Bird's Eye View of HP Inc

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Dave

0:00

All right, folks, welcome to Investing for Beginners podcast. Tonight we're going to do a bird's eye view, we're going to take a look at HP Inc. This is the company that the buff dog the great Warren Buffett bought or some of his lieutenants bought not too long ago. So we have this great question that kind of leading us to talk about HP today. So I'm gonna go ahead and read this. Hi, Andrew. Dave, I'm a bit desperate you have to help me on this.

Buffett recently bought Hp Q when it was trading around 35 to $40 a share. It is down since then to $27 I opened a small position and spent a lot big letters of time studying the company and I still don't understand why Warren would invest in it. It has no moat huge competition from Dell PC and printing demand slowing the balance sheet is horrible debt increasing rapidly. negative equity, current ratio and quick ratio are bad.

Revenue Growth almost stagnant, free cash flow growth, not impressive at all. And earnings per share are saved only by aggressive buybacks. Why would you do such aggressive buybacks when you have so much growing debt? I think your bird's eye view on Hp Q would be of tremendous value to listeners, as we give a deeper look into a company that's screams value trap from the outside. But it's still chosen by Warren Buffett really appreciate your podcast weren't a ton so far. Regard Leviticus. So Andrew, what are your thoughts? Let's start talking about each PQ? Can you kind of give everybody a guess, a lowdown on what the company does?

Andrew

1:24

Sure. So, you know, kind of trying to take this bird's eye view of how would we approach an idea whether it's why is this company seems so terrible? Or why is it a potentially good investment? Before I even think about what the company does and kind of how it spreads out that sales, I would always want to look at what's the big picture overview. We've talked about stratosphere.io is a website for that. And also quick fs.net.

So when I pull up quick invest on that I want to get, as we've talked about in the other bird's eye view episodes, I want to get a story about what's going on with the revenue. So the revenue in this case has been declining since 2012. However, you can see it bottom in 2016. And that's been steadily going up since 2017. So that kind of makes you ask, Was there a good reason for that revenue decline? If there's not a good reason, and it's just kind of like a dying company, then I would pass. But if there's a good reason for why the revenue is down, then maybe it's one of those initial red x's that we've talked about that you turn into a, you know, maybe we erase that because it's fine in this case. So I guess, do you want to talk about the history of hp in a nutshell, and maybe describe why the revenue has this V pattern?

Dave

2:50

Sure. So let's talk a little bit about hp. hp is a company that's been around for a while. And they specialized long time ago, they were one of the leading printing companies, printers, copiers, printer paper ink, and that was really kind of their first, I guess, claim to fame. And then they got into the whole computer space a produce laptops, desktops and other paraphernalia that you can use with your computers. I am not actually on an HP but I have owned several HP laptops in my lifetime. And so that's one of the things that I've always known them for, I've always considered them more of a air, quote, old school kind of company, it seems like they're a little more techie that I gave them credit for.

But that was kind of my perception for that for a long, long time. In 2014 2015, they went through a spin off and so they had a separate business, it was a internet consulting business, is that correct? Or a cloud, something in the cloud. And so what happened was is they spun that part of the business off. And that explains why the revenues went from doing okay to cut in half. And it took the company a few years to kind of get back on his feet. And now it looks like they're kind of finding their way and discovering what it is they're really going to be. And moving forward with that if you are interested in the spin off at the the ticker symbol for that as HPE. And I will just refer to that as going forward as the dumpster fire.

And then we'll kind of move on from there. So I think that kind of says everything you need to know about that company. But Hp Q is I wouldn't say it's an old school computer company, but it's kind of an older, you know, more of a legacy tech, if you will computer company that specializes in laptops, desktops, and printing of all different varieties. So does that give I guess a good overview of the company?

