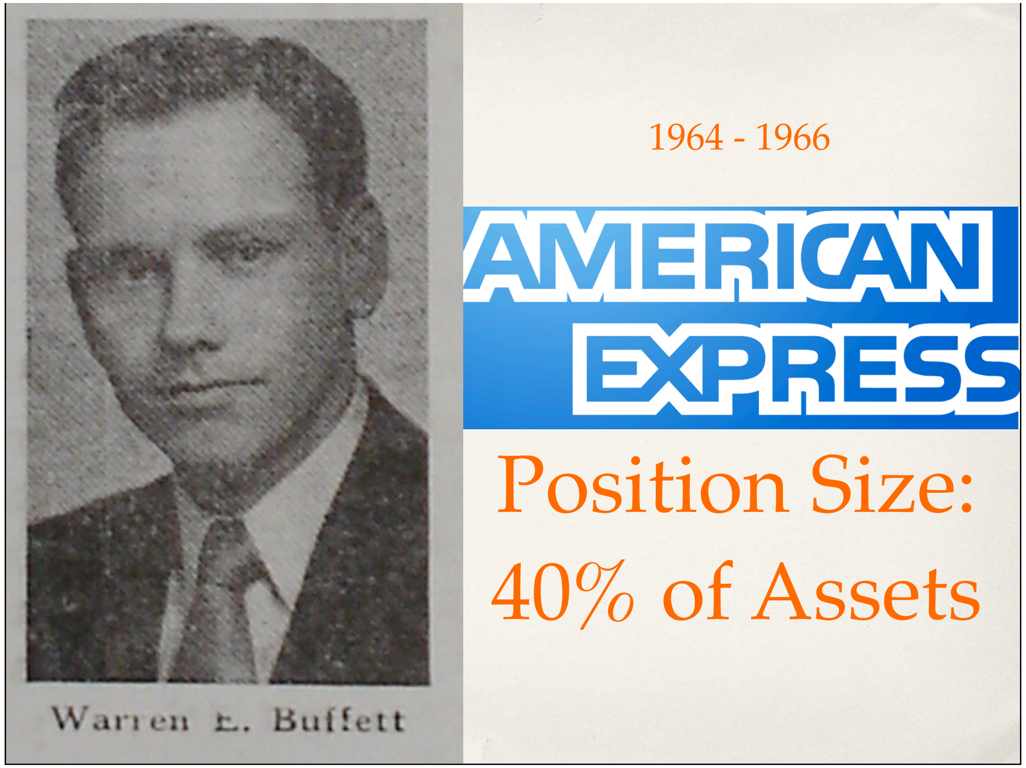
I am going to talk about two different ideas. Floats. And Moats.

Over the last few months, I have been obsessed by these two ideas.

I have spent a lot of time researching them and thinking about them and also about they might be related.

It's been a fascinating journey so far.

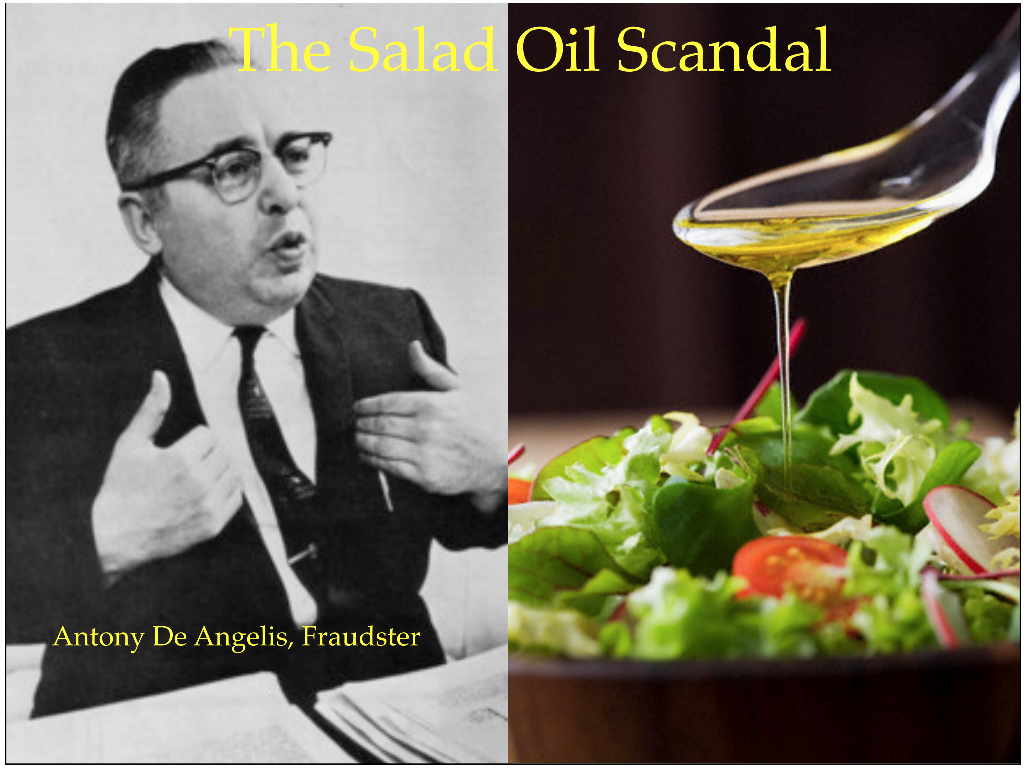
This talk is the story of that journey.



The story starts in 1964. Warren Buffett is a young, dynamic investment manager. He makes his first big bet.

Between 1964 and 1966, he buys 5% of American Express. That's 40% of his assets under management.

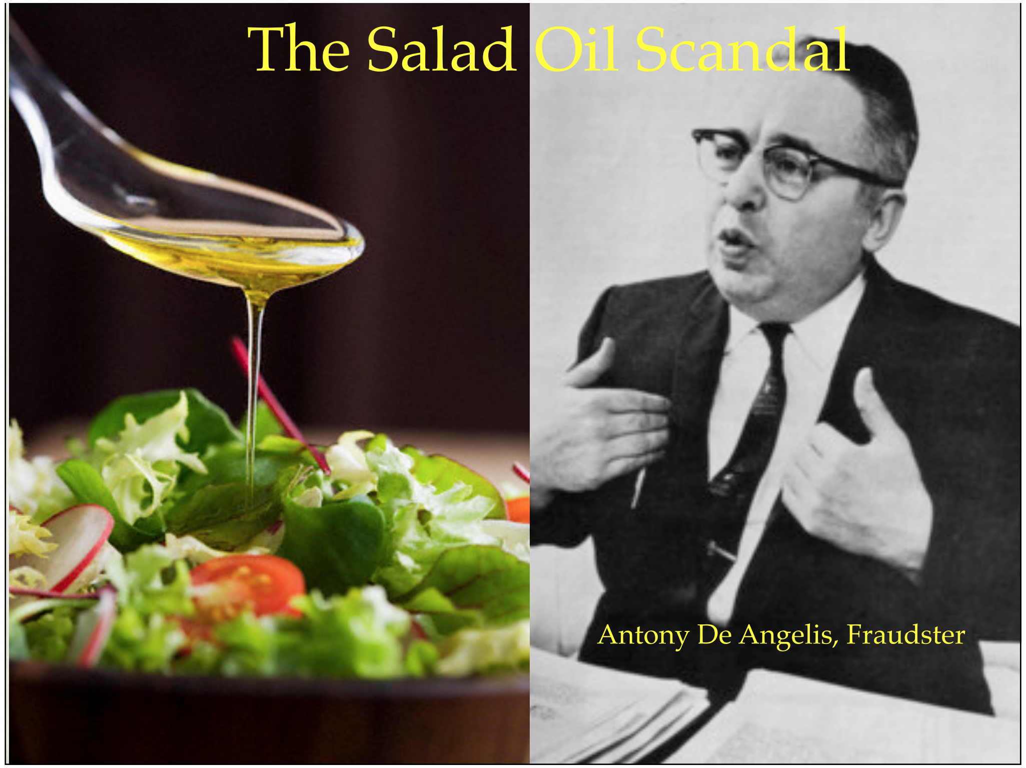
And Amex is embroiled in a scandal involving of things, salad oil.



This guy can't get credit from a bank because he is a convicted fraudster. So he comes up with a neat plan. Amex is a prosperous company with a stellar reputation. It also has a subsidiary which owns and rents warehouses.

Don't ask why in the world is Amex in the warehousing business. Anyway, Antonio De Angelis goes to Amex warehouse and deposits tank loads of sea water. Except that he tells the warehouse that those tanks contain salad oil. No one checks out this guy or the tanks. I guess there were issues with KYC even back in 1964.

