not provide such pleasant news. Most managers probably will acknowledge that they need to spend something more than (b) on their businesses over the longer term just to hold their ground in terms of both unit volume and competitive position. When this imperative exists - that is, when (c) exceeds (b) - GAAP earnings overstate owner earnings. Frequently this overstatement is substantial. The oil industry has in recent years provided a conspicuous example of this phenomenon. Had most major oil companies spent only (b) each year, they would have guaranteed their shrinkage in real terms.

All of this points up the absurdity of the "cash flow" numbers that are often set forth in Wall Street reports. These numbers routinely include (a) plus (b) - but do not subtract "c". Most sales brochures of investment bankers also feature deceptive presentations of this kind. These imply that the business being offered is the commercial counterpart of the Pyramids - forever state-of-the-art, never needing to be replaced, improved or refurbished. Indeed, if all U.S. corporations were to be offered simultaneously for sale through our leading investment bankers - and if the sales brochures describing them were to be believed - governmental projections of national plant and equipment spending would have to be slashed by 90%.

"Cash Flow", true, may serve as a short hand of some utility in descriptions of certain real estate businesses or other enterprises that make huge initial outlays and only tiny outlays thereafter. A company whose only holding is a bridge or an extremely long-lived gas field would be an example. But "cash flow" is meaningless in such businesses as manufacturing, retailing, extractive companies, and utilities because, for them, (c) is always significant. To be sure, businesses of this kind may in a given year be able to defer capital spending. But over a five- or ten-year period, they must make the investment - or the business decays.

Why, then, are "cash flow" numbers so popular today? In answer, we confess our cynicism: we believe these numbers are frequently used by marketers of businesses and securities in attempts to justify the unjustifiable (and thereby to sell what should be the unsalable). When (a) - that is, GAAP earnings - looks by itself inadequate to service debt of a junk bond or justify a foolish stock price, how convenient it becomes for salesmen to focus on (a) + (b). But you shouldn't add (b) without subtracting (c): though dentists correctly claim that if you ignore your teeth they'll go away, the same is not true for (c). The company or investor believing that the debt-servicing ability or the equity valuation of an enterprise can be measured by totaling (a) and (b) while ignoring (c) is headed for certain trouble.

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To sum up: in the case of both Scott Fetzer and our other businesses, we feel that (b) on an historical-cost basis - i.e., with both amortization of intangibles and other purchase-price adjustments excluded - is quite close in amount to (c). (The two items are not identical, of course. For example, at See's we annually make capitalized expenditures that exceed depreciation by \$500,000 to \$1 million, simply to hold our ground competitively.) Our conviction about this point is the reason we show our amortization and other purchase-price adjustment items

separately in the table on page 8 and is also our reason for viewing the earnings of the individual businesses as reported there as much more closely approximating owner earnings than the GAAP figures.

Questioning GAAP figures may seem impious to some. After all, what are we paying the accountants for if it is not to deliver us the "truth" about our business. But the accountants' job is to record, not to evaluate. The evaluation job falls to investors and managers.

Accounting numbers, of course, are the language of business and as such are of enormous help to anyone evaluating the worth of a business and tracking its progress. Charlie and I would be lost without these numbers: they invariably are the starting point for us in evaluating our own businesses and those of others. Managers and owners need to remember, however, that accounting is but an aid to business thinking, never a substitute for it.

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[HTTP://THEINVESTMENTSBLOG.BLOGSPOT.COM/2011/01/BUFFETT-DIG-WE-MUST.HTML](http://THEINVESTMENTSBLOG.BLOGSPOT.COM/2011/01/BUFFETT-DIG-WE-MUST.HTML)

Buffett on **restricted earnings** (the "opposite" of owner's earnings)

From the 1984 Berkshire Hathaway [Shareholder Letter](#):

The first point to understand is that all earnings are not created equal. In many businesses particularly those that have high asset/profit ratios - inflation causes some or all of the reported earnings to become ersatz. The ersatz portion - let's call these earnings "restricted" - cannot, if the business is to retain its economic position, be distributed as dividends. Were these earnings to be paid out, the business would lose ground in one or more of the following areas: its ability to maintain its unit volume of sales, its long-term competitive position, its financial strength. No matter how conservative its payout ratio, a company that consistently distributes restricted earnings is destined for oblivion unless equity capital is otherwise infused.

Restricted earnings are seldom valueless to owners, but they often must be discounted heavily. In effect, they are conscripted by the business, no matter how poor its economic potential. (This retention-no-matter-how-unattractive-the-return situation was communicated unwittingly in a marvelously ironic way by Consolidated Edison a decade ago. At the time, a punitive regulatory policy was a major factor causing the company's stock to sell as low as one-fourth of book value; i.e., every time a dollar of earnings was retained for reinvestment in the business, that dollar was transformed into only 25 cents of market value. But, despite this gold-into-lead process, most earnings were reinvested in the business rather than paid to owners. Meanwhile, at construction and maintenance sites throughout New York, signs proudly proclaimed the corporate slogan, "Dig We Must".)

Businesses with relatively more "restricted earnings" generally require a higher margin of safety (all other things being equal) to account for the potential gold-into-lead folly.