Andrew

4:39

Yeah, totally. And, you know, leave Wikus, I think did a great job of taking a very skeptical look at a company like this because the traditional valuation metrics are all super super low where it starts to scream like, this might be too good to be true. So you see up PE have like four and a price to sales of like point four. And that's just bring some alarm bells in general, because it's like, what is the catch. And so I think looking at what the revenue history has done is a good first place to do that, hopefully the explains why the company has maybe turned it around. So what would be the next kind of big picture number thing you would want to look at as it relates to this company? Well, I

Dave

5:27

guess I would probably continue to work down the income statement. So you look at the kind of the overall view of the revenues. And I think we've kind of covered that, that they were doing, okay, they fell off a cliff, it looked like you know, a horror show. But now it looks like they're starting to rebound. One thing to always keep in mind, over the last few years, things are going to be company specific, and it could be industry wide, you're gonna see a lot of disparity because of COVID. So sometimes in 2020, and 2021, you're going to see funny numbers. And so you kind of have to take that into consideration.

And a good practice to do, especially through that time period is do something that's called normalizing. And basically, what that means is you take a group of numbers, and then you add them all together, and then you divide it by the years that you're normalizing. So let's say you're doing five years, you take five years of revenue, add them all up, and then divide it by five. And that would give you kind of a normal number, if you will. And then you can look at the normal number compared to the current number and see if it is growing. And that can give you I guess, some idea of maybe how the company performed through COVID. And so those are some things you can kind of help or you could do the same thing with operating income, you know, with net income or earnings, you can do all the same things.

And so I guess, when I look at HP, I see that the company is doing a good job of, you know, being profitable, and continuing to do what it is that they do. And so I don't see anything on the income statement out, right, that really jumps out at me, like, you know, run, run, run and hide from anything, you know, their gross margins, their operating income, it's they all look good, you know, historically for the company that actually look like they're kind of maybe starting to improve a little bit.

Andrew

7:06

I'm glad you brought that up, because it reminds me the first time I pulled up this company, when you think about HP, like Dave said, it's laptops, its desktops. And they also have a printing segment, and paraphernalia like that. You have to think in the big picture what has happened recently, because they did have a big revenue increase in 2021 12%, revenue increase. And so remembering how we had the pandemic, and everybody started working from home, you had a huge, I mean, it seems like decades ago now. But it really wasn't all that long ago, where you had this huge demand for laptops.

As people worked from home, my daughter got a Chromebook provided from the school, and a lot of those went out. And so that had a big impact on a lot of these laptops and desktop and tech hardware companies in general. And so you do want to be careful that okay, if the numbers were great in 2021, was that just a temporary pandemic thing? Or is it indicative of better long term results? One way you can look at what management has said about how things have developed in their business is through a section called the MDNA, or management, discussion and analysis. And so if you skim to that part of their annual report, they talked about for 2021, their segment grew. And they did mention the factors like work from home remote learning and gaming. And there were also supply chain constraints.

And then they talked about how that really grew their unit growth, which is the number of units that they sell. And then if you compare that to their latest 10 Q, which talks about the 10 Q is the quarterly report. So that's going to talk about what happened in the summer of 2022. So if you look at at their quarterly, they talk about how that came down a little bit. Because the demand for Chromebooks lowered, the consumer demand was lower, and the mix was lower, which means they sold more of the cheaper Chromebooks rather than the expensive that's what they mean when they talk about mix volume mix.

So they also mentioned this is kind of interesting, the volume declined 25%, which is a huge number, and the ASP, or average selling price increased by 29%. You know, you got the big boost from the pandemic, and then that came back. And so you're starting to see kind of more of as normal as as environment as we've seen lately. But you can see how the price increases really canceled out the decreases in demand. And so that's interesting because there's some areas of the economy where you did not see that like I'm thinking of peloton or some of the more fad kind of trends that we saw during the pandemic, but other things like cars, automobiles, and apparently these desktops and laptops saw price increases has overcome any drops in demand. So that's why the revenue really hasn't shrunk as much. And so it makes you wonder is that growth that they've had recently, that was boosted that from the pandemic? That could be more of a permanent stay now, because prices have gone up so much.