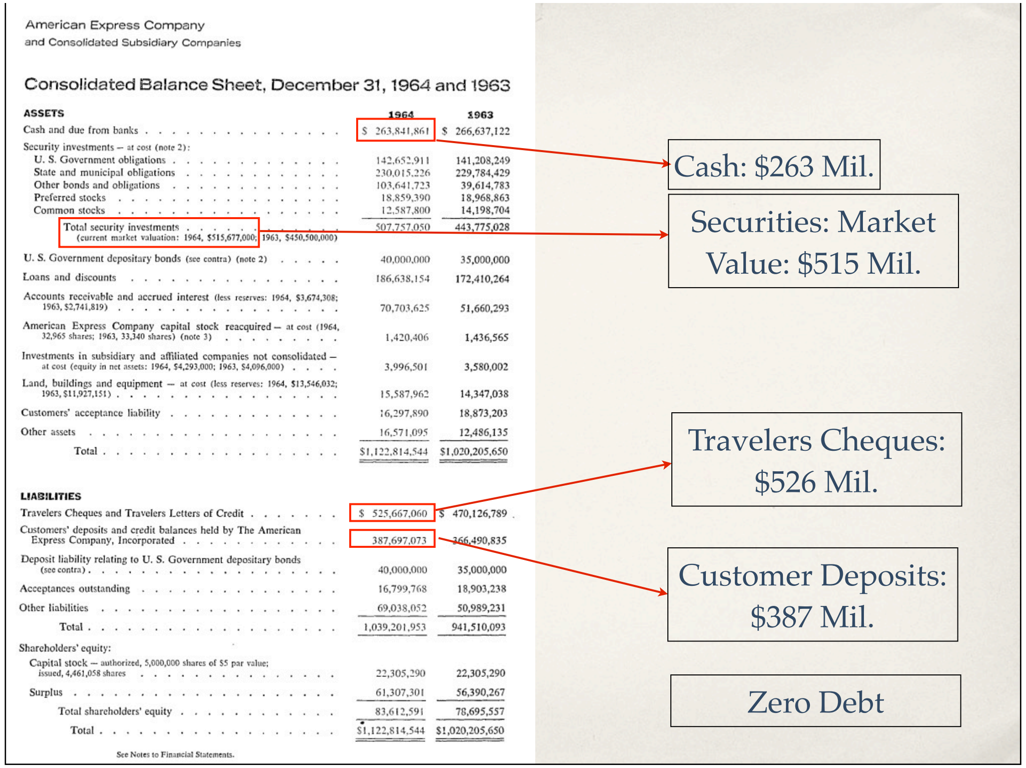
The warehouse takes the sea water and issues a warehouse receipt certifying that it has in storage a large amount of vegetable oil. The receipt carries the name of American Express, which is a name that stands for trust. An elated De Angelis takes the warehouse receipt to a bank and offers it as collateral and gets a loan, whereupon he goes gambling in futures and options. As you'd expect, he loses, and promptly goes bankrupt. Now the bank has a warehouse receipt as collateral on what it thinks is valuable salad oil, except that it's sea water.



Shit hits the ceiling and Amex discovers that "it has a problem subsidiary." The extent of the problem? About $150 mil. That's a very large sum of money in 1964. Amex's Warehouse sub files for bankruptcy but for Amex trust is everything. Its CEO says that Amex has a moral obligation to pay the bank even though its not legally obliged. So much for ring fencing using limited liability companies as subsidiaries. Recall this is what happened in the case of Tata Corus.

The market gets spooked. The stock drops from 60 to 35.

Ok, now let’s look at the magnitude of the problem.


American Express Company
and Consolidated Subsidiary Companies

Consolidated Balance Sheet, December 31, 1964 and 1963

ASSETS	1964	1963
Cash and due from banks	$ 263,841,861	$ 266,637,122
Security investments — at cost (note 2):		
U. S. Government obligations	142,652,911	141,208,249
State and municipal obligations	230,015,226	229,784,429
Other bonds and obligations	103,641,723	39,614,783
Preferred stocks	18,859,390	18,968,863
Common stocks	12,587,800	14,198,704
Total security investments (current market valuation: 1964, $515,677,000; 1963, $450,500,000)	507,757,050	443,775,028
U. S. Government depositary bonds (see contra) (note 2)	40,000,000	35,000,000
Loans and discounts	186,638,154	172,410,264
Accounts receivable and accrued interest (less reserves: 1964, $3,674,308; 1963, $2,741,819)	70,703,625	51,660,293
American Express Company capital stock reacquired — at cost (1964, 32,965 shares; 1963, 33,340 shares) (note 3)	1,420,406	1,436,565
Investments in subsidiary and affiliated companies not consolidated — at cost (equity in net assets: 1964, $4,293,000; 1963, $4,096,000)	3,996,501	3,580,002
Land, buildings and equipment — at cost (less reserves: 1964, $13,546,032; 1963, $11,927,151)	15,587,962	14,347,038
Customers' acceptance liability	16,297,890	18,873,203
Other assets	16,571,095	12,486,135
Total	$1,122,814,544	$1,020,205,650

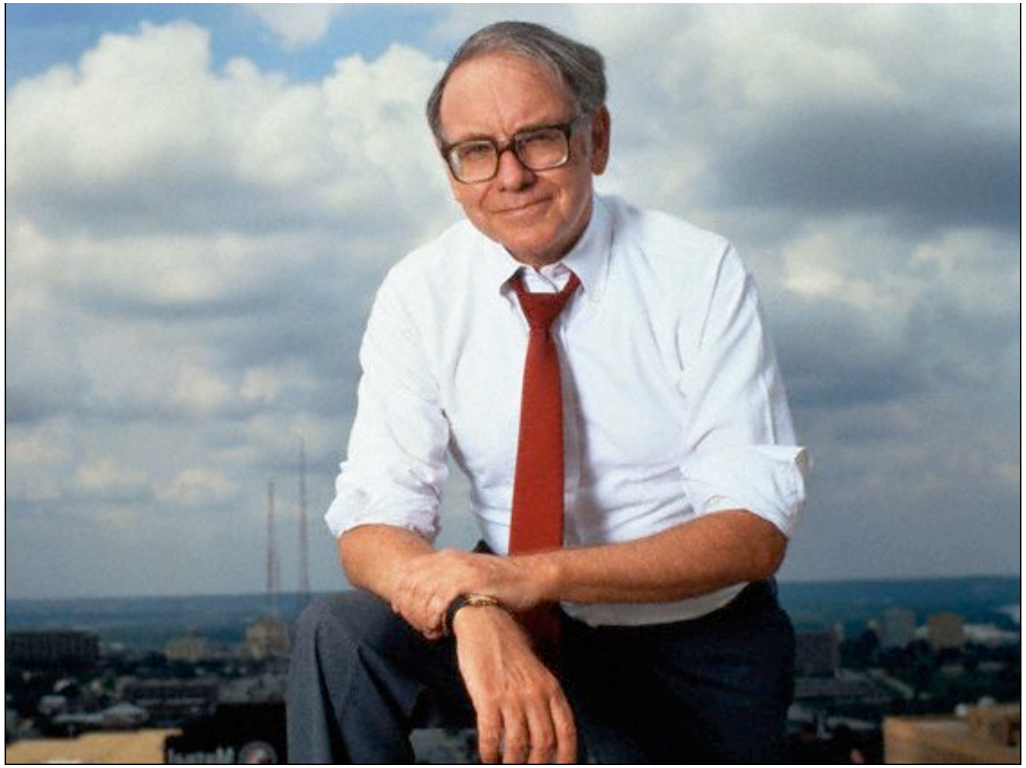
LIABILITIES		
Travelers Cheques and Travelers Letters of Credit	$ 525,667,060	$ 470,126,789
Customers' deposits and credit balances held by The American Express Company, Incorporated	387,697,073	366,490,835
Deposit liability relating to U. S. Government depositary bonds (see contra)	40,000,000	35,000,000
Acceptances outstanding	16,799,768	18,903,238
Other liabilities	69,038,052	50,989,231
Total	1,039,201,953	941,510,093
Shareholders' equity:		
Capital stock — authorized, 5,000,000 shares of $5 par value; issued, 4,461,058 shares	22,305,290	22,305,290
Surplus	61,307,301	56,390,267
Total shareholders' equity	83,612,591	78,695,557
Total	$1,122,814,544	$1,020,205,650

See Notes to Financial Statements.

Cash is $263 Mil. Securities are $515 Mil. Some are quite liquid. The loss on account of the scandal is $150 mil. So, what's the problem?

The half a billion dollar problem is that of the outstanding TCs. Those TCs are are cashable on demand. What if there's a run on Amex? The consequences could be devastating.

Death spiral is the word that comes to mind. Amex has not missed a dividend in 94 years and suddenly market feels that risk of insolvency is high.



Warren Buffett disagrees with the market. We know that because he goes out and puts $13 million into the stock for a 5% stake in Amex. That's 40% of his partnership's money.

What was he thinking?

Let's speculate on that.

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See Notes to Financial Statements.

What if this was Bank Debt of $ 525 Mil?

First, imagine that instead of T/Cs, Amex had bank debt outstanding. Would Buffett have invested?

I think not. Why? Too risky.

But there's is no Bank debt! T/C outstanding: $526 Mil.

Risk of run on Amex. Consequences of a run are severe but what’s the probability? Buffett finds out by going shopping. He finds out that customers don't care. The tarnish on Wall Street has not spread to Main Street.

He buys the stock.

By 1968, he has sold his sake which cost him $13 mil for $33 mil.

My Name is My Bond

Trust = Everything

When Buffett correctly figured that trust behind that half a billion dollar promise is not evaporating, he gets convinced about buying into Amex.

He also discovers something else. That AMEX T/Cs represent an unusually attractive form of financing. To see how, let's compare this with traditional debt.

Plain vanilla debt is onerous for three reasons. Buffett has discovered that Amex's half a billion dollar liability represented by T/Cs have none of these onerous terms.

