Skaffold®
INVESTMENT. SIMPLIFIED.

10 qualities of a top stock

A ‘top stock’ can mean different things to different investors. For some the very best stocks will offer opportunities for growth, whilst for other investors yield will make the stock attractive.

At Skaffold, we believe great companies display similar distinguishing characteristics. As a value investor, you need to know what they are to ensure you look beyond short-term hype to more meaningful measures when deciding which stocks to buy.

The key to unearthing superior stocks is being able to identify what separates them from their lower quality counterparts. Stocks that stack up well against key criteria are more likely to withstand financial storms, and as such are more worthy of a place in your portfolio.

At Skaffold we look for businesses that have solid balance sheets, are consistently profitable and undervalued. To help stock market investors evaluate the underlying quality and performance of individual companies, Skaffold, an advocate of value investing principles, has automated the process. It’s called the Skaffold Score.

Business quality and safety is determined via Skaffold’s Quality Score with every stock rated from A to C. The highest quality businesses are rated A. These businesses have very strong balance sheets, good cash flow and low debt.

Skaffold also rates year-to-year performance of every listed business, from 1 through 5. This gives us a measure for consistent profitability. A company that scores 1 for performance consistently generates high and rising earnings, produces a solid return on its equity and has plenty of cash.

Companies that have these characteristics (also known as key indicators or performance ratios) are more likely to deliver a sustainable competitive advantage and deliver value to their shareholders.

Skaffold’s filters, embedded within the stock market software, help to highlight 10 essential characteristics you should always look for in any stock.

Top stocks checklist

1. Debt is low and/or declining

We are all familiar with the real-world consequences of debt. If mismanaged, they can be disastrous. In business, the use of debt directly impacts the bottom line – debt requires ongoing servicing and increases the risk in a business. The very best companies are able to increase profits and return on equity whilst reducing the amount of debt on their balance sheets.

2. The company isn't constantly calling on its shareholders for more equity

Ideally we are looking for companies that are able to fund their expansion through the profits that the business is generating. If a company raises additional equity and then earns a return on that equity that does not exceed the previous return it was earning, then the return on the entire pool of equity is reduced. The company may be growing its absolute profit level, but the level of profitability on each dollar of equity capital is declining.

Often when new equity is raised, it is not raised in a proportional manner across all shareholders. Some shareholder groups may find their percentage ownership of the business being diluted.

The practice of raising equity capital in the same year as paying dividends is questionable. Why raise capital simply to hand some of it straight back?

3. Earnings per share are rising

Too many investors focus on a company's earnings, meanwhile ignoring the debt or capital raisings that contribute to the artificial earnings per share figure. Whilst rising earnings are one quality of a top stock, earnings must not be examined in isolation from the other attributes to the company.

4. Normalised profits are rising

A company's reported profit figure includes its regular earnings, plus one-off items that may not reoccur in the future, such as the sale of an asset or the windfall from a successful lawsuit. Removing abnormal and non-recurring revenues and expenses provide a more sustainable representation of the company's ongoing profits. If normalised profits aren't rising, this will have a negative impact on the business' intrinsic value, and ultimately the share price.

5. Return on equity is rising and higher than what you'd get elsewhere

Return on equity measures the profitability of a company by comparing how many dollars were required to produce the company's profit. It is the return being generated on your equity. You want a business that can generate a return higher than what you could earn from a term deposit or bond, and allowing an extra margin for the additional risk. A company that has $100 million of equity and produces a profit of $20 million generates a return on its equity of 20%. That's attractive, particularly when you factor in compounding, and certainly better than putting your money in a term deposit. If the same company produced a profit of $2 million, the return on equity would fall drastically to just 2%. Top stocks are consistently able to generate impressive and rising returns on their equity in excess of 15%.

6. Cash flow generated from operations exceeds net profit and is rising

Cash flow generated from operations represents the cash flows from the company's day-to-day trading activities. Cash Inflows can include sales, receipts from debtors, and any other cash revenues. Outflows include all payments related to expenses (usually including interest), payments to creditors, prepaid expenses, and any payments for expenses incurred in previous periods (such as accrued wages). Top stocks consistently generate cash flow from their operations that is higher than net profits. In business cash is king. The more the better!

7. The company has plenty of cash to cover its interest bill

Some companies are able to use debt wisely, and retain enough cash to more than cover their interest bill. For the past four years US-listed Time Warner Cable (TWC), despite reporting a net debt/equity ratio in excess of 200% and paying dividends, has consistently reported surplus cash.

8. Dividends paid do not exceed reported profits

Whilst high yielding stocks are desirable, chasing dividends at the expense of good economics can be a recipe for disaster. Think about it this way. You have $10,000 cash in the bank, earn $5000 a month and spend $6000. After 10 months your $10,000 would be depleted. You'd need to curb your spending, pull out the credit card, or raise funds some other way to sustain your spending habits. Businesses are no different. If dividends are consistently higher than earnings, something will have to give.

Some large Australian businesses, including CSR and Alumina, pay dividends equal to or higher than their earnings per share. In the case of these two stocks, dividends have been declining for the past three years.

