Back to Basics: Identifying Value Traps and Bankruptcy Signals

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we're going to continue our series on back to the basics. This is something we're going to do every Thursday for a while. We have about 20 shows lined up to talk about a variety of topics. Today's topic is going to be bankruptcies and value traps. Super exciting stuff, actually. It is kind of fun. So we're going to talk about bankruptcies and value traps and what to look for and how to avoid them.

Dave [00:00:23]:

So let's start with what is a bankruptcy? Andrew, you are the bankruptcy guru. So what is a bankruptcy for investors? What do they need to know about bankruptcies?

Andrew [00:00:34]:

Well, that sounds like a fun title, right? Everybody's favorite person. So just in a nutshell, if you are buying stocks and the company goes in bankruptcy 99% of the time, you're going to lose all your money. And so that's just kind of the way the structure of companies are. Theres different levels of ownership in the sense that you have the equity investor, which are the people who buy the stocks. Theyre going to participate in the upside of the business, but theyre also going to participate completely in the downside if the business ever fails. And then the bondholders, they have a senior claim to the business's cash flows. And so because they are lending to a business, they might still get paid even if a business goes bankrupt and it all gets decided on court. But the nutshell is if you're owning stocks and the company goes bankrupt, you're going to lose.

Andrew [00:01:36]:

So please avoid that because losing all your money is a lot. Right?

Dave [00:01:41]:

Right. Very much so. Would it be safe to say this is the one way you can lose your whole investment?

Andrew [00:01:46]:

Yeah.

Dave [00:01:47]:

So this is something you definitely want to avoid.

Andrew [00:01:49]:

Yes.

Dave [00:01:50]:

At all costs.

Andrew [00:01:51]:

Yeah. And, you know, it happens. We haven't seen any big ones for a while. So, you know, consider ourselves blessed. But even the regional bank crisis, First Republic shareholders and signature bank, Silicon Valley bank and whoever the third one was.

Dave [00:02:07]:

I think it was signature bank.

Andrew [00:02:08]:

I think it was a signature.

Dave [00:02:09]:

Yeah, I think so. Yeah.

Andrew [00:02:10]:

Those shareholders all lost. So even though First Republic's now part of JPMorgan chase, the shareholders themselves got completely wiped out.

Dave [00:02:20]:

Yeah, exactly. So in anticipation of our conversation today, I actually looked this up and I did some research and I found that last year there were 623 bankruptcies according to S and P Global. And the largest ones were the banks that you mentioned. And I think it was called birds or bird. It was the company that did the scooters, they declared bankruptcy as well and so did wework. Finally it was bird IPO.

Andrew [00:02:51]:

I don't know. Yeah, they were, yeah, it was, it.

Dave [00:02:54]:

Was a public company, so they declared bankruptcy and we worked too, which was kind of an interesting that it took this long for them to finally kind of get to that point where they declare bankruptcy. But interestingly, Adam Newman, who was the founder and CEO that was ousted, is now trying to buy the company back out of bankruptcy.

Andrew [00:03:15]:

Interesting. Thats kind of strange to me.

Dave [00:03:18]:

Right. Id be very curious to see if that actually comes to pass.

Andrew [00:03:22]:

Yeah.

Dave [00:03:24]:

So how can a bankruptcy kind of affect how people think of the market in investors? How can that impact investors other than losing their money?

Andrew [00:03:33]:

Trey? I guess. In what way?

Dave [00:03:36]:

Maybe made their perception like their, how they think about companies, you know, how they go about investing, you know, how can that kind of impact it?

Andrew [00:03:44]:

It scares a lot of people off and people don't want anything to do with the stock market when stuff like that happens. Enron was a great example of that back in 060708 time frame. That was just a straight up accounting scandal and a straight up fraud. And it ended up happening that those numbers were completely fabricated and they were playing all these accounting tricks. And that was a big one for a lot of people because that company was like on the Forbes 100 lists. You know, their CEO's were celebrities. Everybody loved them. They had these presentations everybody would tune into, and all the employees were laughing and enjoying the ride.