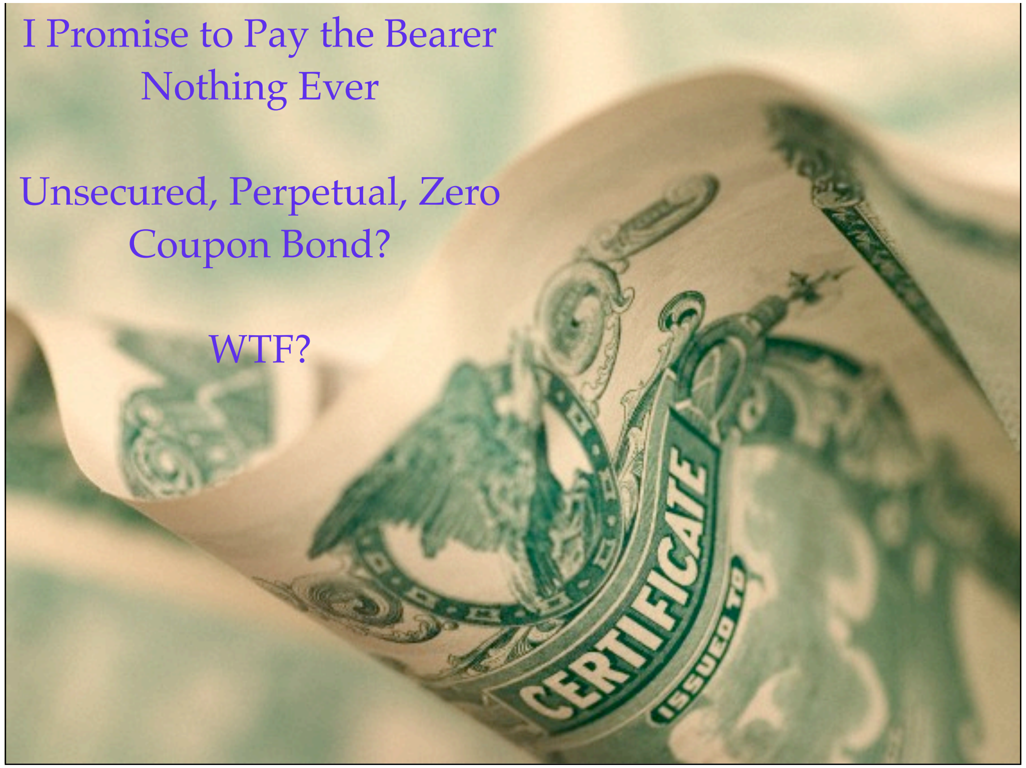
When Amex took this money, it simply issued a piece of paper without giving any collateral. So there's no collateral.
There is no interest either. The paper is redeemable at demand, but there is a lag between issue and en-cashment and sometimes people don't en-cash them. More importantly, even if some people encase them, there are others who buy new ones, so the balance in the liability account has become a "revolving fund."

General point. When we look at a consolidated liability account or for that matter any account which consists of balances from a large number of accountholders, then what matters is not what the individual account holders are doing, but what the account balance is doing. Even if such a liability is classified as a "current liability" it could indeed be a perpetual one, if you are sure that the account balance won't shrink.
I know this sounds like a ponzi scheme and it IS a ponzi scheme but without the derogatory connotation that goes with the world Ponzi.

Buffett wanted to be certain that the T/C account balance won’t fall. That there won't be a run on the Amex bank.

And if is no run, Amex has collected half a billion dollars in cash, issued pieces of paper in return with no collateral, without any interest, and without any effective repayment because its a revolving fund.

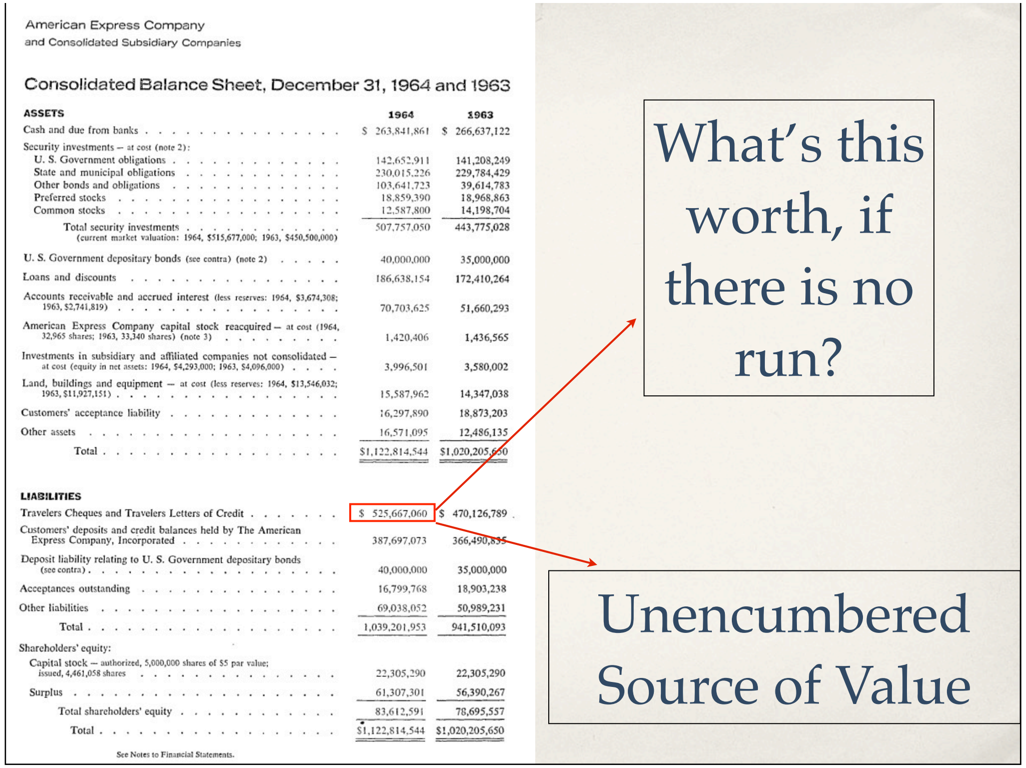
Now let’s invert this situation.



Suppose you bought a bond issued by a company, which

1. gives you no collateral
2. pays you no interest
3. and effectively will never return your money, then

What is that bond worth?



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Let's return to our Amex story.

What's this liability worth if there's no run?

Liquidation value vs. Going concern value.

If it’s not worth anything to the owner, then its worth nothing to the issuer too isn't it?

So what Buffett has discovered is something he writes about years later: “an unencumbered source of value”

Other People's Money. As addictive as Opium

Our man Buffett is hooked.

And why not? What other form of financing is better than this one? No collateral, no interest, no repayment.

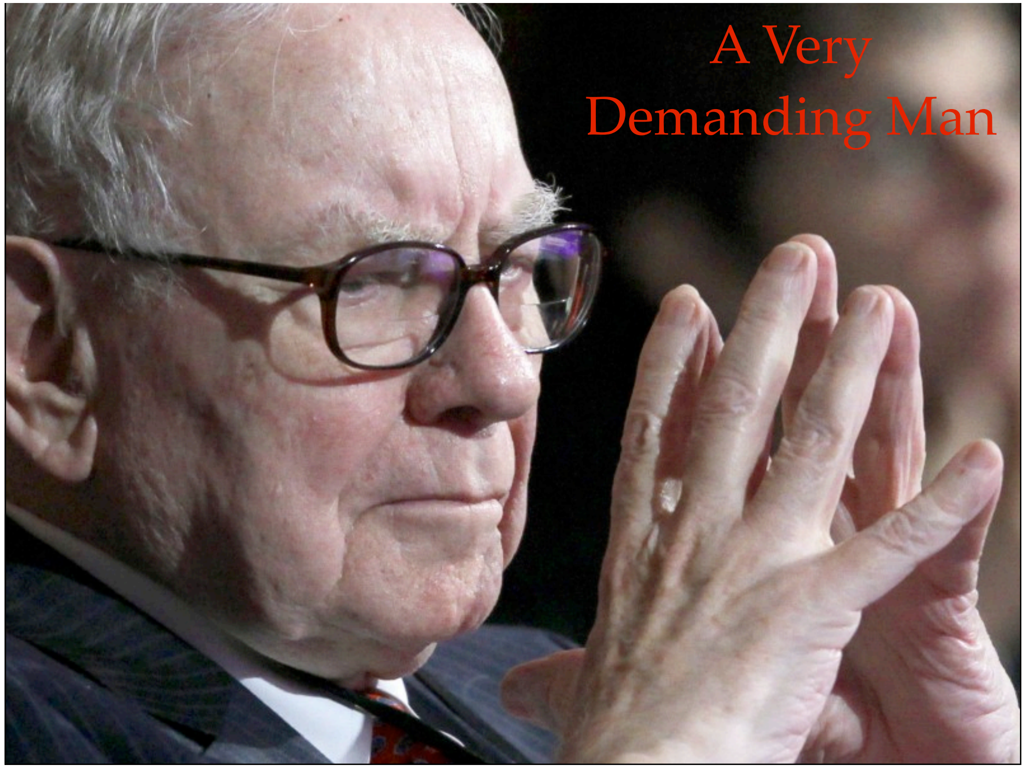
So what's this type of OPM worth? To figure that out, let's do another thought experiment. Just like the value of someone is realized when he or she is no longer there, let's see what happens if we remove float and replace it with alternatives.

Equity – will lead to dilution
Debt will lead to drop in earnings
Both will result in drop in earnings on a per share basis.

No wonder Buffett LOVES this type of financing.

Buffett Discovers Float

Float, he writes years later, is, in effect, the money that we are holding that eventually will go to other people, but of which we have temporary possession.



There's something about Amex's float that he absolutely hates.

What does he hate? Two things

1.He can't get his hands on it.
2. The money provided by the float tends to get invested into warehouses.

Now that REALLY sucks!

Buffett loves the magic on one side of the balance sheet but hates the tragedy on the other side.

Enter Blue Chip Stamps (1970).

Retailers buy blue chip stamps for cash. Shoppers given a certain number of stamps for each dollar spent in a store, which they pasted into books, then redeemed from Blue Chip for prizes such as toddler toys, toasters, mixing bowls, watches.

Stamp collecting takes time. People forgot to redeem.

Float!

Except this time, the money that float provides doesn't go into warehouses which end up storing salty sea water. Instead, it goes into a sweet little company called Sees Candy.

Buffett uses Blue Chip's float to buy See's Candies for $25 Mil in 1972. Between 1972 and 2011, See's delivers pre-tax earnings totaling to $1.65 billion. Almost all of that $1.65 billion after paying taxes is paid to BRK (or earlier to Blue Chip) as dividend.

