# A WONDERFUL COMPANY AT A FAIR PRICE

## A Guide for Serious Investors on the Australian Share Market by Brian McNiven

### Book Summary

Chapter-by-chapter summary of the key takeaways derived from the book.

The book is available for purchase from Amazon **HERE**

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# A Wonderful Company at a Fair Price – A Guide for Serious Investors on the Australian Share Market

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## Benjamin Graham Approach Page 3

Benjamin Graham's requirements were:

1. The company had to have a continuous record of paying dividends for at least 10 years
2. Its share price needed to be at least one-third less than its net tangible value of assets (NTA).
3. He also advocates to sell a stock after two years, or after the price had risen 50%

## Grossed-up Dividends Page 7

The grossed-up component of a fully franked dividend is calculated by dividing the dividend payment by one minus the corporate tax rate (30%).

Example for a fully franked dividend of $100:

$$\begin{aligned} Grossed\ up\ Dividend &= \frac{Dividend}{(1 - Corporate\ Tax\ Rate)} \\ &= \frac{100}{(1 - 0.30)} \\ &= \$142.86 \end{aligned}$$

## Dividends Paid Out Vs Profits Retained Page 8

When a company has the ability to reinvest profits at 20% per annum and has a sustainable PE of say, 20. If it pays a dividend, each dollar of dividend costs the shareholder $4 of market capitalisation in one year's time. That is, if the dollar dividend were retained within the business, it would produce 20 cents of profit a year later. These 20 cents multiplied by a PE of 20, will result in a $4 increase in market value. Even if the PE would fall to 10, $1 today would be worth $2 next year.

Conversely, if a company with a ROE of 5% and a PE of 10 retains all profits, $1 of reinvested profits will shrink to 50 cents (5 cents x $10) of market capitalisation a year later.

## When to Receive a DRP or Not Page 10

When the share price exceeds the equity per share (Book Value), those who do not reinvest under the DRP are benefiting from the premium paid by those who do.

There is also no reason to pay an unfranked dividend in the same year that new capital is required.

## High PE Ratio Page 27

A high PE Ratio can only be justified if the company has the ability to reinvest 75% or more of its profits at a high ROE. Many companies eventually fall victim to the institutional imperative of buying growth with overpriced acquisitions, which diminish the ROE.

## Good Company Qualities Page 83

1. Capability and integrity of management
2. Business attributes and influences
3. Financial status and efficiency
4. Historical business performance and future prospects

## Recognising bad management Page 85

1. A fondness for empire-building with overpriced acquisitions that permanently diminish ROE
2. The use of share buy-backs to support the price rather than paying suppliers or reducing debt
3. Unbridled and unfounded optimism, leading to irresponsible actions
4. A lack of full and proper disclosure. Failure to keep the market informed ahead of time, and reluctance to highlight the negatives and take responsibility for bad situations
5. Misrepresentation – failure to re-value assets to market value or make proper provisions in the accounts for replacement costs
6. The payment of unfranked dividends when the company needs additional capital
7. A failure to think as proprietors
8. Various naive acts of share price promotion, including splitting shares under the guise of bonus issues, or the stated intention of making the stock more marketable
9. The employment of remuneration systems such as options, that only make an investment in the business less viable, but also provide incentives for managers to work against shareholders' interests
10. The payment of dividends that could be better reinvested into the business
11. The retention of profits that do not add sufficient value to the business and therefore would be more beneficially distributed as dividends

## Protective Moat Page 95

Providing a monopoly is operating efficiently and charging a fair price, it would take a brave challenger to attempt to compete. If a monopoly is not operating efficiently and is therefore overcharging for its product or service, of course, an opportunity exists for profitable competition. While price is a factor in determining gross revenue and market share, efficiency and productivity are what determine profit.

## Impact of Economic Change Page 98

Some things never change, such as humanity's basic need for food, clothing, and shelter. Financial insurance and services are two further necessities in today's world.

Changes in technology are altering our lives for the better, but this does not necessarily mean that it is a good investment. Take a look at the car and aircraft industries that have changed our lives for the better are not necessarily great investments

New technologies can always be superseded, and draw a lot of costs from R&D. If you are unsure where an industry will be in 10 years, putting money into it is speculation.

## What Makes a good Business Page 103

The basic attributes of a good business never change. Businesses offering products or services that humanity has always needed and will always need are simple businesses and easy to understand. Simple businesses that have an edge by virtue of brand recognition, reputation, innovation, established market share and status have a major head start. Businesses that require high capital investment in depreciating operating assets whose replacement costs are constantly increasing are best avoided. Finally, and most importantly, the integrity and competence of corporate management is the deciding factor.

## Current Ratio, Debt Ratio and Equity Ratio Page 108

### *Current Ratio*

The current ratio is determined by dividing current assets by current liabilities. An acceptable but far from robust current ratio is at least 1.25. this means that for every $1 of current liabilities the company has $1.25 of current assets to meet those obligations. A healthy current ratio of greater than 2 indicates good liquidity and therefore capacity to increase gross revenue without increasing debt or equity.

## *Debt Ratios*

Debt ratios are used to measure a company's percentage of borrowings relative to its gross assets or equity. It is normally construed to mean interest-bearing secured borrowings only.

$$\frac{\text{Secured debt less cash and short-term deposits}}{\text{Shareholders' equity}}$$

Hence, if:

1. Secured debt were $100 million
2. Cash and short-term deposits were $10 million
3. Shareholders equity were $180 million
4. The debt ratio would be: 90/180 = 50%

## *Equity Ratio*

A more meaningful ratio than the debt ratio is the equity ratio. This ratio measures the percentage of gross assets funded by shareholders funds or equity. In the same way that shareholders equity is determined by deducting liabilities from total assets, gross assets can be quickly determined by adding shareholders equity to total liabilities. So, if gross assets were $100 million and equity $50 million, the equity ratio would be 50% (50/100), meaning that half of the company's gross assets are funded by liabilities and half shareholders' funds. An equity ratio for a trading company of less than 35% indicates that resources of the business might be overextended.