Bad Assets vs Good Liabilities: A Financial Perspective

Got a mail from someone who wrote about bad assets versus good liabilities and it really got me thinking. What is a bad asset? What is a good liability?

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Example of GT2RS owned by a listed Indian company

A few years ago, I was at Buddh Circuit—India's only F1 track—and I saw a beautiful GT2RS. Out of curiosity, I used an app to find out who the owner was. It turned out the car was owned by a listed Indian company. Subsequently, I found that the company owns several such cars. So, when we discuss bad assets, we must decide from whose point of view we are looking at the situation. Those cars have been capitalized in the books of the listed company as fixed assets. Their purchase appears as capex to the stockholders in the cash flow statement, but those "assets" will do nothing for the minority shareholders. They are "good assets" for the users but bad for the minority stockholders.

Bad Assets

Traditional accounting focuses on the quantum of assets and liabilities, rather than their quality. Assets owned by a company may not necessarily benefit minority shareholders.

Good Liabilities

Liabilities, when managed properly, can actually be beneficial to a company and its shareholders. The quality of assets and liabilities is more important than just their quantity.

Loan Losses in the Banking Industry: A Necessary Risk

Cost of Doing Business

Loan losses are a necessary expense for banks, a cost of providing credit to customers.

Finding the Right Balance

The goal is not to eliminate loan losses entirely, but to maintain a small, manageable amount that indicates a healthy risk appetite.

Balancing Risk and Reward

This approach helps banks find the right balance on the risk spectrum, between recklessness and excessive conservatism.

This idea is controversial, and not everyone will agree with it. It challenges the traditional view of loan losses as purely negative, suggesting instead that they can be indicators of a healthy risk appetite in banking.

Fictitious Assets: The Illusion of Value

Accounting Goodwill

When a company pays a premium over the book value for a poor acquisition, it creates accounting goodwill - an inflated asset that distorts the company's true financial position.

Impairment and Inflation

The goodwill asset sits on the balance sheet for an extended period, temporarily inflating the company's value, until it is eventually written down through a slow impairment process.

Illusion of Value

These fictitious assets create a misleading representation of the company's true financial position, artificially boosting the book value of its common stock.

Maintenance Capex: A Hidden Fictitious Asset

Fictitious Asset

When companies capitalize maintenance expenditures instead of expensing them, they artificially inflate their assets and reported profits, creating a misleading picture of financial health.

Inflation and Competition

Inflation and competitive pressure can tempt companies to capitalize expenses to maintain profit margins, leading to long-term financial distortions and risks for shareholders.

Overstatement of Assets Due to Inflation and Original Cost Accounting

Replacing Aging Assets

In a fixed capital-intensive business, using original cost accounting in an inflationary environment results in the overstatement of assets because of under-provision for depreciation. When the asset needs to be replaced, the money required will be far more than what it cost in the first place.

Fictitious Asset Values

The correct treatment would be to amortize not the original cost but the replacement cost. Not doing so will result in the overstatement of earnings and the appearance of a fictitious asset on the balance sheet.

Incremental Capex in an Inflationary World

Rising Costs

In an inflationary environment, the cost of replacing dying assets will be much higher than the original purchase price due to inflation.

Maintaining Capacity

This incremental capex is necessary to maintain earning power by replacing capacity, but it does not create a new revenue stream.

An Expense, Not an Asset

While the higher capex may not increase future earnings, not spending it would lead to a decline in earnings. This incremental capex is therefore an expense, not an asset in economic terms.

For more information on this topic, see Purchase-Price Accounting Adjustments and the "Cash Flow" Fallacy in https://berkshirehathaway.com/letters/1986.html

Under-provision of Depreciation in Capital-Intensive Businesses

Frequent Replacement of Equipment

Competition in capital-intensive industries requires companies to constantly replace their plant and machinery to keep up with the competition's massive capex programs.

Under-Provision of Depreciation

This rapid replacement results in an under-provision of depreciation, leading to an overstatement of assets on the balance sheet.

Commonplace in High-Obsolescence Industries

This issue is very common in industries where the rate of technological obsolescence is high, but companies must still discriminate between defensive and aggressive capex strategies.

