

Given that the fundamentals in the agricultural sector appear stable and the sharp rise in the use of renewable fuels across the world, market participants seem to be positively biased towards stocks that are part of the “agricultural story”. But, as always, at Multi-Act, we believe that following the herd and placing bets on stocks that enjoy a pro-cyclical review is futile if one does not also cast an eagle’s eye at the quality of the company’s financials.

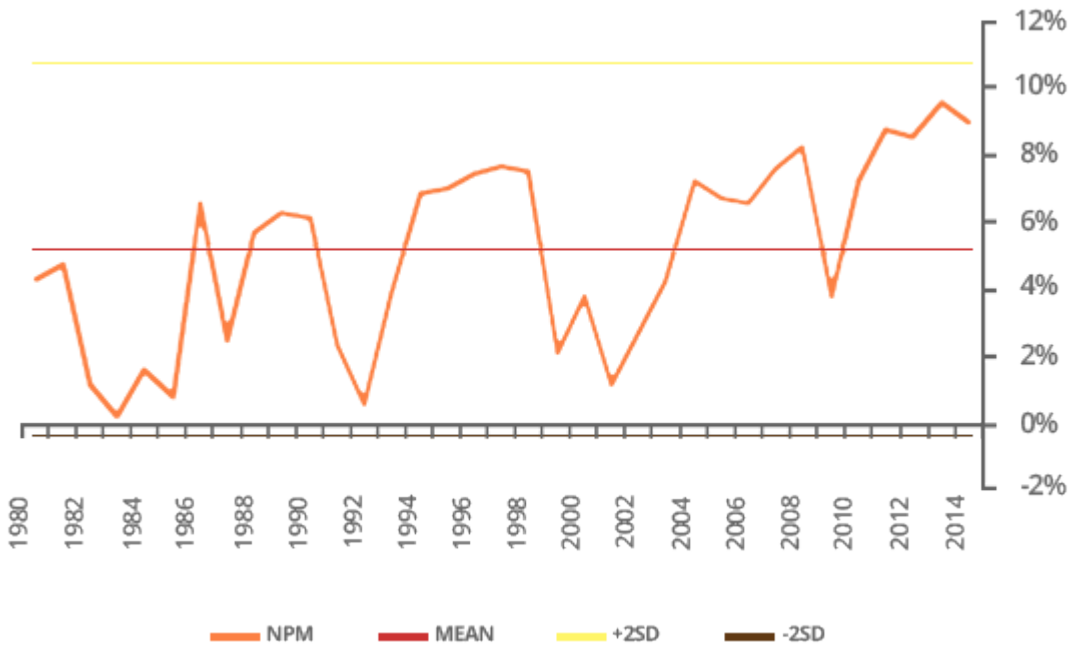
For instance, Deere & Co, a well-known global agricultural and construction equipment manufacturer has been enjoying an A rating on its stock. The company has had positive reviews given the excitement around the growing demand for crops globally. The agricultural sector’s improving conditions coupled with the company’s claim to raise dividend by targeting a 25%-35% payout ratio of mid-cycle earnings, seems to indicate that the company is a positive bet. However, Multi Act’s analysis suggests that investors should not overlook some of the serious red flags on the company’s books:-

## Questionable Margin Sustainability

The company’s net profit margins on an average have moved very close to +2SD in 2014 (Chart 1). However if we look at the period 1980-2014, we see that this is very high from a historic view; the margins have a tendency to revert to mean. This movement away from the mean has been the main cause for ROE expansion, apart from an increase in leverage (which will be discussed later).

Hence, investors attracted by the P/E ratio (close to 12), should be a little wary.

Chart 1: Deere & Co Profit Margin



Source: Multi-Act analysis, company 10K

## Increased Financing To Boost Sales

Over the last few years, the company seems to have focused on financing dealers for equipment sales. This shows up as an increase in its finance receivable assets. The major moves in this respect occurred in 2006 and 2013. In October 2014, the ratio of finance receivables to total assets was at 52% and finance receivables was 3.9 times tangible net worth. (See Chart 2 and Chart 3 below).

