



Monthly Newsletter - February

Hello there,

Welcome to the February newsletter.

To our investors - thank you for investing alongside us, for the long term.

In this edition you'll find:

- February performance
- Market rotates out of “Growth” and “Tech”, again
- Alfen now using recycled concrete
- **Feature Article:** Manipulating Depreciation to Inflate Earnings

February Performance

Please find performance data by clicking on the links below.

[Wholesale Strategy](#)

[Retail Strategy](#)

Market Rotates Out of Growth and Tech... Again

As we've seen happen many times before, the market has rotated out of “growth” and “tech” stocks looking for “value” (Factset). This latest rotation has impacted our portfolio, and it's still playing out, but I'm not concerned, this is why:

This is not a material problem for two main reasons:

- Valuations were high and needed to come down. Whilst I disagree with the reasons the market has sold off (as outlined below) its effect has been correct. Many stocks, particularly those growing their revenues quickly became overvalued towards the end of 2020 and beginning of 2021. It's actually been a good thing that stocks have sold off as valuations are now much more sensible, in that they are more aligned with intrinsic value and a lot of risk in the market has now been removed (that is, risk that the market could fall because stocks are overvalued).
- Market valuations reflect intrinsic value over time. Whilst the market is selling off, businesses we are invested in continue to grow, and when that divergence is recognised the market is forced to go back in and buy these stocks, reverting their discounted value back to intrinsic value.

Markets frequently overshoot and undershoot intrinsic value

As investors we stay focused on the growth in intrinsic value of companies we are invested in. Over time, the performance of our portfolio matches that value, allowing compounding to take place.

These rotations happen frequently

The market picks up on what it sees as being a logical thread and runs with it. This often continues until reporting season when the market must reconcile its view to the reality of the reports. Companies we invest in grow the value of their businesses and so the market is forced to correct misvaluations it made in overselling entire “sectors” or what it sees as “growth” stocks. This recent rotation occurred shortly after earnings season, so we have another two to three months before each company reports again. Without the guidance of those reports the selloff can continue or at least until valuations become obviously discounted. Outlined below is what we see as the market's view and what our interpretation of that view is.

The Market's View

Interest rate rises in the US have had a cascade of effects through the market with investors selling out of technology and growth stocks (Factset). Their conclusion being that companies in those camps have relied on access to cheap sources of capital and, as the cost of that capital rises, those business models will come under pressure.

Our View

The situation, from our view, is made up of four parts, each needing to be addressed individually:

1. **Rising interest rates lower business valuations** - This is the most tangible aspect of the market's view. Businesses are worth as much as their future cash flows. To value those cash flows we must deduct the cost of inflation or how much the value of money is being eroded by. As that value goes up the value of businesses goes down. We just need to keep in mind that this can be a negligible difference when compared to the growth rate of the business (it's materiality will be different for different businesses). Out of an abundance of caution, and recognising that interest rates have been at historic lows, we have always used a much higher discount rate than the recent risk free rate and current interest rate rises have not affected our valuations.
2. **Growth Stocks don't have high borrowings by default** - Many companies with fast growing revenues are being financed by cash flows produced by their own operations and have little to no debt. **These companies are the focus of our portfolio.**
3. **The concept of sectors is oversimplified and misleading** - The so called “technology sector” contains business models from a great diversity of revenue sources. Both carsales.com and Xero are grouped as “technology” companies, but in reality their revenue sources have nothing to do with each other; with one being a

marketplace for vehicles and the other providing business accounting solutions. Every company uses technology to enable its service and so it is overly simplistic, and without value, to use a sector label such as technology.

4. **The concept of growth vs value omits the fundamentals of sound investment**

- Investors need to be looking for companies with growth at a fair or discounted value. Not one or the other. Shareholder value creation comes from growth in both revenues and cash flows from operations. In theory, the best investment possible would be one with the highest growth in revenues, capturing the largest portion of those revenues in cash flows from operations, which is valued at a discounted price.

Alfen Now Using Recycled Concrete

Concrete recycling is the use of rubble from demolished concrete structures as aggregate for new concrete. There are several benefits of using recycled concrete aggregate (RCA) over natural aggregate (NA). These are:

- Demolished concrete is usually shipped to landfills for disposal. But, if it's repurposed, it saves space at landfills and provides an alternative to a non-renewable source.
- Using recycled material as gravel reduces the need for gravel mining¹.
- Extraction of aggregates from pits and quarries destroys the natural habitats of many organisms and affects pre-existing stream flow and water resources¹.
- Excavation of aggregate alters the topography and changes the water drainage patterns. It also destroys underground water reservoirs, diminishing the water storage capacity of the ground¹.
- Transporting the aggregate from quarries to crushing plants, and/or to ready-mix concrete plants, is becoming more expensive with the depletion of nearby quarries. Furthermore, the mining, processing, and transportation operations for natural aggregate produce greenhouse gas (GHG) emissions¹.

Alfen piloted the use of recycled cement for the concrete housing of its substations in 2020, in order to further reduce its environmental impact⁴.

The following components are involved in the construction of a substation - Housing, Medium voltage switch(es), Low voltage installation, Transformer, Medium voltage cables, and Low voltage cables. Concrete is mainly used for housing. Alfen has estimated that about 34% of the total carbon dioxide emissions resulting from construction of a substation is caused due to housing⁵.

Alfen produced approximately 3,320 substations in 2020, a growth of 13% compared to 2019 with approximately 2,930 substations, and this growth is likely to continue⁶. If Alfen is able to use recycled concrete for all its new substations, it will be able to significantly reduce its carbon footprint.