Contextual Classification of Capex as an Asset or Expense

The classification of capital expenditure (capex) as an asset or expense depends heavily on the context and the business's strategic position. Here's a breakdown of the different scenarios:

- **Defensive Capex:** When a business must spend money on capex to stay competitive and maintain current earning power, without creating new earning potential, this should be considered an expense rather than an asset.
- **Aggressive Capex:** For companies like Nvidia, Taiwan Semiconductor Manufacturing Company, or Amazon, aggressive spending on research and development or fulfillment centers can increase their competitive moat. In these cases, such expenditures can be regarded as assets.

The key distinction lies in whether the spending merely maintains the status quo or enhances the company's competitive position and future earning power. Context is crucial in making this determination.

Examples of 'White Elephants' and Their Impact

In the corporate world, we often encounter "white elephants" - expensive and showy acquisitions that provide little value to stockholders while incurring significant costs. These assets not only require substantial initial investments but also demand ongoing maintenance expenses, further draining company resources.

- **Flashy corporate headquarters:** Impressive but often unnecessary structures that consume large amounts of capital
- **Corporate jets:** Luxurious modes of transportation that are costly to purchase and maintain, often benefiting executives more than shareholders

These "white elephants" represent a misallocation of company resources, prioritizing image over stockholder value. While they may boost corporate prestige, they often fail to contribute meaningfully to the company's bottom line or competitive advantage.

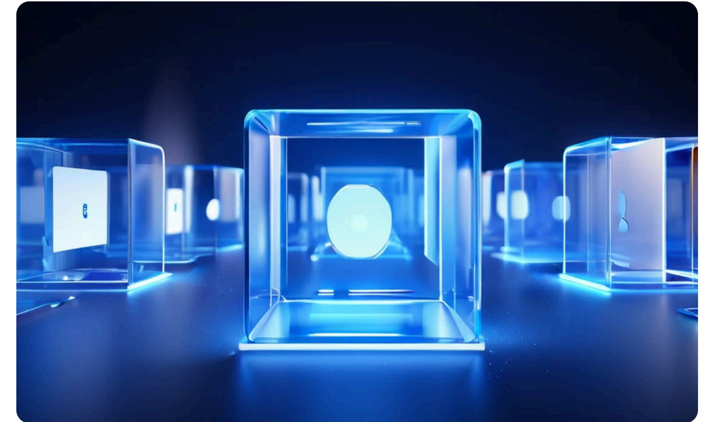
Assets on the Books That Should Have Been Expensed

Black Holes: Losing Businesses

Companies often continue investing capital in losing ventures, despite ongoing losses, due to misguided reasoning. These "black holes" drain company resources and shareholder value.

Recognizing Liabilities

The case of Berkshire Hathaway's textile operations illustrates the importance of recognizing when an asset has become a liability and taking decisive action to cut losses.



Pitfalls of Prolonged Investment

These "black holes" represent a common business pitfall, where companies keep throwing good money after bad for various ill-conceived reasons, significantly impacting financial health and long-term prospects.

The Impact of Litigation on Asset Value

Legal Disputes and Asset Valuation

The role of litigation can significantly affect the value of an asset. If you can't use an asset because of an ongoing legal dispute, how much is it really worth?

Market Tendencies

The market generally tends to undervalue litigated claims when they are considered assets, and overvalue them when viewed as liabilities.

Insights for Investors

Understanding this market behavior can provide valuable insights for investors and analysts evaluating companies involved in legal disputes.

Legal Obligations

Encumbrances can take the form of legal burdens that reduce the true value of a company's assets and liabilities for stockholders.

Contractual Commitments

Contractual obligations can also act as encumbrances, altering the perceived value of a company's financial position.

Impacting Shareholder Value

Understanding the diverse nature of encumbrances is crucial for accurately valuing a company and making informed investment decisions.

Situations Where Valuable Assets Become Less Valuable

Long-term bonds

The value of these assets on the balance sheets of many global investors has plummeted as US interest rates have risen from nearly zero to 6%.

Impairment due to disruption

Technological or market changes can rapidly devalue once-profitable assets.

Thermal power projects

Fixed-price power contracts became less valuable when input prices (coal from Indonesia) skyrocketed.

These examples illustrate that there is a whole category of situations where what is valuable today will not be valuable tomorrow. The dynamic nature of markets and external factors can significantly impact the long-term value of assets, requiring constant vigilance and reassessment from investors and financial managers.