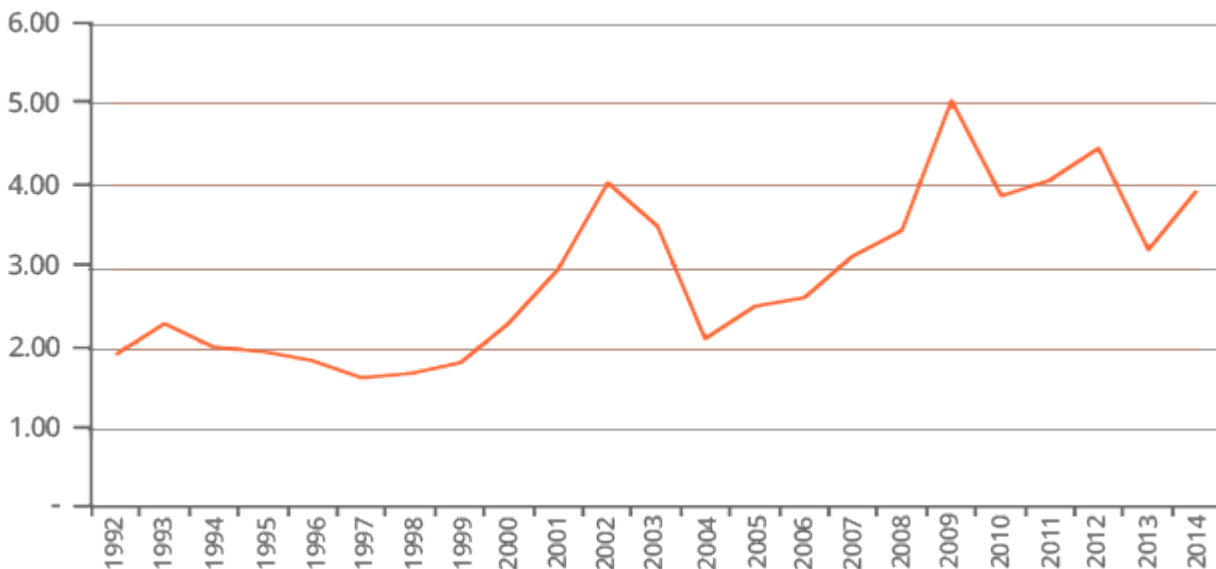
Chart 2: Finance Receivables Growth

**FINANCE RECEIVABLES / TOTAL ASSETS**



Chart 3: Finance Receivables to Net Worth

**FINANCE RECEIVABLES / Tangible Net Worth X**



Source: Multi-Act analysis, company 10K

The finance receivables have shown a tendency to peak against a decline in net worth. As seen in the Chart 3, in 2009 and 2002 the ratio rose due to a plunge in net worth. Our analysis has found that the decline in net worth in these years was because pension plan

losses were reported under the 'other comprehensive income' section.

As of October 2014, the company's pension plan assets to net worth were around 137%. These pension plan assets were reflected on the balance sheet on a net basis, under standard accounting practice. In other words, liability was reported as pension liability minus pension related asset. Owing to which, the balance sheet could not fully reveal the gross total leverage. As of October 2014, if one had to add up pension related assets, the total assets to tangible net worth would be 9 times instead of the reported figure of 7.5 times.

Apart from the company generating higher finance receivables to maintain sales growth, securitization of receivables is also rising, which in turn generates an additional source of credit for growth (Table 1). Being an off-balance sheet liability, this securitization coupled with pension asset leverage can potentially affect the company's books going ahead. So investors going purely by improving sales numbers; may overlook the fact that it may just be a short-term positive.