Buffett uses the cash to buy other attractive businesses which generate surplus cash. A virtuous circle is created.

By this time, Buffett has shifted from being a Graham kind of an investor who focused on statistical bargains to a Munger type of an investor who focused on buying stocks of great businesses and holding them for a long time.

This act of buying and holding stocks of high quality companies gives rise to another form of OPM for BRK.

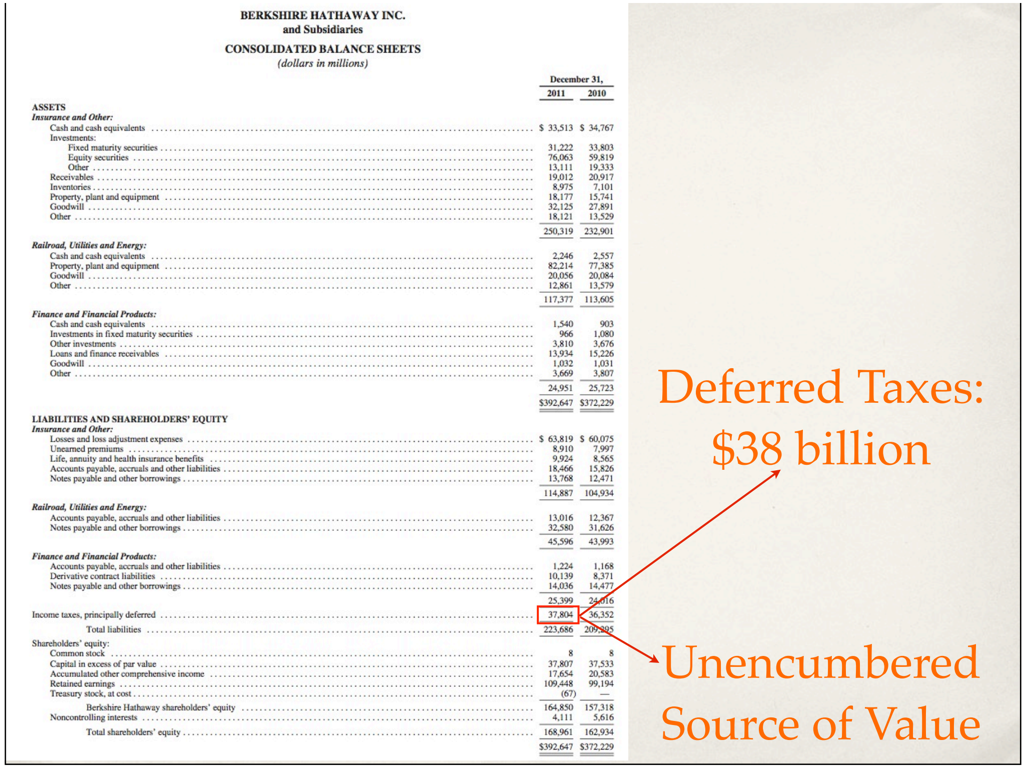
In 1989 He tells his shareholders:

“We would owe taxes of more than $1.1 billion were we to sell all of our securities at year-end market values. Is this $1.1 billion liability equal, or even similar, to a $1.1 billion liability payable to a trade creditor 15 days after the end of the year? Obviously not - despite the fact that both items have exactly the same effect on audited net worth, reducing it by $1.1 billion.”

On the other hand, is this liability for deferred taxes a meaningless accounting fiction because its payment can be triggered only by the sale of stocks that, in very large part, we have no intention of selling? Again, the answer is no.

In economic terms, the liability resembles an interest-free loan from the U.S. Treasury that comes due only at our election…”

so In DCF terms, the value of this liability is MUCH less than it’s book value.


BERKSHIRE HATHAWAY INC.
and Subsidiaries

CONSOLIDATED BALANCE SHEETS
(dollars in millions)

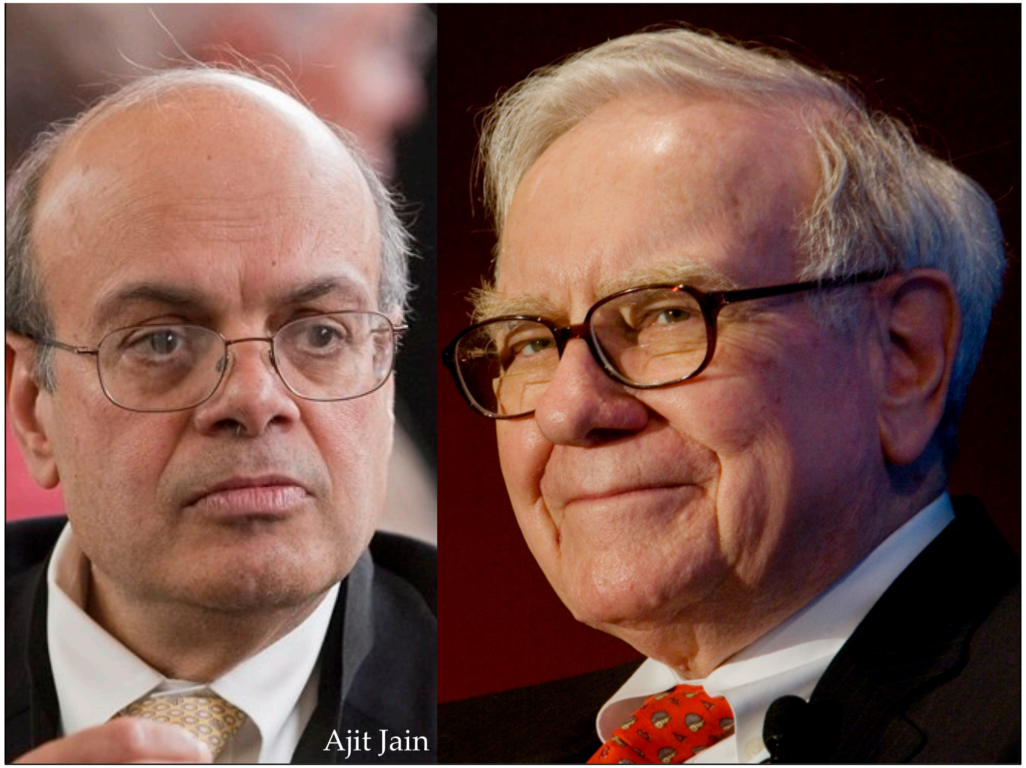
	December 31, 2011	December 31, 2010
ASSETS		
Insurance and Other:		
Cash and cash equivalents	$ 33,513	$ 34,767
Investments:		
Fixed maturity securities	31,222	33,803
Equity securities	76,063	59,819
Other	13,111	19,333
Receivables	19,012	20,917
Inventories	8,975	7,101
Property, plant and equipment	18,177	15,741
Goodwill	32,125	27,891
Other	18,121	13,529
	250,319	232,901
Railroad, Utilities and Energy:		
Cash and cash equivalents	2,246	2,557
Property, plant and equipment	82,214	77,385
Goodwill	20,056	20,084
Other	12,861	13,579
	117,377	113,605
Finance and Financial Products:		
Cash and cash equivalents	1,540	903
Investments in fixed maturity securities	966	1,080
Other investments	3,810	3,676
Loans and finance receivables	13,934	15,226
Goodwill	1,032	1,031
Other	3,669	3,807
	24,951	25,723
	$392,647	$372,229
LIABILITIES AND SHAREHOLDERS' EQUITY		
Insurance and Other:		
Losses and loss adjustment expenses	$ 63,819	$ 60,075
Unearned premiums	8,910	7,997
Life, annuity and health insurance benefits	9,924	8,565
Accounts payable, accruals and other liabilities	18,466	15,826
Notes payable and other borrowings	13,768	12,471
	114,887	104,934
Railroad, Utilities and Energy:		
Accounts payable, accruals and other liabilities	13,016	12,367
Notes payable and other borrowings	32,580	31,626
	45,596	43,993
Finance and Financial Products:		
Accounts payable, accruals and other liabilities	1,224	1,168
Derivative contract liabilities	10,139	8,371
Notes payable and other borrowings	14,036	14,477
	25,399	24,016
Income taxes, principally deferred	$\boxed{37,804}$	36,352
Total liabilities	223,686	209,295
Shareholders' equity:		
Common stock	8	8
Capital in excess of par value	37,807	37,533
Accumulated other comprehensive income	17,654	20,583
Retained earnings	109,448	99,194
Treasury stock, at cost	(67)	—
Berkshire Hathaway shareholders' equity	164,850	157,318
Noncontrolling interests	4,111	5,616
Total shareholders' equity	168,961	162,934
	$392,647	$372,229

By end of 2011, that liability account has grown to a staggering $38 billion.

So here is another very large unencumbered source of value for BRK's stockholders.

Not only does he get the best out of his businesses. He wants to get the best out of capital structures too.

This time he will take the help of a man from India.



Ajit Jain. With his help, they generate insurance float.

“Float” in the insurance business, says Buffett, “arises because most policies require that premiums be prepaid and, more importantly, because it usually takes time for an insurer to hear about and resolve loss claims.”

“This float is “free” as long as insurance underwriting breaks even, meaning that the premiums we receive equal the losses and expenses we incur. Over our entire history, we’ve been profitable, and I expect we will average break-even results or better in the future. If we do that, our investments can be viewed as an unencumbered source of value for Berkshire shareholders.”