Dave

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Yeah, those are all great points. So I guess where would you move then from looking at those things? I guess what would be kind of next step for you? Well, I

Andrew

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kind of go back to the great listener question, because I feel like we've done a good job of looking at the income statement. But a lot of the red flags also seem to come from the balance sheet. And all of the traditional metrics do look concerning, like I've talked about in the past how I've stayed away from Home Depot and Lowe's, because I did not like their current ratio, which is comparing their current assets to their current liabilities.

And in particular, the quick ratio, which adjusts for inventory. So inventory is only a real asset to yourself, if you can actually sell it, if you can't sell it, it doesn't become an asset anymore. So in the case of HP, if you back out the inventory, they owe more than they own, in that short term timeframe. So if for whatever reason, they can't sell any laptops anymore, they would be highly likely to go out of business or need to raise additional capital in order to keep things going. So that's where something like the quick ratio comes in. And at first glance, it looks bad for HP because they do have a lot of liabilities compared to the assets and the short term side, what about the debt situation. So you were mentioning the spin off. And so they spun off a lot of the assets that were linked to the cloud, and a lot of that stuff was on the books. So now that that's gone, their equity has gone negative, we've talked in the past, and I'll explain it again, in case you haven't listened to previous episodes, a company's shareholders equity, or book value can go negative because of things like brand value.

So if a company has built a brand, it does not count as an asset on their balance sheet. And that's just because of the way accounting works. So Apple, Nike, and HP, their brands get zero value on the balance sheet, even though obviously, those bring in lots of cash flows on the balance sheet, you get zero. And so some companies will build more liabilities, like debt. And they will let that build up, even though they don't have the hard assets to back it up. Because they're, they have a brand that's not on the books, but it is powering the business. And the people who lend to them know that that's the case. And so they feel comfortable enough to lend them that money, even though technically on the books, it's not there,

Dave

12:49

I guess how does that impact the balance sheet? Because we're talking about I guess, negative, not negative, but like, not a great quick ratio, and not a great, great current ratio, and then it looks like they have growing debt. And then we have negative equity. So I mean, if you had to assign a score, if you will, for their balance sheet, you know, how would you rate that, you know, like a one to 10? Like, if you had to say something about their balance sheet, what would you say?

Andrew

13:14

Well, if I was just looking at the numbers, just as they're presented right now, with no other context, I would probably give it like a two or three. But you have to look deeper into each kind of aspect into it. And, you know, I don't think it's good for me to go into every little detail. But for example, on the quick ratio side, which is talking about, again, that short term, things like cash and inventory, and things like liabilities that are due in the next 12 months, I would argue it's not as bad as it seems, because two reasons.

Number one, they have a credit facility for $5 billion, which is a lot. And when you add that to what they have now, it makes kind of balances that out and makes it look like okay, in the short term, they could probably cover anything that comes up. But the other aspect of that, too is how much they're earning on their income statement is a lot compared to what that difference is in like that risk from inventory. I don't know if there's a particular metric for it, but I'm just gonna pick on Home Depot again, because it's like, you know, it's like such a drastic difference. But like their inventory, Home Depot's inventory in 2022 was 22 billion.

I'm going to pick on Lowe's for a second because they're another one of those companies where if you assume that they don't sell any of their inventory, they're probably going to be bankrupt. So if you look at Lowe's inventory for the last year, they had 17 billion in inventory. And then if you look at their income statement, they earned 8 billion so you got to figure like even if they earn the scale of that is so different, you know, you have 8 billion and 17 billion so even if you sell through a lot of your inventory, you still have a lot of unsold inventory, and you compare that to HP, they had inventory of 7.9 billion to earnings of 6.5 billion.

So it's not necessarily apples to apples, but it's a very big difference in scale, when you compare those two things, not to say that Lowe's is gonna go bankrupt or anything like that far from it, but it's just one of those situations where, okay, if we're earning a lot of profit general, maybe some of that can be mitigated with inventory risk, if we're going to assume that that inventory is going to come through really quickly. Does that make sense?