Besides using recycled cement, Alfen has introduced cementless concrete foundations to further reduce their carbon dioxide impact⁴. In recent years, the company's business has

been growing strongly.

Alfen's business is growing, but the firm wants to ensure its carbon emissions aren't. For 2021 and 2022 the company is aiming to maintain its carbon dioxide emissions per FTE (full time equivalent) at 2019 levels, despite business growth ⁴.

Initiatives like the use of recycled concrete will help the company reduce its ecological footprint and achieve its environmental goals.

Feature article

Manipulating Depreciation to Inflate Earnings

by Pavel Braganza

Financial statements have been manipulated for as long as they've existed. While some manipulations may not be material, others mask more complex problems. Management may resort to such malpractices for financial incentives or worse, to hide problems at the company. Firms have found ways to manipulate financial statements within the confines of GAAP regulations, while still avoiding scrutiny and punishment. Depreciation is a common target, and recording less depreciation to boost income is one of the oldest tricks in the book.

How depreciation is recorded

Depreciation is a non-cash charge meant to reflect the decrease in the value of physical assets.

When a physical asset is purchased, it is recorded in the assets section of the balance sheet with no corresponding expense entry on the income statement. As the benefits derived from the asset would extend to more than one reporting period, a portion of the asset's cost is shifted from the balance sheet to the income statement periodically in the form of depreciation. While this periodic recording is better than recording the entire expense in the beginning, it does not always accurately reflect the amount on the balance sheet or the income statement.

How it can be manipulated

Depreciation can be used to manipulate earnings. By increasing the useful life or the residual value (the expected price at the end of its useful life), annual depreciation can be reduced to minimise its effect on net income.

In 2013, an SEC order found that Hertz, a global car rental company, failed to adequately disclose its decision to extend the planned holding periods (useful life) for substantial portions of its US rental car fleet. This artificially boosted their net income by lowering their depreciation expense for the current quarters, while increasing maintenance costs in the subsequent quarters. Many of the company's top models, for example, had their planned holding periods extended from 20 to 24 or 30 months ⁷⁻⁹.

How Hertz benefitted from extending their vehicle holding period is explained with the help of the following hypothetical example. There are three things that will determine the depreciation expense on Hertz vehicles: a) the cost to acquire the vehicle; b) how long the company expects to hold it (useful life); and C) the amount it would realise on its disposition at the end of its useful life (residual value).

If a vehicle is purchased for \$28,000, and is expected to have a useful life of 4 years and a residual value of \$8,000, the depreciation in each of the four years using the straight line method would be \$5,000, calculated as follows: $(\$28,000 - \$8,000) / 4$. The amount recorded at the end of each of the four years on the balance sheet, known as the carrying value of the asset, would be \$23,000, \$18,000, \$13,000 and \$8,000 respectively.

Upon the disposal of the vehicle, the depreciation expense would need adjustment should a difference exist between the net proceeds it receives for the vehicle and its remaining net book value. If the vehicle is disposed of after four years for \$6,000, the difference will be \$2,000 (\$8,000 book value minus \$6,000 selling price). \$2,000 would be added to the depreciation expense to account for the difference.

If Hertz increases the useful life of the aforementioned vehicle from 4 years to 5 years, assuming the same residual value of \$8,000 at the end of its useful life, the depreciation expense would be calculated as follows: $(28,000 - 8,000) / 5 = 4,000$. A mere change of one year in the useful life of a single vehicle would be decreasing their depreciation expense by \$1,000 and increasing their income by the same amount.

An overstatement in the vehicle's residual value will increase the loss recognised when a vehicle is sold, but until then, the net income will be boosted by a lower depreciation expense.

Hertz's infractions did not escape the SEC's notice. The SEC order required Hertz Global to pay a \$16 million penalty for various accounting violations, including, manipulation of depreciation expenses. Without admitting or denying wrongdoing, Hertz CEO and chairman Mr. Mark Frissora agreed to reimburse Hertz \$1,982,654, and also pay a \$200,000 civil penalty. The settlement required a Judge's approval¹⁰.

While Hertz increased the useful life of its vehicles, Waste Management Inc., an American waste management company, engaged in similar deceitful activities.

Disposing of expenses

Waste Management Inc was found to have inflated the salvage/residual values, and extended the useful lives, of the company's garbage trucks from 1992 to 1997¹¹. In collusion with their auditors, Waste Management Inc. eliminated or deferred current period expenses by extending the useful lives of their garbage trucks and making unwarranted increases to the truck's residual value. To put it simply, the more their trucks were used, the higher they'd be valued.

The company would get each of its operating units known as "Groups" to record their operating results. The depreciation expense would be recorded using an eight-year useful life and no salvage value. Unbeknownst to the Groups, management were making top-level adjustments. For example in 1993, management assumed a useful life of 12 years

and a salvage value of \$30,000. A macro calculation was then made to utilise the impact it would have on the operating income¹², which artificially decreased quarterly depreciation expenses.

The Devil is in the Detail

As shown in the examples above, depreciation is a non-cash expense based on management discretion. But there are a few components that can be altered to decrease depreciation expense and boost income. While any changes to the calculation of depreciation should be adequately disclosed to stakeholders, it's clear that this needs to be monitored.

Assessing the management of depreciation is a key element of the Blue Oceans analysis methodology. It sits alongside a range of other checks-and-balances that are used to unearth any potentially fraudulent activity, all focussed on protecting investors' portfolios.

All the best

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