Checklist: How to Find a Great Stock

Description

Sometimes, with all the hype that surrounds the market and certain stocks, it’s hard to know what to focus on when looking for a good buy for our investment portfolios. I know how easy it can be to get lost in all the information that is put out there on a daily basis. So let’s take a step back and go through a checklist of very important variables to look at when considering and evaluating a stock. While there are also many qualitative factors to look at, this checklist is a great starting point.

Strong and growing free cash flow generation

Earnings can be misleading, as they are affected by many non-cash items such as depreciation, amortization, and depletion, all of which can be subjective to a degree because they depend on assumptions, and this can lead to manipulation by management. There is less room for manipulation with cash flows, so investors should start there when evaluating a company. But we need to consider the capital investment that goes into a business.

This brings us to free cash flow, which is defined as operating cash flow minus capital expenditures. **CCL Industries Inc.** (TSX:CCL.B) is a good example of a company that has generated free cash flow in the last five years. In 2015, CCL generated free cash flow of $303 million (for a strong free cash flow yield of 10%), a +200% increase over 2011 free cash flow of $90 million.

Negative free cash flow is a warning sign because it basically means that the company is spending too much money in order to generate those earnings. And this is not sustainable.

Strong balance sheet/manageable debt levels

We all know that in our personal financial lives, too much debt is risky. The same goes for companies. Every individual and every company must have room and flexibility in their balance sheets to cover the hard times and ensure sustainability. Appropriate debt levels depend on the industry that a company is in, because some industries are, by their very nature, more capital intensive.

A good example of a company which is deep into debt and suffering the consequences is **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX). With over $30 billion in debt at the end of 2015 and a total-debt-to-capitalization ratio of 87%, the company is in a very risky position. Valeant has had to sell off assets in order to keep afloat, and management expects to sell off $5 billion in assets in the next 18 months.

We all know what has happened with the stock, and, going forward, investors need to keep in mind that this massive debt level the company is carrying is a red flag and has made it a much riskier proposition.

High shareholder returns

Finally, a company that is focused on shareholder returns is aligned with your interests. Watch out for companies that are growing simply for the sake of growing and are making decisions that are too short-term oriented. Companies that have consistently high returns on equity are generating real value that investors can hang their hats on.

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3. TSX:CCL.B (CCL Industries)

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