9. Intrinsic value of the company has been rising, and is forecast to continue doing so

A company's intrinsic value represents the value of the business based upon its fundamentals. Earnings, dividends and equity are some of the inputs into Skaffold's intrinsic value formula. Top stocks are able to increase their intrinsic value year after year. Value investing theory is based on the premise that over the longer term share prices tend to converge with value, so if value is continuing to rise, prices should eventually do the same (provided the price hasn't already run too far ahead).

10. Future prospects are looking good

Its one thing to identify a great quality and high performing company. Looking in the rear view mirror however will not guarantee a thriving portfolio. Businesses are dynamic. Economic conditions change and impact business models. Consumer sentiment also changes. Companies that fail to adapt to changing conditions can be left behind.

When assessing a company's future prospects, investigate if the business is in a period of growth. Be cautious of companies whose growth is beginning to slow or stagnate. Other questions to ask include: Is the business of the company unique, or will competitors potentially steal some of its market power? Will the businesses benefit from government regulation? Has the company's profits risen in all market conditions, or is revenue susceptible to business cycles?

Top stocks Checklist

- [ ] Debt is low and/or declining
- [ ] The company isn't constantly calling on its shareholders for more equity
- [ ] Earnings per share are rising
- [ ] Normalised profits are rising
- [ ] Return on equity is rising and higher than what you'd get elsewhere
- [ ] Cash flow generated from operations exceeds net profit and is rising
- [ ] The company has plenty of cash to cover its interest bill
- [ ] Dividends paid do not exceed reported profits
- [ ] Intrinsic value of the company has been rising, and is forecast to continue doing so
- [ ] Future prospects are looking good

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Serious fun.

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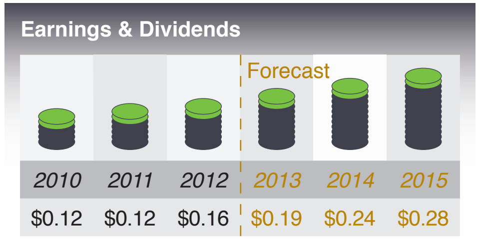
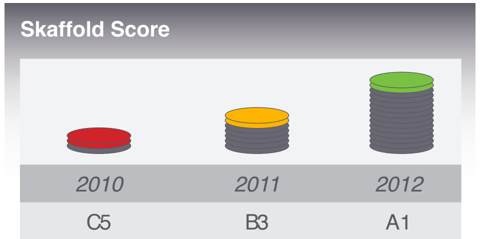
Sophisticated global stock research, as easy as child's play.

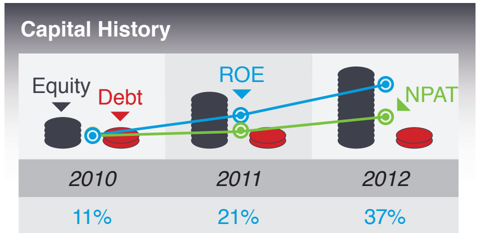
Skaffold makes it easy to pick the best value stocks from around the world in a blink of an eye. You'll be amazed by the level of analytical scrutiny presented in an easy to use interface, allowing you to evaluate thousands of stocks and identify investment opportunities in an instant.



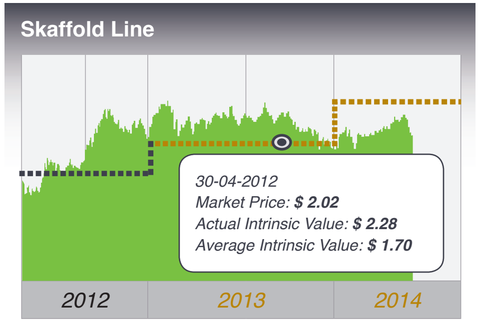
View up to ten years of historic Earnings and Dividends Per Share and where available, three years of forecasts. Instantly see if a company's earnings and dividends have been rising, and if growth is forecast over the next few years.



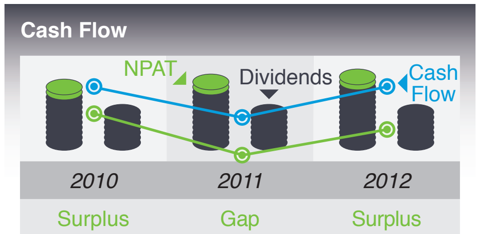
The Skaffold Score rates the quality and performance of every company, including consistency of earnings, debt levels and the quality of cash flow, from A1 to C5. Its easy to instantly see if a company meets your criteria and is worth further investigation.



Capital History displays a company's relationship with its owners and lenders to help you understand its history of equity, debt and performance. Are profits rising? Are you comfortable with the level of debt? What about return on equity? A data table provides even more granular information.



A key component in evaluating a company and deciding when to purchase it is to estimate its intrinsic value. Every Skaffold Line chart, for every listed company, displays up to three years of future valuations and ten years of historical valuations so you can identify historically good-performing companies forecast to offer future growth.



Skaffold's Funding Surplus / (Gap), the green line, reveals how the cash generated has been utilised and whether the company has required external funding to finance its activities. Skaffold makes it easy to evaluate these vital aspects of a company's performance.

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