The Problem of Exit Barriers for Bad Assets

Another aspect of bad assets is the problem of **exit barriers**. We think a lot about **entry barriers** but not much about **exit barriers**. Some businesses are like Hotel California — you can check in, but you can't check out. For example, loss-making schools, hospitals, or an airline route where the regulators don't allow you to shut down in the community's interests. In such cases, bad assets must be run and maintained — you can't walk away from them easily.

Exit Barriers in Europe

Rigid labor markets and community ownership make it difficult for European companies to shut down uncompetitive plants and shift production to lower-cost regions.

BKT's Cost Advantage

BKT, the world's lowest-cost producer of off-road tires, benefits from its manufacturing operations in India, where labor costs are lower compared to Europe.

Prolonging Competitive Edge

Exit barriers on the bad assets of competitors can actually make a company like BKT stronger, as its European rivals are reluctant to move production to Asia and lose market share.

Understanding the Value of 'Float' as a Liability

The Concept of 'Float'

Float refers to money that a company holds but does not own, essentially other people's money that the company can use to its advantage. This can significantly reduce the need for borrowing or raising equity.

Leveraging Float: Costco and Amazon

Companies like Costco and Amazon have successfully leveraged float to enhance their financial positions and create value for their shareholders. This form of liability is considered very beneficial to a company's financial health and operational capabilities.

Factors Affecting the Value of Float

The value of float as a liability isn't uniform across all situations. The degree to which float can be considered "good" depends on various factors that can influence its impact on a company's financial structure and performance.

Understanding the Value of 'Float' as a Liability

Duration of Float

The longer the duration of the float, such as for a 30-year insurance policy, the more stable and valuable it becomes for the company.

Flexibility in Deployment

The less restrictions a company faces in using its float, the more value it can generate, as seen with Buffett and Munger's use of Blue Chip stamp float.

Regulatory Constraints

Strict industry regulations can limit how companies can deploy their float, reducing the potential value, unlike the freedom enjoyed by Buffett and Munger.

Indian Examples of Companies with 'Float'

RITES Limited

This company receives float but is required to return the interest earned on the float money to Indian Railways.

Cochin Shipyard and MSTC

Unlike RITES, these companies are not obligated to return the interest on their float.

City Gas Distribution Companies

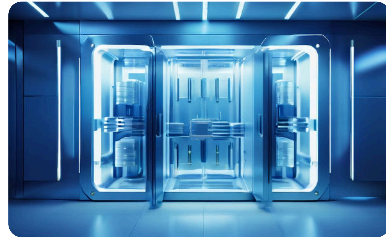
Similar to Cochin Shipyard and MSTC, these companies also benefit from float without the requirement to return interest.

These examples illustrate the varying conditions under which Indian companies can utilize float, highlighting the importance of understanding specific arrangements when evaluating the value of float as a liability.

Buffett's View on Banking and the Importance of Deposits

Banking as a Platform Business

Warren Buffett views banking as a platform business that must maintain a balance to keep customers satisfied on both the deposit and lending sides.



The Value of Stable Deposits

Contrary to common perception, Buffett argues that higher-cost but more stable deposits are more valuable than cheap, non-interest-bearing float.

Lessons from M&T Bank

Buffett cites M&T Bank as an exemplary model, praising their approach of offering competitive deposit rates to attract quality lending customers.

Refinancing to Convert Bad Liabilities into Good Ones

Transforming Liabilities

Refinancing can transform a bad liability into a good liability under certain conditions, significantly improving a company's profitability and stability.

Reducing Asset-Liability Mismatch

The process involves converting short-term debt into long-term debt with fixed interest rates, reducing the asset-liability mismatch and making the business less fragile.

Improved Profitability

When the opportunities on the asset side yield more than the cost of the money used to fund it, the business becomes more profitable and less vulnerable to financial shocks.

Vendor Financing as a Source of Float

Vendor Financing

Retail operations commonly use vendor financing of receivables and inventory as a source of float money to fund their business.

Amazon's Float

In 2011, Amazon's float of $15 billion surpassed the combined total of all their assets, demonstrating an extraordinary financial situation funded by Other People's Money.

A Missed Opportunity

In hindsight, the author admits they should have bought Amazon stock when they discovered this unique financial structure, but did not due to what they can only describe as "insanity".

Thank You