If you're driving a truck across a bridge that says it holds 10,000 pounds and you've got a 9,800 pound vehicle, if the bridge is 6 inches above the crevice it covers, you may feel okay, but if it's over the Grand Canyon, you may feel you want a little larger margin of safety. - Warren Buffett

Also, those businesses with fewer "restricted earnings" are intrinsically more valuable as they have greater flexibility to invest earnings in a manner producing a high return on capital for investors.

The problem is, of course, financial statements alone don't explicitly reveal how much of a business' earnings are restricted. I mean, it would be nice if "restricted earnings" could be found somewhere on an income statement. Any business that has a high ratio of assets on the balance sheet relative to the profits it generates on average over

the entire business cycle is a likely candidate.

The bottom line is it makes sense to pay less for companies with a lot of "restricted earnings" both because the intrinsic value of the earnings is lower and a larger margin of safety is required.

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Both earnings per share (EPS) and cash flow have serious deficiencies in business valuation. Earnings per share was briefly mentioned in the previous article on return on assets, its problem being that in times of inflation, companies with a low return on assets suffer as the replacement cost of these assets increases. A better way of assessing earnings would be to look at actual cash flow.

But cash flow has problems of its own, as it is invalid to compare the cash flow of a company requiring high capital expenditure with one with low capex. Cash flow works fine when a company has little need for large ongoing outlays past initial setup costs, such as real estate companies, cable and telco companies and oil and gas industries. However cash flow is a poor measure of the worth of companies that require extensive ongoing capital expenditure, such as manufacturers and airlines.

"Owner earnings" is a concept invented by Warren Buffet that overcomes the capex deficiency of cash flow. You add back to earnings the deductions made for depreciation etc. and subtract capital expenditures. Owner earnings are calculated as:

Owner earnings = net income + depreciation + depletion + amortization - capital expenditures - additional working capital.

Admittedly it isn't a precise measure, it requires the analyst to make an estimation of upcoming capital expenditures, which can be a fairly approximate exercise, however this is probably the best anyone can do. The answer is going to be approximately right, rather than exactly wrong.

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Reported Earnings versus "Owner Earnings"

John P. Hussman, Ph.D.

[HTTP://WWW.HUSSMAN.NET/WMC/WMC100201.HTM](http://www.hussman.net/wmc/wmc100201.htm)

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WARREN BUFFETT ON OWNER EARNINGS

Warren Buffett has referred to the 'owner earnings' of a company as the true measure of earnings. He has defined 'owner earnings' as:

Reported earnings + depreciation, amortization, other non-cash items - average annual amount of capitalized spending on plant, machinery, equipment (and presumably research and development).

REASONING BEHIND OWNER EARNINGS

His thinking seems to go like this.

Depreciation

You should not consider depreciation because this is generally a fixed percentage of an amount spent in the past that does not necessarily reflect the true cost of replacing things when they are obsolete.

Amortization

Buffett has often criticized accounting amortization of things such as economic goodwill. Economic goodwill, including things such as brand name, reputation, monopolistic or market dominance, might actually increase in value rather than depreciate.

Capital expenditure

It is difficult to estimate true capital spending. Items may be deferred or brought forward. Averaging actual expenditure is a more reliable guide of a company's true capital needs.

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www.csinvesting.wordpress.com:

Estimating Capex? You need to compare a company's capex vs. competitors and understand the differences if significant adjusted for size. Note the recent article below.

Wall Street Journal November 17th, 2011

SEARS SUFFERS AS IT SKIMPS ON STORES, RENOVATIONS ARE RARE AND MODEST, MAKING OUTLETS SEEM LIKE 'DEAD MAN WALKING'

The average retail store spends \$6 to \$8 per square foot on maintenance versus \$1.50 for Sears.

"Sears remains in critical condition," said analyst Greg Melich of ISI Group. "We continue to believe that underinvestment will not support the asset base and [we] find much better opportunities in retail."

Wall Street has repeatedly faulted Sears Holdings, which is majority owned by hedge-fund investor Eddie Lampert's ESL Investments, for skimping on investment in stores, which analysts view as the key to attracting shoppers.

The company has lost market share to retailers including Wal-Mart Stores Inc., Target Corp. and Kohl's Corp., analysts said.

Lampert has said that online is a key part of retailers' future as the company has aggressively invested on the online efforts and digital front. The company's domestic online business saw a 20% increase in sales.

That's not enough, analysts said.

Reuters

Edward Lampert announcing the merger of Kmart and Sears Roebuck in 2004.

“We continue to be impressed by Sears’s online efforts,” said Credit Suisse analyst Gary Balter. “It is a shame that the company has seemed resolute in underinvesting in its core stores, as, in our opinion, the poor consumer experience at the stores takes away from this approach.”

He said besides Williams-Sonoma, Sears is among the “most forward thinking” among the hardline retailers on the opportunities of online sales and of the potential to use multiple touch points with consumers to its advantage.

Sears Domestic comparable-store sales declined 0.7%, Kmart’s comparable-store sales declined 0.9% and Sears Canada’s comparable-store sales declined 7.8%.

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Mr. Lampert may be a great investor but the quality of Sear’s business may overcome management’s efforts.



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