Dave

15:38

Yeah, it totally does. I mean, those are all great points. And I think you've covered the balance sheet really well, something that I was thinking about while you were talking and I looked it up quickly, HP has a Moody's rating of BA two, which for those of you out there that don't know what that means. Moody's is a company that rates company debt.

And one of the ways that businesses can raise money to do things is by issuing debt, which are bonds. And so Andrew was talking about their credit facility, but they also have the ability to go out and raise new funds, by offering their debt to investors to buy then he gets our money. And they can do with it, when they will they pay the coupons, and then they pay the debt back at some point. But the higher the rating is on the scale, the stronger financially a company will be. So for example, a company like Apple, or Johnson and Johnson, Microsoft, those are all triple A rated companies that's as high as you can go. b a is probably I guess, you would say middle of the road, if you will.

And this is what Moody's says about a BA rating obligations rated ba are judged to be medium grade and subject to moderate credit risk. And as such, may possess certain speculative characteristics. So basically, what they're telling us is that the company is solvent, it's strong ish. And it's something to be aware of. And if they get too much debt, they could be in trouble. So it's not like, Hey, this is horrible. It's not like this is the most awesome company ever. It's just like, okay, they're in pretty good shape. It's a quick, easy way to get a sense of a financial strength of a business is by looking at those ratings. And it can kind of, you know, if you see something that's rated C, for example, like Tesla was a few years ago, then you'd want to run and run hide. That's proven wrong. So I mean, obviously, I was wrong about that.

But it is a cheap, easy way to kind of look at the strength of a company. Because if you're looking at all these things that were answering the question, they're all super negative. But I think Andrew pointed out that, if you look beyond that a little bit, and kind of look at the context of what you're looking at, it helps give you a better picture of what's actually going on with the business. Yeah, that's

Andrew

17:49

really tough to I think, because the numbers are, in general supposed to help you sift through a lot of stocks. And sometimes being able to just pass and not even make an exception on a stock can save you a lot of time. And generally, I'm all for that. But in this particular case, I had looked at this stock before. And, you know, I may look at it again in a couple months. And hence, there are reasons why. Like, for me, it's a little more higher on the risk scale than I would prefer. But that doesn't disqualify. And only because when you go deeper, there are other factors that aren't shown

Dave

18:26

on the books. Right, exactly. Something else I wanted to throw out there. When you're looking at different businesses, you have to sometimes take into consideration what industry it is that they operate in, and how they operate their business. And by that, I mean, Andrew was talking about Lowe's and Home Depot. When we think about those stores, we go to their stores to buy stuff. And a lot I mean, when you think about the amount of inventory that sits on the shelves in those stores, it's massive. And so that is how those businesses generate revenue is from us going to the store and buying what we need from those stores.

Same idea applies with grocery stores, same idea applies with Walmart, or target or any of those kinds of companies. So looking at Gurufocus really quickly, they have this cool little liquidity ratios. So the current ratio for Walmart is 0.24. And the current ratio for Walmart is 0.84. So those tell me that the company has more liabilities than they do assets. And so the short term in the short term. And so that's exactly what we're talking about here with hp. And none of us would work at Walmart or Target and think that they have a horrible balance sheet.

So sometimes you have to kind of look at the company in relation to its industry to get a better sense of how that's functioning. Now, if you saw this in let's say the payments industry like with Visa or MasterCard and you saw these same kinds of numbers, that'd be awful. That would be a whole reason All, because you wouldn't want to see those companies don't carry inventory. That's not how they make money. And so those are just some things that I guess I wanted to highlight, as you're kind of working through the balance sheet is think about the industry that it's in as well. And it's

Andrew

20:13

a really excellent point. Thank you. I guess the last thing that really stood out to me about this company was returns on capital. For whatever reason, they're super, super high,

Dave

20:26

abnormally high, like 50 to 100%, high, like, just out of character. And I think some of that has to do kind of going back to looking at other companies in relation, we were looking at Lenovo, who was another company that produces laptops, and desktops, and whatnot, and their returns on capital were in the what 10 to 15% range, give or take? Well, it

Andrew

20:49

depends who's calculating it.

