A Look at the Balance Sheet, Cash Flow and Cap Rate

CORNERSTONES OF OUR VALUE APPROACH

Balance Sheet

During our security selection process, we have historically focused on five categories of risk: valuation, business strategy, market, portfolio and financial. Of these, financial risk is probably the most important to us. Smaller companies, by virtue of their size, are generally more fragile than large companies, which makes strong financial condition paramount. But how do we evaluate a company's financial strength?

We measure leverage more broadly by looking at the ratio of assets to stockholders' equity. Using this method allows us to note changes in long- and short-term debt, as well as in accounts receivable.

One of the most important steps involves the careful scrutiny of the balance sheet. This evaluation is as much art as science, which is one way of saying that the process entails a number of subjective measures in addition to more objective, quantifiable ones. It is not simply the numbers that tell the story, but one's interpretation of their significance.

Rather than concentrate primarily on long-term debt, we search for companies whose balance sheets show low leverage. We measure leverage more broadly by looking at the ratio of assets to stockholders' equity. Using this method allows us to note changes in long- and short-term debt, as well as in accounts receivable. Items that can have an adverse effect on a company, such as higher-than-usual levels of receivables or increasingly bulging inventories, are not always financed as long-term debt. This type of examination paints what we believe is a more complete picture. Our general rule of thumb is to look for a two-to-one ratio of assets to stockholders' equity for non-financial companies. This represents what we refer to as the company's "margin of safety."

If a company is carrying too much debt, it impedes its own ability to meet the challenge of out-of-left-field occurrences such as lawsuits and overseas currency crises. A conservatively capitalized company can better weather these storms because it has the necessary financial reserves to do so, while a company with too much debt on the balance sheet runs a greater risk that stormy weather will turn into a hurricane. We also view financially strong companies as well-positioned to grow. The assets of these companies are derived more from retained earnings than paid-in capital; i.e., they have the ability to foster growth out of their own success as a business.

The balance sheet and its accompanying footnotes and schedules also reveal companies whose businesses are conservatively managed: debts may be written off early, LIFO inventories are used that may understate profits, and asset ownership and depreciation are the norm as opposed to leasing. Such practices give us critical insight into the way a company operates. The presence or absence of such items tells us something about management and their goals for the company.

Other factors are also important in our analysis. We ask certain questions as we study annual reports and financial statements: What is the schedule for bad debt provision? Is the company massaging earnings in the short term via advertising or repair expenditures? Are there any notices or indications

of pending litigation? We take an in-depth look at the ratio of retained earnings to total equity and capitalized items such as development costs. All of these factors may have a bearing on a company's—and by extension our own—exposure to risk. We take time to look back and compare balance sheets (as well as the rest of the financial statements) from previous years because we are interested in the history of a company. We look for changes from period to period that can tell us about a company's direction. If the balance sheet takes a shape we like, we want to understand how it evolved to its current status.

The process of balance sheet analysis is often time-consuming, seldom exciting and certainly never glamorous. It is critical, however, in our search to find the kind of healthy smaller companies that have been our mainstay for more than 35 years.

Cash Flow

When we discuss specific security selection criteria for many of *The Royce Funds*, four qualities are commonly listed: a strong balance sheet, a history of earnings, high returns on invested capital and the ability to generate free cash flow. Each is a critical part of determining both a company's current quality and the likelihood that it will be able to maintain that quality in the future. They are also in many ways interrelated. For example, previously we discussed the importance of a low-debt, asset-rich balance sheet in helping to maintain or fuel earnings, especially when a business is experiencing earnings trouble. Similarly, a company's ability to generate free cash flow is often linked to its ability to sustain positive earnings and to generate high internal rates of return. We think that it's a positive sign when earnings and cash flows are closely aligned.

Cash flow is usually defined as the amount of net cash that a company brings in that may be used for various company purposes, such as to build assets or pay dividends. (Cash flow can also be negative, in which case there are no funds with which to further capitalize business activities or make payouts to shareholders). For most businesses, cash flow comes from three activities—operations, investment and financing.

Our preference in most cases is for a company that generates the bulk of its net cash flow from operations, from the day-to-day activities of its business. Cash flow from operations is also significant because it may likely affect the other two activities. Although they are similar in that they help us to understand a company's profitability, cash flow differs from earnings (the profits a company makes) because it also takes into account certain non-cash accounting items, most importantly depreciation.

A company's statement of cash flows is crucial because it provides a record of how the firm has handled cash inflows and outflows over a given quarterly or annual period. It also helps to reconcile information found on the balance sheet (which shows a firm's assets and liabilities) and the income statement (which shows all revenue, costs, expenses and earnings). While the balance sheet can be used to determine the increase or decrease in assets and the income statement shows the profits that have made an impact on that growth (or lack thereof), the statement of cash flows gives us an idea of how that growth was financed. It tells the story of where the money came from and where it went.