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Year	*Float (in $ millions)*
1970	$ 39
1980	237
1990	1,632
2000	27,871
2010	65,832
2011	70,571

No Collateral
-Ve Interest
No Repayment

Unencumbered
Source of Value

This float has grown from $17 million in 1967 to an astounding $71 billion by the end of 2011,

"So how does this attractive float affect intrinsic value calculations? Our float is deducted in full as a liability in calculating Berkshire's book value, just as if we had to pay it out tomorrow and were unable to replenish it. But that's an incorrect way to view float, which should instead be viewed as a revolving fund. If float is both costless and long-enduring, the true value of this liability is far lower than the accounting liability."

Key words: Revolving Fund, Costless, Long-enduring

Buffett's Alpha

Andrea Frazzini, David Kabiller, and Lasse H. Pedersen*

First Draft: May 3, 2012

Table 3

Buffett's Cost of Leverage: The Case of His Insurance Float

This table shows the cost of Berkshire's funds coming from insurance float. The data is hand-collected from Buffett's comment in Berkshire Hathaway's annual reports. Rates are annualized, in percent.

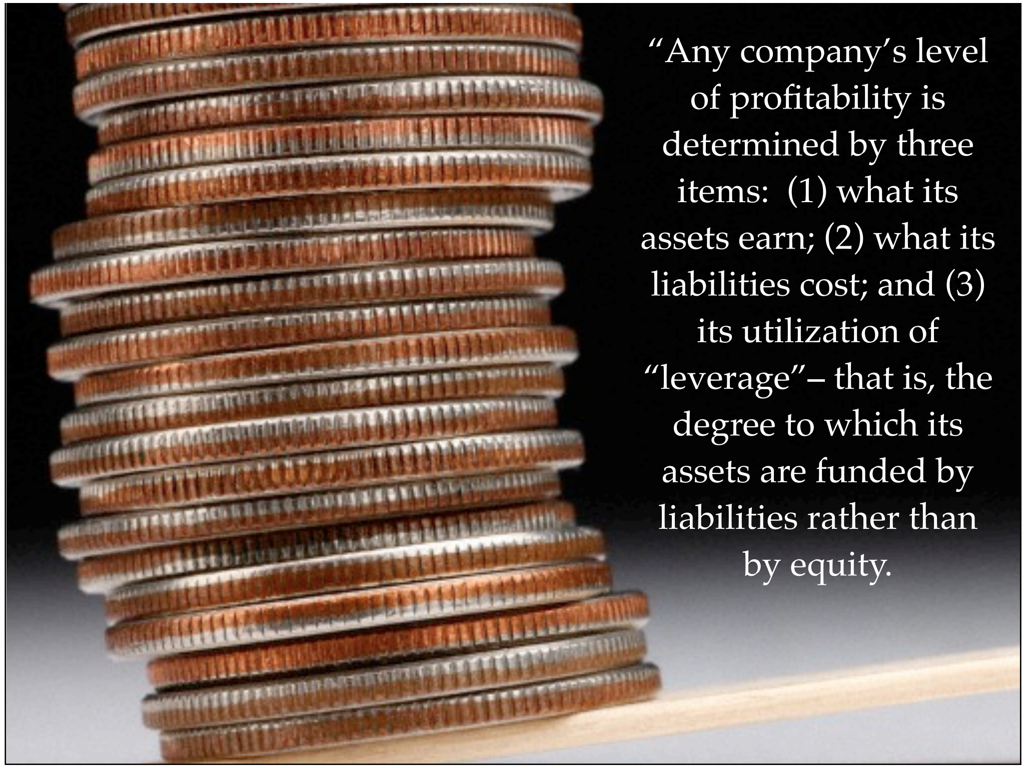
	Fraction of years with negative cost	Average cost of funds (Trucated)*	Spread over benckmark rates				
			T-Bill	Fed Funds rate	1-Month Libor	6-Month Libor	10-Year Bond
1976-1980	0.79	1.67	-4.59	-5.65			-5.76
1981-1985	0.20	10.95	1.10	-0.27			-1.28
1986-1990	0.00	3.07	-3.56	-4.61	-4.80	-4.90	-5.30
1991-1995	0.60	2.21	-2.00	-2.24	-2.46	-2.71	-4.64
1996-2000	0.60	2.36	-2.70	-3.10	-3.33	-3.48	-3.56
2001-2005	0.60	1.29	-0.82	-0.96	-1.05	-1.19	-3.11
2006-2011	1.00	-4.00	-5.84	-6.06	-6.29	-6.59	-7.67
Full sample	0.60	2.20	-3.09	-3.81	-3.69	-3.88	-4.80

* In years when cost of funds is reported as "less than zero" and no numerical value is available we set cost of funds to zero

For 60% of the time, Buffett got paid to borrow money!

When he actually paid to borrow money, he paid an average of 2.2% p.a. which is 4.8% below 10-year treasury bonds yield. Buffett borrows cheaper than U.S Treasury!

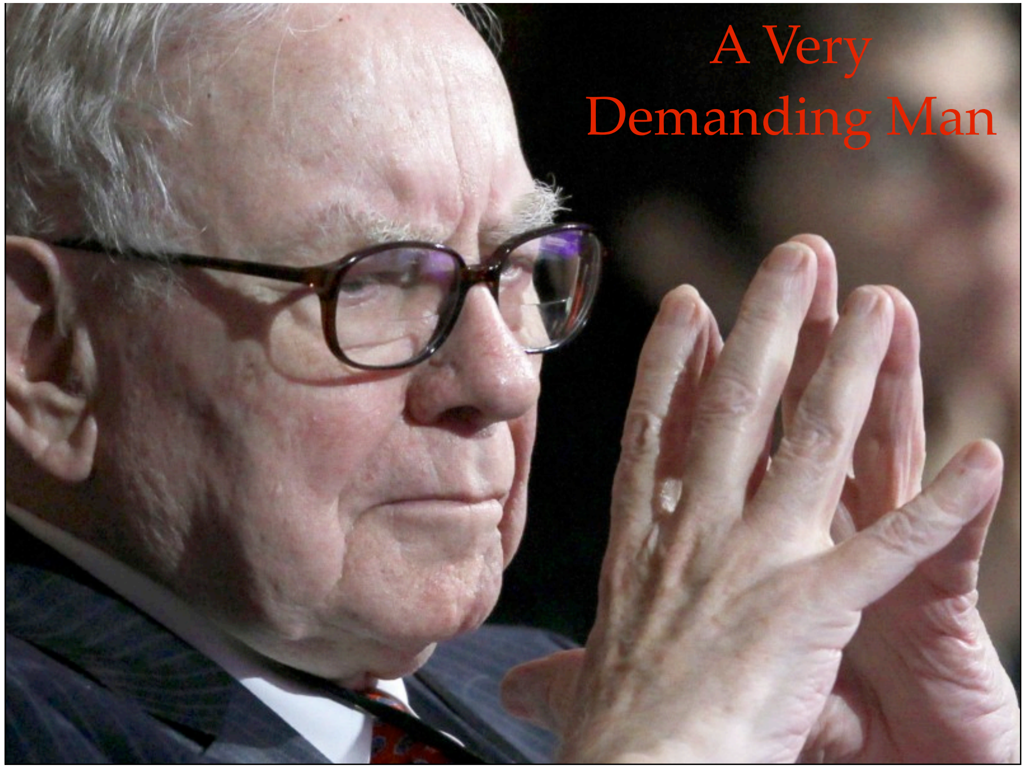
And he did that with not just small sums. He is now doing it with $71 billion!



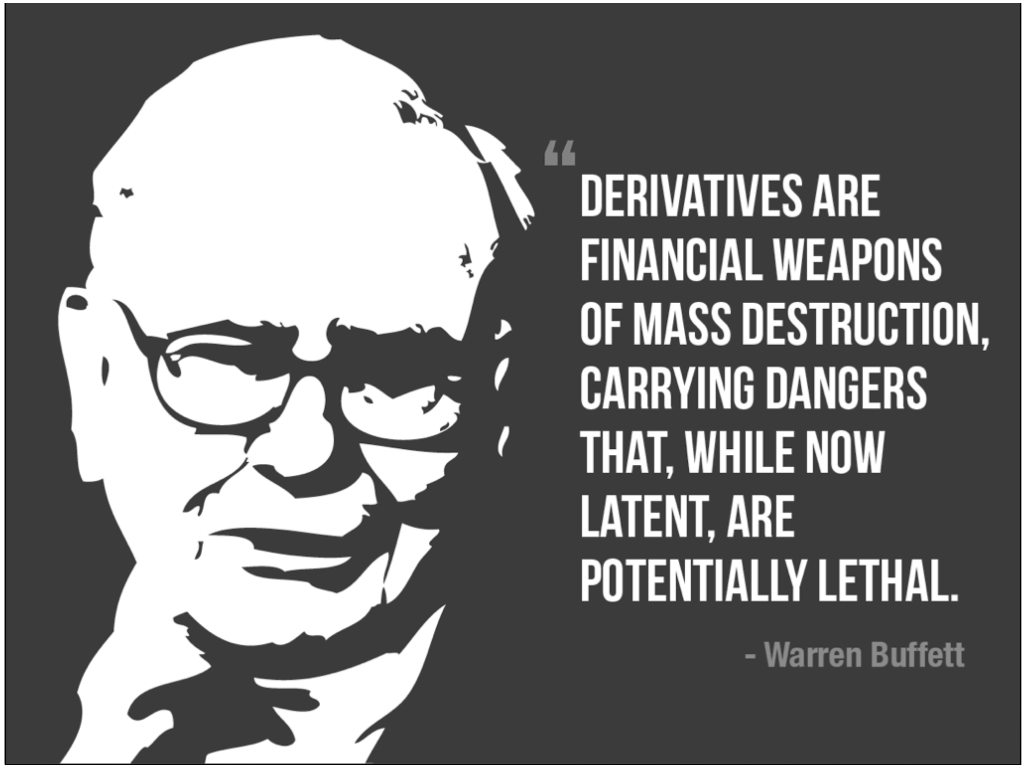
He used the word "liabilities" and not "debt. That's key. The more of an asset that you can fund with a free float, the less the need to fund it with expensive debt or equity becomes.