Dave

20:51

Yeah, true. Which website, there's so many different ways, it can be really confusing. They're in the 10 to 15% range, if you will. Whereas if you look at each piece there anywhere from 40 to 100%, you know, depending on the year, and which website you're looking at.

Andrew

21:06

I mean, for Lenovo, I calculated it as like 90%. Okay, and that was weird, because depending on which items you included or not, we would see swings of like 40%, right? It's not as simple as estimating, you know, like pieces return on capital or something like it really swings a lot. And because we just kind of took a dip the toe in and you know, haven't researched his business for hours and hours and hours, we can sit here and speculate all day long on why that's the case.

If it really is Buffett's Midas touch on this, I would tend to believe that HP probably is super, super capital efficient. And if they are, I would imagine their competitors are at least decently capital efficient, as well. And so that makes me think that for whatever reason, this is a really efficient business and a really efficient industry, even if in the past, it hasn't been. Yeah,

Dave

22:02

I would totally concur with that.

Andrew

22:05

I mean, just surface level is usually the idea around consumer hardware has always been that it's a terrible industry to be in. Because every year it gets better and better. And every year it gets cheaper and cheaper. And so it's very hard to make returns as a business, if that's the case. But even in you saw it trending even before the pandemic, where HP was starting to make this comeback, you're starting to see some of that maybe change.

And I don't know if it's because the industry is maybe matured, so has Lenovo, Dell and HP gotten to this level of economy of scale, or nobody else can find it worthwhile to compete. And so they go somewhere else, that could be a possibility. We don't really have the answer for you on that. But those are just some things to consider. And I guess that's a good thing about looking at things like returns on capital and how they change over time, as it can help you potentially identify when a business or industry has fundamentally changed, because these things change, and they're not always constant for 20 years.

Dave

23:12

Yeah, that's a good insight. And I think that's something that that can help people learn as they're trying to investigate these companies, because it can be overwhelming, and there can be lots of things to try to keep track of. And one thing I guess I want everybody to remember is the first time you do it, it's going to seem overwhelming. And the second time, it's going to be less overwhelming. And the third time, even less.

And over time, you're going to pick up little tidbits and tricks and just experience will start to teach you that you can learn from these different things. And that's why Andrew and I want to kind of approach these bird's eye views this way of kind of looking at companies and how we would kind of work through looking at the companies and at different points, you may come across things that may either give you pause, or make you think outright No, no way. Or the flip side, you may come across something like how is this so great, and nobody else is noticing it. And that happens too. So you're gonna see a wide range of things.

But I guess always try to keep an open mind when you're looking at the companies and try not to go into it with preformed judgment about companies and just try to learn as much as you can along the way. And if you don't know something, look it up or ask somebody. And again, the more experience you gain, the better you'll get at this.

Andrew

24:29

Yeah, and I love the way that everybody has been asking us these kinds of questions, even though I almost like as a default, take the opposite side, just because it's in my nature probably drives Dave crazy. But those are all good things to ask about and learn about and to your point. It gets easier and I feel like we touched on probably the three major themes that I look at with any stock I'm serious about and it's not much more than that. I mean, growth returns on capital and balance sheet.

Dave

24:59

Yeah, the You know, keep it simple. The KISS principle, right? Keep it simple, stupid. It's so easy to get nitty gritty into the weeds. But if you focus on those things, and then trying to find other tidbits that can help you, I guess, confirm or deny your ideas about those big three, if you will, that will put you a long ways towards finding great investments over a long period of time. I agree. All right. Well, with that, we will go ahead and wrap up our discussion on HP wanted to thank our guest for sending us a great question. That was fantastic. Love the detail. And hopefully you guys got some good information about this about kind of how we go about looking at companies. If you have any questions about anything, please go to our website, e investing for beginners.com. Check out the search bar at the top.

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