This is especially relevant for capital-intensive businesses such as industrial companies, which maintain physical plants and own stores of equipment that will eventually need upgrading or replacing. Without positive cash flow, these businesses are likely to have trouble keeping up with more profitable, cash-laden competitors. In such businesses, we like to see cash flows that are greater than earnings because it means that the company's depreciation expenses are healthy. In high-returning businesses, we prefer that cash flows be reinvested to enhance these returns.

In all cases, regardless of the type of business, we want to see cash flows used intelligently. To our way of thinking, this means reinvesting in the business or paying dividends to shareholders. As with most things, we think about the long-term picture when it comes to cash flow. We may be willing to buy a firm in a negative cash flow moment if we think the firm is capable of righting itself. However, cash flow problems should be temporary as few factors signal quality more definitively than stable, growing cash flows.

Cap Rate

For most of our portfolio managers, the security selection process begins with an examination of a company's balance sheet. As our analysis proceeds, other important measures quickly follow, such as a company's earnings history (particularly if the firm is not posting positive earnings at the time of our review) and its ability to generate free cash flow. Additional factors come into play as well, with each

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of our portfolio managers and analysts emphasizing different metrics as they evaluate businesses. Of course, regardless of where the emphasis on particular metrics falls, our managers are looking for indicators of strong absolute value.

One company's financial profile may look terrific relative to its industry peers or to other companies in the stock market, but that does not necessarily make it a compelling value. Similarly, its stock price may be attractively low when compared to others in the same or a similar business or to other stocks in the market as a whole, but that alone will not make the stock a potential purchase candidate. In our security analysis process, a company must stand or fall on its own merits. We have always believed that the best way to pick stocks is to act as if we were buying a business.

An important metric in determining a company's absolute value is capitalization rate, or cap rate. Most commonly used in real estate asset analysis, cap rate measures the ratio between the cash flow an asset yields and that asset's purchase price. Our managers calculate cap rate in a couple of different ways: One looks at a company's EBIT (earnings before interest and taxes) divided by the business's enterprise value; another uses operating income (a close cousin of EBIT) divided by the enterprise value. In both cases, enterprise value is derived by taking a company's current market value, subtracting cash and adding in debt.

Our use of operating income is based on the belief that it is the purest way of understanding normalized income. It is similar to cash flow, but also includes amortization and depreciation, which is critical to us as long-term investors. When calculating cap rate, we have to decide how best to compute operating income. It is closely related to a firm's earnings, which helps to explain why cap rate for us is synonymous with earnings yield.

When a company is posting positive earnings or is in a traditionally cyclical business, we look back historically in an attempt to put together a pattern of normalized operating income. If a business is experiencing earnings trouble, we look back in an effort to project what its normalized operating income may be over the next year. The result of these efforts allows us to come up with a figure that reflects a longer-term measure than the operating income line that is found on a company's income statement. This in turn provides us with a cap rate estimate that's also in line with our long-term investment horizon of two to five years.

Most commonly used in real estate asset analysis, cap rate measures the ratio between the cash flow an asset yields and that asset's purchase price.

Generally, the higher the cap rate, the lower the valuation risk, which is why we seek cap rates beginning in the double digits. Conversely, cap rates in the mid-single digits or lower mean that we generally will look elsewhere. They represent little more return potential than owning risk-free U.S. treasuries, and we expect more compensation for taking the risk of equity ownership. A high cap rate is ultimately important because it offers us more potential upside, i.e., a more attractive risk-reward scenario, and that is critical in our search for strong absolute value.

Wealth Of Experience

Royce & Associates is committed to the same investment principles that have served us well for more than 35 years. Charles M. Royce, our President and Co-Chief Investment Officer, enjoys one of the longest tenures of any active mutual fund manager. Royce's investment staff also includes Co-Chief Investment Officer W. Whitney George and more than 30 investment and trading professionals.

Multiple Funds, Common Focus

Our goal is to offer both individual and institutional investors the best available micro-cap, small-cap and/or mid-cap portfolios. We have chosen to concentrate on smaller-company investing by providing investors with a range of funds that take full advantage of this large and diverse sector.

Consistent Discipline

Our approach emphasizes paying close attention to risk and maintaining the same discipline, regardless of market movements and trends. The price we pay for a security must be significantly below our appraisal of its current worth. This requires a thorough analysis of the financial and business dynamics of an enterprise, as though we were purchasing the entire company.

Co-Ownership Of Funds

It is important that our employees and shareholders share a common financial goal. Our officers, employees and their families have substantial investments in *The Royce Funds* and are often among the largest individual shareholders.

Please read the prospectus carefully before investing or sending money. For a prospectus please call (800) 221-4268. The prospectus contains information regarding the Funds' respective investment objectives, risk profile, fees and other expenses. *The Royce Funds* invest primarily in securities of micro-cap, small-cap and/or mid-cap companies, which may involve considerably more risk than investments in securities of larger-cap companies (see "Primary Risks for Fund Investors" in the prospectus). Royce Fund Services, Inc. is The Royce Fund's distributor and a member of FINRA and SIPC.

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