Equity will lead to dilution.

So will Debt.



But that’s not enough. He wants more.



He calls derivatives as financial weapons of mass destruction.

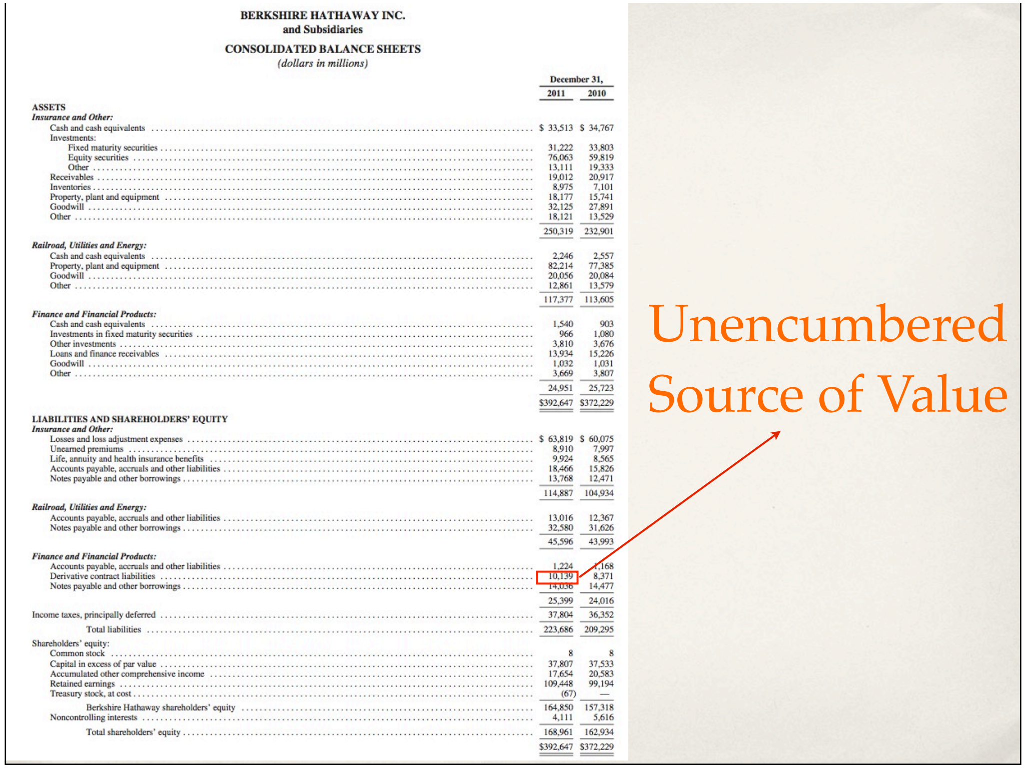
But he is tempted.

He is tempted by the derivatives can do for him to obtain the most optimum capital structure in the world's largest companies.

By 2008, BRK is is a party to 251 derivative contracts: equity puts, credit default swaps, and others. Describing these contracts, Buffett noted:

"As of yearend, the payments made to us less losses we have paid – our derivatives "float," so to speak – totaled $8.1 billion. This float is similar to insurance float: If we break even on an underlying transaction, we will have enjoyed the use of free money for a long time. Our expectation is that we will do better than break even and that the substantial investment income we earn on the funds will be frosting on the cake."

Notice the similarities to insurance: an underwriting profit (implying less-than-free float), and freedom to invest that float in buying undervalued assets



BERKSHIRE HATHAWAY INC.
and Subsidiaries

CONSOLIDATED BALANCE SHEETS
(dollars in millions)

	December 31, 2011	December 31, 2010
ASSETS		
Insurance and Other:		
Cash and cash equivalents	$ 33,513	$ 34,767
Investments:		
Fixed maturity securities	31,222	33,803
Equity securities	76,063	59,819
Other	13,111	19,333
Receivables	19,012	20,917
Inventories	8,975	7,101
Property, plant and equipment	18,177	15,741
Goodwill	32,125	27,891
Other	18,121	13,529
	250,319	232,901
Railroad, Utilities and Energy:		
Cash and cash equivalents	2,246	2,557
Property, plant and equipment	82,214	77,385
Goodwill	20,056	20,084
Other	12,861	13,579
	117,377	113,605
Finance and Financial Products:		
Cash and cash equivalents	1,540	903
Investments in fixed maturity securities	966	1,080
Other investments	3,810	3,676
Loans and finance receivables	13,934	15,226
Goodwill	1,032	1,031
Other	3,669	3,807
	24,951	25,723
	$392,647	$372,229
LIABILITIES AND SHAREHOLDERS' EQUITY		
Insurance and Other:		
Losses and loss adjustment expenses	$ 63,819	$ 60,075
Unearned premiums	8,910	7,997
Life, annuity and health insurance benefits	9,924	8,565
Accounts payable, accruals and other liabilities	18,466	15,826
Notes payable and other borrowings	13,768	12,471
	114,887	104,934
Railroad, Utilities and Energy:		
Accounts payable, accruals and other liabilities	13,016	12,367
Notes payable and other borrowings	32,580	31,626
	45,596	43,993
Finance and Financial Products:		
Accounts payable, accruals and other liabilities	1,224	1,168
Derivative contract liabilities	$\boxed{10,139}$	8,371
Notes payable and other borrowings	14,036	14,477
	25,399	24,016
Income taxes, principally deferred	37,804	36,352
Total liabilities	223,686	209,295
Shareholders' equity:		
Common stock	8	8
Capital in excess of par value	37,807	37,533
Accumulated other comprehensive income	17,654	20,583
Retained earnings	109,448	99,194
Treasury stock, at cost	(67)	—
Berkshire Hathaway shareholders' equity	164,850	157,318
Noncontrolling interests	4,111	5,616
Total shareholders' equity	168,961	162,934
	$392,647	$372,229

Unencumbered source of value in what way?

1. The value of the liability is much less than book value.
2. Free or cheap float gives you a competitive advantage.
3. Cheap money levers ROA just like debt levers ROCE

Ok, so now Buffett has a great capital structure. Let's now shift focus from the liability side to the asset side.

If Buffett has created a super-efficient capital structure, isn't it natural for him to want to buy other businesses which also have super-efficient capital structures?

Businesses employ assets. These assets can be financed by (1) Equity; (2) Debt; and (3) Float. Float is preferable if it's free or cheap and if it's long-enduring. Recall float is Other People's Money. Who are the other people? They aren't equity, and they aren't debt. So who can they be? Well there are only four main categories: suppliers (trade credit, deposits from distributors), customers (advance from customers), employees and government (deferred taxes). Let's focus on suppliers and customers.

What kinds of businesses are those where suppliers and/or customers provide float? Those with moats.

Buffett loves moats. He uses the metaphor to illustrate a business's superiority "that make life difficult for its competitors."

"What we're trying to find is a business that for one reason or another — because it's the lost-cost producer in some area, because it has a natural franchise due to its service capabilities, because of its position in the consumer's mind, because of a technological advantage or any kind of reason at all - has this moat around it. And you throw crocodiles and sharks and piranhas in the moat to make it harder and harder for people to swim across and attack the castle."

A truly great business, says Buffett, must have an enduring moat around its economic castle that protects its excellent returns on invested capital."

Key term: INVESTED CAPITAL. Why did he use that term? How do you obtain excellent returns on invested capital? By getting your customers and suppliers to provide free financing of course.

Businesses which dominate their markets can dictate their terms.

Beggars can't be choosers. Suppliers will provide lenient credit and not charge higher prices (no implicit interest). Customers will pay in advance and not ask for cash discount (no implicit interest). Distributors will give interest free deposits.

Negative working capital without implicit interest.

Think Wal-mart. If you are a supplier to Wal-Mart, life is not cool! You cannot tell Wal-Mart, "Pay me tomorrow, I will give you a cash discount" because you cannot afford to give a cash discount! Doing so will wipe out or greatly diminish the margin you are currently making in the business of supplying to the mighty Wal-Mart.

AMAZON.COM, INC.

CONSOLIDATED BALANCE SHEETS
(in millions, except per share data)

	December 31, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,269	$ 3,777
Marketable securities	4,307	4,985
Inventories	4,992	3,202
Accounts receivable, net and other	2,571	1,587
Deferred tax assets	351	196
Total current assets	17,490	13,747
Fixed assets, net	4,417	2,414
Deferred tax assets	28	22
Goodwill	1,955	1,349
Other assets	1,388	1,265
Total assets	$25,278	$18,797
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$11,145	$ 8,051
Accrued expenses and other	3,751	2,321
Total current liabilities	14,896	10,372
Long-term liabilities	2,625	1,561
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value:		
Authorized shares — 500		
Issued and outstanding shares — none	0	0
Common stock, $0.01 par value:		
Authorized shares — 5,000		
Issued shares — 473 and 468		
Outstanding shares — 455 and 451	5	5
Treasury stock, at cost	(877)	(600)
Additional paid-in capital	6,990	6,325
Accumulated other comprehensive loss	(316)	(190)
Retained earnings	1,955	1,324
Total stockholders' equity	7,757	6,864
Total liabilities and stockholders' equity	$25,278	$18,797

Unencumbered
Source of Value

Inventories: $5 billion
Accounts Receivable: $ 2.5 billion
Accounts payable, accrued expenses: $15 billion.

Huge negative working capital. In fact, even fixed assets are financed by accounts payable. Why is Amazon debt-free? Because of float! Those boring current liabilities are not so boring after all. Source of float.