Andrew [00:04:29]:

Unfortunately, you can't always 100% prevent fraud. And so that's why diversification is important as an investor. You never want to put everything in one basket.

Dave [00:04:39]:

No, for sure. Not beyond Enron. What are some other ones that were kind of big ones? It seemed like there was like a condensed period of time where there were some really big ones. And then we've kind of gone a while since we've had any big ones.

Andrew [00:04:52]:

Yeah. I mean, if I was a good history teacher, I would, I would have something a little more organized. But two of the big ones that stood out to me was Circuit City and blockbuster. Partly because if you were alive at the time, you were familiar with these businesses. And I think also partly that each bankruptcy tells a very unique story. And it goes to show that sometimes a bankruptcy is kind of see it before it happened. Who was it was bed, bath and beyond recently feels like everybody kind of saw that one coming.

Dave [00:05:30]:

Right.

Andrew [00:05:31]:

But a company like Circuit City, actually, that was really surprising. And even if you were astute and could look at the financials, that one might have shocked you.

Dave [00:05:40]:

I felt like toys r us kind of came out of nowhere, too. I mean, it wasn't a company that I followed at all, but I certainly used, when my daughter was born, I certainly used babies r us a lot. So when that whole ecosystem failed, that, to me caught me by surprise.

Andrew [00:05:57]:

Yeah, I think I never really studied that story, but it seems like I've heard people say the whole being able to buy toys at Target and Walmart and then obviously Amazon coming later on, those things all took place, the rest of the business. But there could have been other factors as well.

Dave [00:06:18]:

Right. So what do you feel like are the most, what are the biggest leading causes of companies going bankrupt?

Andrew [00:06:25]:

So the causes are sort of like what they say about unhappy families. They say there's a million different reasons for unhappy family, but only a few for a happy one. So it's very similar with businesses, something I tried to do when I was first starting out because I was terrified of losing money in a stock that goes bankrupt. To me, that was one of the big risks that I was worried about when I first started investing. I went back and tried to look at a lot of the big name bankruptcies during the 21st century, and I looked at around 30 of them and I havent updated it since. Crazy to say like almost ten years now. But looking at that list, the first 15 years of the two thousands, the symptoms were somewhat obvious. So, like, as an example, a lot of these businesses had negative earnings and a lot of them went from positive earnings to negative earnings.

Andrew [00:07:25]:

And so that can be a pretty big, obvious, easy red flag that you can just say, I don't want to play that game. If somebody were to do that with these businesses, they would have avoided a lot of them. The other big symptom that can be common is a lot of debt on the balance sheet. And depending on the company and depending on the timing, that can wipe out a business as well.

Dave [00:07:45]:

Robert Right. The debt is one that I think its an interesting conversation, because when I first got into investing, I felt like all debt was bad. But as ive learned, like everything in finance, theres some nuance to it.

Maybe we could talk a little bit about that and maybe what is good debt and maybe not necessarily what is bad debt, but maybe what could people look for to avoid that downfall for a company?

Andrew [00:08:15]:

Now we're starting to speak my love language, and this is the part that makes any normal person's eyes glaze over. There's several things, but I think a big one is the way that that is. I'm blanking on the term structured or layered? Layered, yeah.

Dave [00:08:32]:

Yeah.

Andrew [00:08:32]:

Like the way that the maturities are. There's a term. Staggered.

Dave [00:08:35]:

Staggered.

Andrew [00:08:36]:

Staggered. There you go. I knew you would know that one. I feel like you've written a blog post about that one.

Dave [00:08:42]:

I think I have, yeah.

Andrew [00:08:44]:

So, you know, if a company have debt that's due and if they can spread that out so that it's even, instead of all coming due all at once, that can save a lot of trouble. That's one way from a debt perspective. I know you have some thoughts on it, too. What would be some other ways for you?

