WHAT DOES BOOK VALUE MEAN TO INVESTOR?

Earnings, debt, and assets are the building blocks of any public company's financial statements. For the purpose of disclosure, companies break these three elements into more refined figures for investors to examine.

Investors can calculate valuation ratios from these to make it easier to compare companies. Among these, the book value and the price-to-book ratio (P/B ratio) are important for value investors. But does book value deserve all this importance? Let's find out.

Book value is the amount found by totalling a company's tangible assets (such as stocks, bonds, inventory, manufacturing equipment, real estate, and so on) and subtracting its liabilities.

Companies with lots of machinery, like railroads, or lots of financial instruments, like banks, tend to have large book values. In contrast, video game companies, fashion designers, or trading firms may have little or no book value because they are only as good as the people who work there.

Book value is not very useful in the latter case, but for companies with solid assets, it's often the No.1 figure for investors.

If a P/B ratio is less than one, the shares are selling for less than the value of the company's assets. This means that, in the worst-case scenario of bankruptcy, the company's assets will be sold off and the investor will still make a profit.

Failing bankruptcy, other investors would ideally see that the book value was worth more than the stock and also buy in, pushing the price up to match the book value. That said, this approach has many flaws that can trap a careless investor.

Value Play or Value Trap?

If it's obvious that a company is trading for less than its book value, you have to ask yourself why other investors haven't noticed and pushed the price back to book value or even higher.

The P/B ratio is an easy calculation, and it's published in the stock summaries on any major stock research website.

The answer could be that the market is not favouring the company, but it's equally probable that the stated book value does not represent the real value of the assets.

Companies account for their assets in different ways in different industries, and sometimes even within the same industry. This mix up book value, creating as many value traps as value opportunities.

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Depreciation and Book Value

You need to know how aggressively a company has been depreciating its assets. This involves going back through several years of financial statements.

If quality assets have been depreciated faster than the drop in their true market value, you've found a hidden value that may help hold up the stock price in the future.

If assets are being depreciated slower than the drop in market value, then the book value will be above the true value, creating a value trap for investors who only look at the P/B ratio.

If the book value is based largely on equipment, rather than something that doesn't rapidly depreciate (oil, land, etc.), it's vital that you look beyond the ratio and into the components.

Even when the assets are financial in nature, and not prone to depreciation manipulation, the mark-to-market (MTM) rules can lead to overstated book values in bull markets and understated values in bear markets.

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Loans, Liens, and Lies in Book Value

Usually, links between assets and debts are clear, but this information can sometimes be played down or hidden in the footnotes. Like a person securing a car loan by using their house as collateral, a company might use valuable assets to secure loans when it is struggling financially.

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Companies Suited to Book Value Plays

Critics of book value are quick to point out that finding genuine book value plays has become difficult in the heavily-analyzed stock market (such as the U.S.). Oddly enough, this has been a constant refrain heard since the 1950s, yet value investors continue to find book value plays.

The companies that have hidden values share some characteristics:

- They are old. Old companies have usually had enough time for assets like real estate to appreciate substantially.
- They are big. Big companies with international operations, and thus with international assets, can create book value through growth in overseas land prices or other foreign assets.

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- They are ugly. The third class of book value buys is the ugly companies that do something dirty or boring. The value of wood, gravel, and oil goes up with inflation, but many investors overlook these asset plays because the companies don't have the dazzle and flash of growth stocks.

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