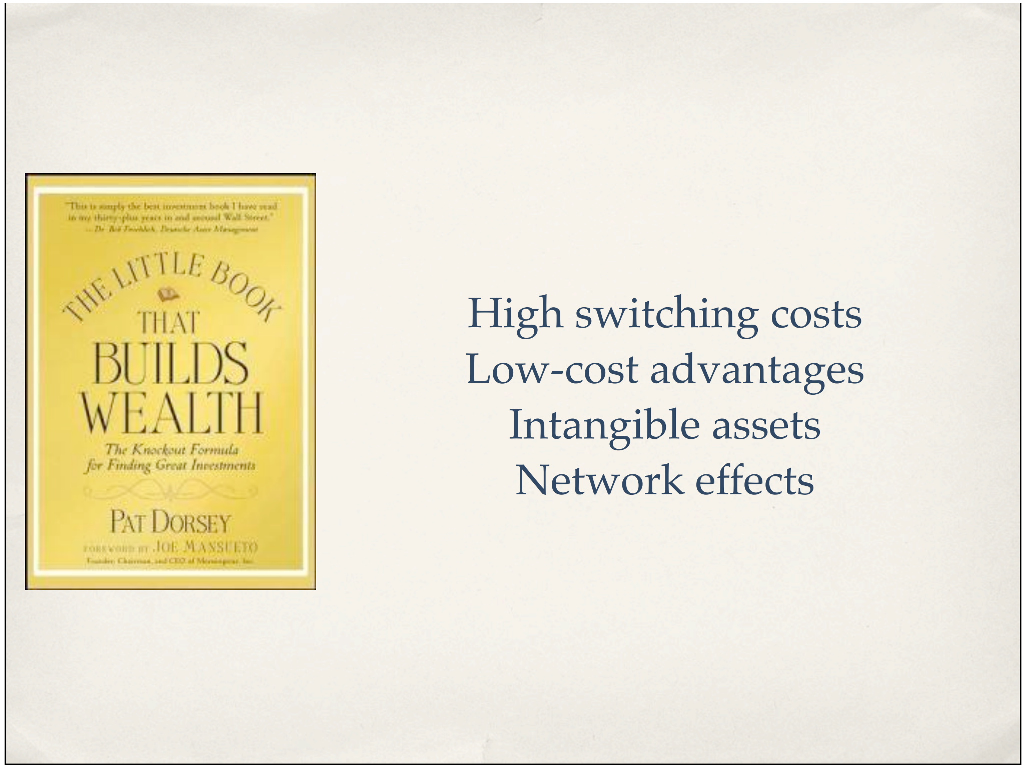
What's the value of Accounts payable? What if it's permanent, and costless? What if its a "revolving fund?" Does it not become an unencumbered source of value?

Here's what I have found when I look at the world of business from float's point of view. I have come up with seven thoughts.

<u>One</u>

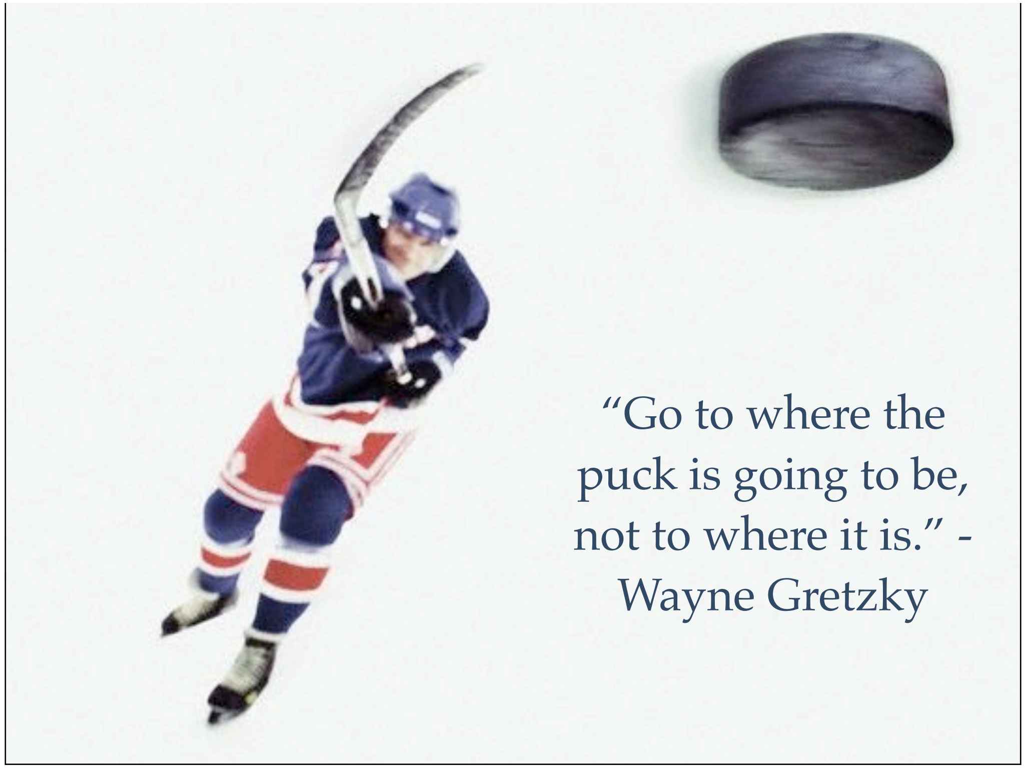
Wherever you find large negative working capital, absence of debt, a liquid balance sheet, and high ROCE, it's very likely the result of a moat.

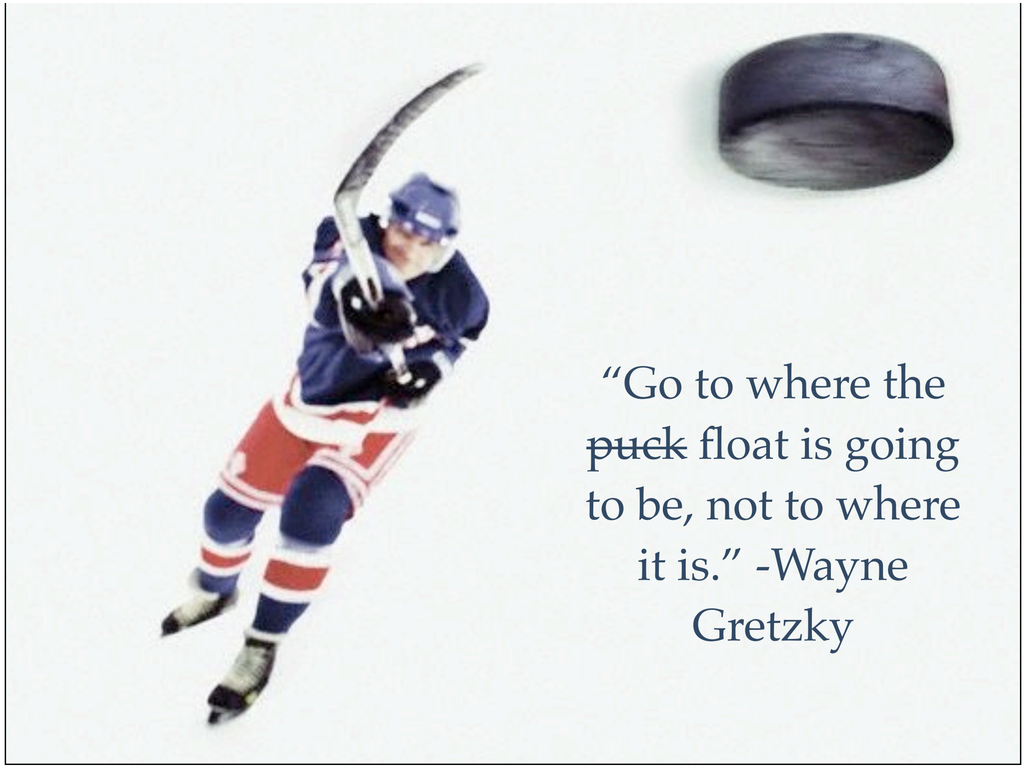
The moat, which gives it's owner market power allows it to dictate terms to its suppliers and customers. This results in the creation of long-enduring floats.



Two

You may also spot an enduring moat by simply monitoring the size and movement in floats.


"Go to where the puck is going to be, not to where it is." - Wayne Gretzky



I would change “puck” to “float.”

When moat quality deteriorates floats will go down. Surplus cash will disappear, debt will appear, because float has disappeared.

MTNL. Invert, always invert. Quantitative criteria. You can measure the competitive threats by monitoring the size of float relative to assets and revenue over time.

As moats improve, floats will go up, debts will disappear, treasury will rise. It makes sense to monitor progress of float to see if improvement is happening or not.

Then there may be business which have a mediocre ROA but have high ROCE because they have large trade credit. Basic business is not great but looks attractive on ROCE basis. Weak link is trade credit. What if it goes away for some reason?

<u>Three</u>

Beware of floats created because of shortages.

They are not enduring.

Power shift in a value chain. It makes sense to monitor how power is shifting by quantitatively measuring float in an value chain.

For example, think about how power shifts in the “Iron ore-steel-auto ancillary-automobiles” value chain. In times of shortage, an iron ore supplier can not only command high prices, he can also insist on advance payments from buyers. But such good times won’t last!

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JSW Steel understated debt: Report

JULY 7, 2012 READ LATER

MUMBAI: A report by foreign broking major Credit Suisse on JSW Steel, which noted that the steel maker has understated its debt by nearly Rs 12,000 crore, pulled the company's stock down by over 3% on the BSE on Friday. The share recovered in late trades to close just 1% lower at Rs 715.

The company denied that it had understated its debt.

"While the reported FY12-end net debt was Rs 16,600 crore, we believe it was understated by at least Rs 11,900 crore," the Credit Suisse report by analysts Neelkanth Mishra and Ishan Mahajan said.