Dave [00:09:00]:

I think looking at the, not just the total number, but like you're saying, looking at kind of when the debt is due and kind of, if you kind of compare that with the company's free cash flow or the revenue and the income, that can give you a better sense of, like, how well they're managing the debt. But the other one that maybe is more of a air quote, silent killer is interest payments. And so if a company runs up a big pile of debt, that's where it can also lead to trouble. Because even though you may only owe, you know, I'll just use round numbers. Even though you may only owe maybe 100 million in a year, they may have to pay 50 million in interest payments a year or 100 million in interest payments. And let's say that their income is only 125 million total. Well, that's a really, really big expense for a company to try to cover. And so that becomes a really interesting, like, how they manage, how they navigate that lack of funds to cover that.

Dave [00:10:03]:

And that's where, that's where companies can get in trouble too, because then they can default on the debt and that can lead to bankruptcy as well, or at least a restructuring of the company, which is maybe not a total loss of your money, but it could be a big problem. And so that, to me, is one of the more silent killers. And what we're really talking about is when a company takes out a loan or debt, when they take out a bond payment, they owe interest payments to the people that loan them the money. So if you and I give Microsoft $100 each and they promise to pay US dollar five a month, then they have to pay US dollar ten a month. And if they can't make those payments, then they default on that hundred dollars that we owed them and now they owe us dollar 100 plus the dollar ten. And however long that takes to pay us back. And that can accelerate when those debt payments are due. And to that can be a big, big problem.

Dave [00:10:57]:

For companies. And that's why interest coverage ratio, which is basically measuring the interest the company pays versus the operating income that they generate for a year, then the higher that number is the rate, the higher the number is, the better and the closer to zero that is. That can be a problem, especially because nobody knows when the next COVID is going to hit. That was one of the, I think the big concerns about the shipping industry, in particular with carnival cruises and some of those companies was how are they going to cover those interest payments because they still owe that money and now all of a sudden they dont have revenue. And so thats where having a strong balance sheet can come into play. Because if you have enough cash on the balance sheet, then you can, in theory use that to cover some of the debts while youre trying to get back on your feet. But thats not a fun place to be for a company. And its certainly not a fun place to be as an investor looking at not just the total debt payments or looking at how they have a staggered payments, but also the interest expense or the debt payments that they have to pay.

Dave [00:12:02]:

That can be very critical to look at as well.

Andrew [00:12:05]:

Robert, interest expenses on my checklist, I have a very short checklist for every stock. But yeah, it's one of them.

Dave [00:12:12]:

Yeah, it's really important and it's underrated and it's not very sexy, but it is definitely something that needs to be paid attention to.

Andrew [00:12:19]:

It never is sexy until we have a crisis.

Dave [00:12:22]:

Right.

Andrew [00:12:23]:

It's funny how all of a sudden everybody was looking at revolving line of credit and all these things during April, May, June of 2020, and then nobody looks at that stuff again now that we're out of the crisis.

Dave [00:12:38]:

Right? Exactly. Yeah. There was a company I wrote about on seeking alpha a few years ago, kind of during the height of the pandemic, that they, that was one of the big red flags for me when I looked at their financials was their interest coverage ratio was like 0.02 or something crazy like that, like super low. And I was like, yeah, this is not, that's scary. That's scary. Scary low. I think I read a few quarters later that the company was refinancing their debt and they were taking on additional debt to make sure that they had a cushion so they didn't have to deal with that. So I was like, yeah, that's a company I don't want to deal with.

Dave [00:13:11]:

That's, that goes into the too hard pile.

Andrew [00:13:14]:

Yeah. Even if a company can refinance like that and they don't go bankrupt. To your point, they can change the structure of the company. And if they start issuing equity to try to cover up the difference that they're losing on as a shareholder, you lose in that situation a lot of the time. So it is important to look at, even if you're not scared of company going bankrupt, it prevents situations like that.

Dave [00:13:40]:

Exactly. All right, so let's move on to the next topic. And that's unveiling value traps. So what is a value trap?

Andrew [00:13:47]:

Easiest definition would be a stock that looks cheap. Maybe it is cheap from a numbers basis, but it's cheap for a reason and will still lose you money even if you buy low on it. That's kind of how I would look at value traps.