Table 1: Securitized Finance Receivables

	2010	2011	2012	2013	2014
Securitization of Finance Receivables	2328	3001	3703	4253	4710
Consolidated Securitized Receivables	37%	44%	54%	41%	52%
% of Net Worth					

## Operating Lease Growth

The other important element that led to improvement in sales has been the growth in operating leases. The company transferred equipment from inventory to operating lease assets and due to the growth in operating leases it was able to maintain the inventory to sales ratio. The company transferred inventory to equipment on operating leases of \$794 million, \$659 million and \$563 million in 2014, 2013 and 2012, respectively (Table 2). However, this non-cash operating and investing activity was not included in the statement of consolidated cash flows.

Table 2: Growth of Operating Lease

	2010	2011	2012	2013	2014
Inventory as a % of Revenue	11.78%	13.65%	14.30%	13.06%	11.67%
Transfer of Inventory to Operating lease equipment \$ mn during	405	449	563	659	794

Operating lease equipment asset at year end \$ mn	1,936	2,150	2,528	3,152	4,016
% of Total Assets	4%	4%	4%	5%	7%
as % of Net Worth	31%	32%	37%	31%	44%
as % of Inventories	63%	49%	49%	64%	95%

## Buy backs

Finally, aggressive share repurchases carried out by the company have aided the jump in EPS. As seen in the Table 3 increased repurchases in recent years has potentially improved the EPS. Thus, creating an illusion of higher prospective return for investors.

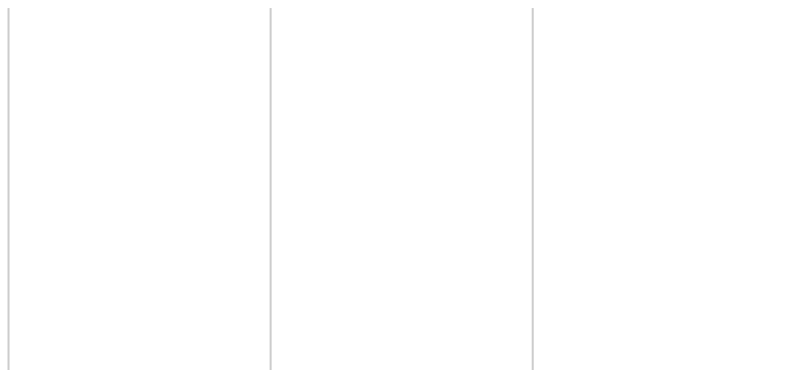
Table 3: Share Buybacks

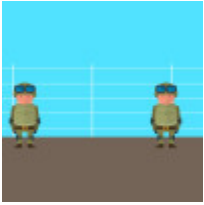
	2010	2011	2012	2013	2014
Average shares diluted mn	429	422	402	389	366
Change	1.0%	-1.4%	-4.9%	-3.1%	-5.9%
Buyback of shares \$mn	359	1,667	1,588	1,531	2,731

### Conclusion:

It is not unusual for investors to take a positive view on a given stock owing to a “good story.” Just like agricultural stocks in this piece, India has witnessed such moves towards ‘rural’ stocks (companies catering to rural markets), ‘infrastructure’ stocks, and so on. While these ‘stories’ can be taken into account while evaluating a stock, it is far more pertinent to look at the data specific to that company. As discussed in this piece, an analysis of the various elements in a company’s books can reveal potential red flags, which may require an investor to take a more cautious view on the stock, than the overall ‘story’ may suggest.

### You may also like:





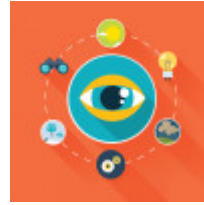
Aircraft  
Manufacturer's  
Risky Currency  
Hedge



A Specialty  
Canadian  
Pharma  
Company: High  
on High Yield



Steel Company  
in News



Crystal ball for  
Nifty - Using  
Transition  
Probability  
Matrix