"Acceptances of Rs 7,500 crore (up from Rs 6,800 crore in FY11) are effectively debt; securitized receivables of Rs 3,100 crore (up from Rs 2,600 crore) and Rs 1,200 crore from the fall in rupee," the report noted.

The company said it prepares its annual financial statements in accordance with Indian GAAP.

Four

Some companies will use financial shenanigans. They will create large amounts of trade credit with implicit cost to understate reported debt.

Presence of genuine cost-less float will make debt unnecessary. But some people will try to game the system.

<u>Five</u>

Value of surplus cash.

What happens when a debt-free company is sitting on a lot of cash but that cash has been supplied by other people – i.e. it does not belong to shareholders.

CONSOLIDATED BALANCE SHEET

AS AT 31ST MARCH 2012

PARTICULARS	NOTE NO.	as at 31-MAR-12 ₹ IN LAKHS		as at 31-MAR-11 ₹ IN LAKHS	
EQUITY AND LIABILITIES					
Shareholders`funds					
Share Capital	2.1	16846.84		16846.84	
Reserves & Surplus	2.2	173030.89	189877.73	132140.02	148986.86
Non-Current Liabilities	2.3				
Other Long term Liabilities		519.48		471.43	
Long Term Provisions		2153.40	2672.88	1755.35	2226.78
Current Liabilities	2.4				
Trade Payables		58810.97		30815.39	
Other Current Liabilities		75598.48		123237.30	
Short term Provisions		53400.96	187810.41	46931.09	200983.78
TOTAL			**380361.02**		**352197.42**
ASSETS					
Non Current Assets					
Fixed Assets:	2.5				
Tangible assets		5486.25		6055.82	
Intangible assets		162.81		268.47	
Capital work-in-progress		5159.54	10808.60	1307.94	7632.23
Non Current Investments	2.6		5750.00		0.00
Deferred Tax Asset (Net)	2.27		21495.87		17611.87
Long Term Loans and Advances	2.7		5773.21		7543.16
Other Non Current Assets	2.8		234.90		4445.87
Current Assets:	2.9				
Current Investments		57100.54		51279.05	
Inventories		82.60		87.49	
Trade Receivables		31578.55		31903.79	
Cash and Bank Balances		168702.11		175398.34	
Short Term Loans and Advances		18597.38		22518.27	
Other Current Assets		60237.26	336298.44	33777.35	314964.29
TOTAL			**380361.02**		**352197.42**

Is this an Unencumbered source of value?

Cash: Rs 2,300 cr.

Is this Rs 2,300 cr. cash surplus? Should we deduct it from its current market cap of 8,400 cr (at current stock price of Rs 249) to arrive at EV of Rs 6,100 cr?

2.4 Current Liabilities :

The disclosure of Current Liabilities Including their sub-classification into major heads is given as under :

		as at 31-Mar-12 ₹ IN LAKHS		as at 31-Mar-11 ₹ IN LAKHS
A) Trade Payables		58810.97		30815.39
		58810.97		**30815.39**
B) Other Current Liabilities :				
Security Deposits & Retentions		23816.59		14814.14
Advances Received from Clients		1841.51		1885.44
Capital Creditors		687.88		16.85
Income Received in Advance		37588.28		86895.30
Service Tax Payable		975.07		2634.77
Unpaid Dividend *		60.56		70.81
Other Payables :				
- Withholding for Employees including Employers Contribution	948.48		1081.24	
- Withholding for Income Taxes	1742.23		1144.17	
- Accrued Employees Benefits	6578.39		9014.84	
- Amount held on behalf of Clients	1210.10		5563.46	
- Others	149.39	10628.59	116.28	16919.99
		75598.48		**123237.30**

Security deposits +advances received from clients+ income received in advance = 632 cr.

Annual Report 2011-12 Engineers India Limited

CONSOLIDATED BALANCE SHEET

AS AT 31ST MARCH 2012

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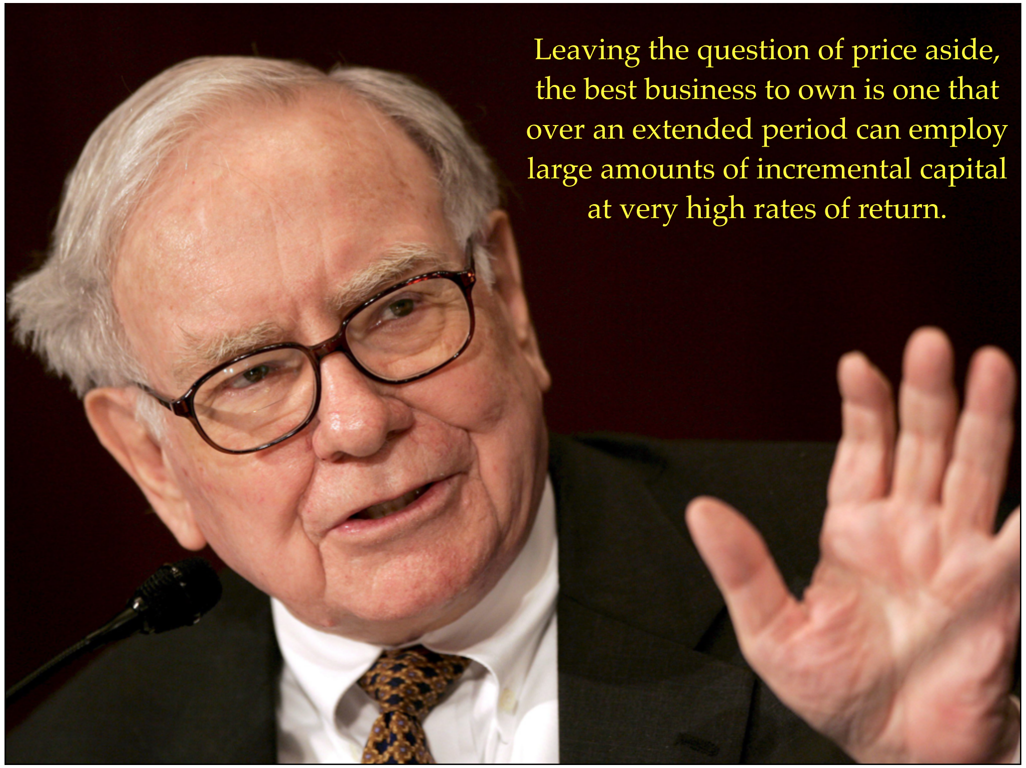
Cash: Rs 2,300 cr.

Is this Rs 2,300 cr. cash surplus? Should we deduct it from its current market cap of 8,400 cr (at current stock price of Rs 249) to arrive at EV of Rs 6,100 cr?

The answer depends on how big the float is and how permanent it is and if its free.

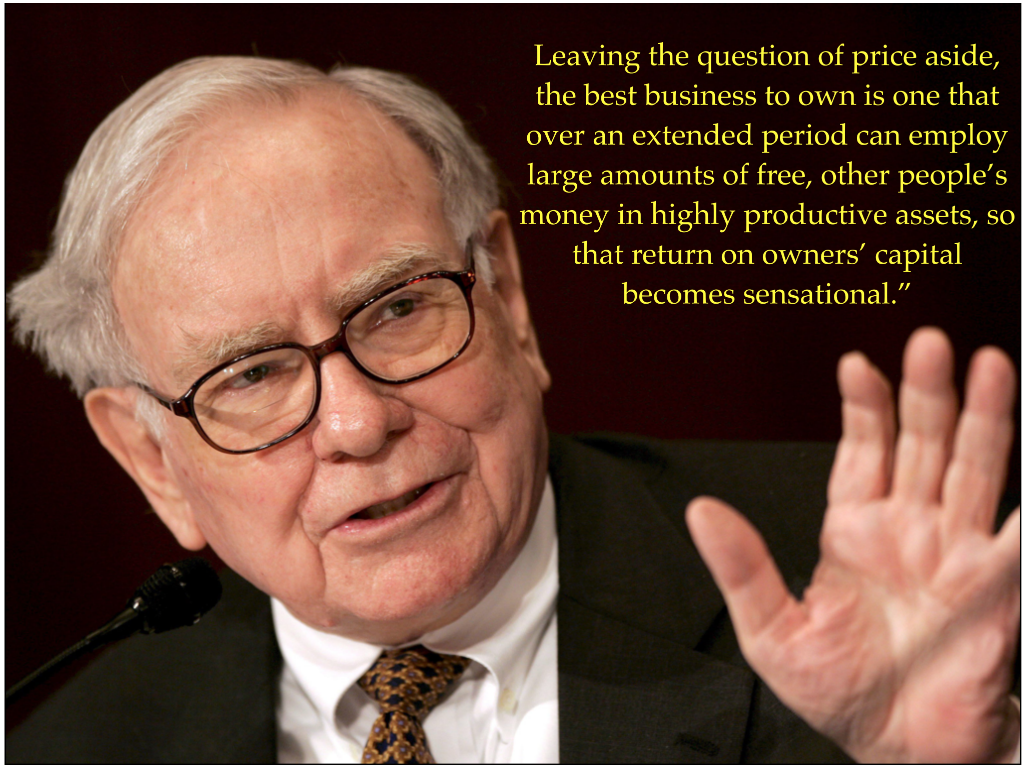
We know its big. If we can figure out if its free and if its permanent, then we know its fair value is like that of our hypothetical perpetual, zero coupon bond we talked about a while back.

So if we erase the book value of this liability and replace it with its very low fair value, doesn't the cash on the other side of the balance sheet becomes unencumbered? And if so, why should we not deduct it from the company's market cap to determine EV?



Six

I would modify this to:



Free Float is the best form of leverage.

Seven

Floats and Moats Go Together

Thank You