Dave [00:14:03]:

Yeah, yeah, for sure. Do you feel like they have any common characteristics or like any red flag indicators that could indicate a value trap?

Andrew [00:14:12]:

Yeah, I mean, one that you mentioned few episodes ago was a high, very high dividend yield. That's generally unsustainable. So that's a good one to look out for. I think declining revenues is a really good one to look for. If a company is shrinking instead of expanding, then all of the issues we just talked about with the debt, on being able to refinance that debt, that all becomes a lot harder if your business is not growing. And then I mentioned the negative earnings, that's another good one. Again, you're not a fast growth young company, and you start losing money, you start hemorrhaging cash, it can compound and it can snowball in all the same ways that success and growth can compound and snowball, so can losses and business failures. So you have to be cognizant of those things and look out for them.

Dave [00:15:02]:

Yeah, absolutely. Who are some examples that you've seen in a market of value traps? I know one that screams to me, which one? Well, it was GameStop. Gamestop. Before the meme craze, it screamed value trap.

Andrew [00:15:17]:

Yeah, it had a very high yield at the time. A business that was not growing, that's almost a story for its own time.

Dave [00:15:28]:

For its own episode.

Andrew [00:15:29]:

Circuit City, I think, kind of makes for a good example of this. At the time they were growing, one that kind of stood out to me from the various times ive looked at bankruptcies is Circuit City back in the day. They actually were growing at the time that they went bankrupt. And so thats a very nefarious, unexpected value trap situation. When youre opening stores and your revenues are going up, up, up, you would never think that you would go bankrupt, but they actually did and what happened was they had way too much inventory. And when they were not able to sell that inventory, they werent able to cover their short term expenses. And as that came with the financial crisis, the two coincided. As you tend to see bad things like that tend to happen.

Andrew [00:16:21]:

And so because they had too much inventory, they couldnt convert it to cash, and then they had too many short term expenses that they needed to cover, they went bankrupt. And so one way you can look for a risk like that is to look at the quick ratio, which is youre looking at the companys short term assets. Youre comparing it to their short term liabilities or expenses, and then you are subtracting inventory. So youre basically saying, whats the worst case? If we cant sell our inventory? Do we still have enough liquidity to cover our short term expenses? And so thats one way, I dont use it as a hard and fast rule, but I use it to make sure I understand if theres a risk there that if the quick ratio is not looking good, then I hope that they have commercial paper or some other way to shore up liquidity in case you get a financial crisis and youre not able to sell your inventory. In the case of circuit city, it was a very, very, I think, under the radar value trap. I feel like, for me, if I was investing at the time, I probably would have fallen victim just like a lot of other people.

Dave [00:17:27]:

Mm hmm. Yeah. The ways that you can spot a value trap or the things that you can see will kind of depend company to company. And I'm thinking of two or three kind of off the top of my head that have been like the deep value investor darlings. Gamestop was one. Best Buy has been one, and Macy's has been another, where investors look at them and they're optically cheap and they have some characteristics that could make them appealing. Macy's, for example, one of the things that people like about Macy's is they own all that land and it has value. So if the company has to liquidate, that's worth something.

Dave [00:18:11]:

But if you look at the number of stores they have to continue to close and the revenue is continuing to decline. All those things just lead to more of a, I feel like more of a falling knife than opposed to a potential turnaround situation that you can get in cheap and benefit when the company turns things around, because it feels like when you look at value traps or companies that could potentially be value traps, one of the, I guess, striking things to me has always been that whatever business line they're in, it's become less and less relevant or less and less popular and you just see a gradual overall decline in the revenue of the company. I'm not talking like from one year to another, like, you know, Tesla year over year's, you know, delivery of cars is down. That doesn't mean that they're a value trap. It's more of a, like a five or ten year trend when you start to see things start to continually ball and the company cant pivot to something else. And im thinking of GameStop in particular, just the way that their business model was set up, they just really couldnt and havent been able to pivot to something else that would allow them to sustain themselves beyond the mean part of it. Thats really why theyve been on the struggle boss for a long time. And kind of the same with Macy's.

Dave [00:19:41]:

Best Buy has been kind of off and on over the last few years. But I think all those things really indicate that a lot of times, you know, we've talked about markets being efficient or not efficient, but sometimes when a company is cheap, it's cheap for a reason and, you know, people don't want to buy it or it's cheap because it's, you know, the business is starting to decline.

Andrew [00:20:03]:

Yeah, that type of stocks. I don't play those games anymore. If you're buying a distressed company, you really have to buy low and sell high. And not saying I think I would find it a lot of fun and I have, but it doesn't fit what I'm trying to do moving forward. And so it does become, I think it's a place of opportunity, but it's also a place of a lot of danger if you're trying to mix the game you're playing with the game that you think you're playing.

Dave [00:20:28]:

Right. Right. So if investors are out there going, okay, this all sounds great, how do I start avoiding, how do I, what do I start looking for in companies? Is there any sort of financial analysis or any sort of other tools besides the quick ratio that you mentioned that could help us start to avoid either bankruptcies or value traps?

Andrew [00:20:49]:

I think the easiest one, if youre a beginner stock picker because its a lot, like I said, theres not any one thing you can hang your hat on. And I feel like the best way to identify value traps is to be a good stock picker. And so part of that will come with experience and part of it will come with knowledge as you continue to learn and grow. So if you're a beginner and you're just first starting out having a hard and fast rule. Like if the company goes negative earnings, I'm just going to not even deal with it. I think that can be hugely helpful because you've really covered a lot of downside by having a simple rule like that. That would be a place to start. And then as you move forward, if you start nerding out on this stuff and you're diving through annual reports and you're like, this is a lot of fun, then I don't really need to give you advice because I think you'll just, through a natural curiosity, you'll start to pick up more and more and more.

Andrew [00:21:40]:

And the learning never ends. I mean, a decade or two ago it was Circuit City, before that it was blockbuster. You know, all of those had different lessons. And this decades bankruptcy will be a completely different story as well. And some of us will see it and some of us won't. And that's what makes stock market interesting.

Dave [00:21:57]:

Yeah, totally. I mean, that's part of what makes it fun is the every company is a new adventure. And it's a challenge to look at the numbers because the numbers are going to tell you a story. And it's our job as an analyst, as a stock picker analyst is to decipher what that story is telling us. And sometimes there will be hidden clues and sometimes it's going to be glaringly obvious. And I think, I guess a couple things that kind of really come to mind when I think about these ideas is, number one, you don't have to swing at every pitch. So remember that when you're going through a company and you like some things about it, but there's some other things you don't like about it, you can pass. You do not have to.

Dave [00:22:39]:

Just because you start reading about a company does not mean that you have to go all the way and end up buying it and invest in it for the next twelve years. If there's something about it you don't like, whatever it may be, you don't like the brand label. I mean, it could be anything and you can pass on it. And then I guess the other part of it too is, is having a few tools in your toolkit to look at. As like Andrew was saying, the interest coverage ratio is a ratio that he uses on his checklist and if the company doesn't meet it, he moves on. And it may not be quite that simple, but it can be a part of what you're using. Debt to equity ratio can be one the quick ratio that Andrew was talking about can be another. You can look at revenue growth.

Dave [00:23:22]:

I mean, there's a lot of different ways that you can look at companies determine what is going to be eligible for you to continue to look at and eventually invest in. But starting to develop, I think a short checklist to help you avoid some of these things can be really helpful. And frankly, the more you do it, the more you're going to get better at it. And the more mistakes you make and learn from those mistakes, the better you can get at it as well.

Andrew [00:23:47]:

Yep.

Dave [00:23:49]:

All right, folks. Well, with that, we will go ahead and wrap up our conversation on bankruptcies and value traps. I hope you enjoyed our back to the basic series today. Come back next Thursday. We'll have another back to the basics for you. So with that, we'll go ahead and sign us off. You guys go out there and invest with a margin of safety. Emphasis on the safety.

Dave [00:24:07]:

Have a great week, and we'll talk.

Andrew [00:24:08]:

To you all next week. Bye.