



VALUE ABLE

How to Value the Best Stocks and Buy Them for
Less Than They're Worth by Roger Montgomery

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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Basic Stock Screener

Page 50

- Stick to stocks that made a profit in the previous year
- Little or no debt
- High rates of Return on Equity (ROE)

How to Identify Extraordinary Companies

Part Two

Company Must Haves

Page 57

- Bright long-term prospects
- A high rate of return on equity driven by sustainable advantages
- Solid cashflow
- Little or no debt
- First-class management

Steer Clear of Commodities

Page 62

When a product or a service is selected and purchased purely on the basis of price, it is called a 'commodity'.

- They are unable to regularly raise prices and so are denied a valuable competitive advantage
- Commodity companies are companies which have lots of expenses like staff and their assets are very expensive and have a high maintenance cost
- Also, they have major expenses of which they cannot control the price, e.g. excessive fuel costs
- A very competitive environment where they are constantly having to match unrealistic prices

A good example of a 'Commodity' company are airlines, they have expensive plains that need to be maintained and eventually replaced with even more expensive planes, they have a lot of staff who need to be paid more each year, thanks to inflation. They have the unexpected problem of ever-changing fuel prices and competitors who keep undercutting the market.

Raising Capital to Pay Down Debt is Undesirable

Page 70

Companies who raise capital/issue shares to pay down debt, the return on that equity – being the equivalent to the interest rate on the debt – is very, very low compared to the risk an investor takes on to be shareholders of a company.

Dividends

Page 77

Owners must guess as to what the rate (of return on equity) will average over the intermediate future. However, once an informed guess is made, the rest of the analysis is simple: you should wish your earnings to be reinvested if they can be expected to earn high returns, and you should wish them paid out to you if low returns are the likely outcome of reinvestment

Logically, a company with historic and prospective high returns should retain much or all of its earnings so that shareholders can earn premium returns on enhanced capital. Conversely, low returns on corporate equity would suggest a very high dividend payout ratio so that owners could direct capital to more attractive areas.



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Unfranked dividends and Capital Raising

Page 79

A company that pays a completely unfranked dividend creates the largest tax liability of this type for its shareholders. Shareholders who receive a \$1 unfranked dividend must now pay tax on that dividend at their full marginal rate of tax. The shareholder is then left with perhaps 55c. If the company then needs money to grow or maintain its business, it raises capital by asking its shareholders for a dollar back.

Why, if the company needed that money, did it pay an unfranked dollar and create a tax liability where none was necessary?

If a company is paying a dividend but requires extra capital it is basically asking for that dividend back again, but after it has had all its tax taken from it.

The conclusion is that a company with a high rate of return on equity and an ability to retain profits, grow equity and continue to generate high rates of return is worth more to an investor than a business generating the same rate of return on equity but paying all of its earnings as dividends.

When Dividends Exceed Profits

Page 80

Be aware if a company's dividend exceeds the profits earned by the company. They can use their cash reserves to pay these dividends which will erode away a company's equity. Or even worse a company could borrow to pay its dividend.

Return on Equity (ROE)

Page 86

Return on equity is a measure of the return the business earns on the capital that has been entrusted to management by shareholders.

The calculation of return on equity must include and compare the profit or cashflow earned over a period to the amount of money invested in the business at the start of that period. To calculate return on equity, divide profits after tax and after dividends on preference shares or cashflow by the ordinary equity, averaged over two years. The denominator is at least the equity at the beginning of the period, plus half of the total of all changes in equity during the period. These changes include capital raised and profits retained, as well as the changes to items called reserves.

The best business to own is one that over an extended period can employ large amounts of incremental capital at very high rate return. The worst business to own is one that must, or will, do the opposite – that is, consistently employ ever-greater amounts of capital at very low rates of return.

Company Take-over Simple Formula / Price to Pay for a Business

Page 107

The basic formula you should use to calculate what you should pay for a mature business is:

$$\text{Return on Equity} / \text{Required Return} \times \text{Equity}$$

For example, if a company was earning a 30 % Return on Equity
You would like to receive a modest return of 10 %
The equity in the business was \$ 100 Million



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The estimated value for such a business would be:

$$\begin{aligned} \text{Business Value} &= \frac{\text{Return on Equity}}{(\text{Required Return} \times \text{Equity})} \\ &= \frac{30\%}{(10\% \times \$100m)} \\ &= \$300m \end{aligned}$$

What is an Extraordinary Business?

Page 135

The best way to beat inflation is to buy shares in extraordinary businesses. You are seeking businesses that:

- Have the ability to raise prices each year – a proper competitive advantage
- Are not capital intensive – in other words, are able to increase volume without a major capital investment
- Have an intrinsic value that raises by a 'satisfactory rate' each year

You must also be able to buy the business at a share price which represents a substantial discount to its intrinsic value.

Cashflow Statements

Page 147 – 153

The cashflow of a company that you invest in must be positive rather than negative. After all is said and done, you only want to own businesses that generate excess cash. Excess cash is cash that can be distributed to shareholders by way of dividends or share repurchases, or reinvested in the business for growth, rather than merely ongoing maintenance.

Three main headings of the cashflow statement are:

1. Operating activities are the principal, revenue-producing activities of the business and other activities that are not investing or financial activities. Receipts from customers, payments to suppliers, interest received, interest paid, dividends received, tax paid etc.
2. Investing activities represent the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Payment for purchases or PP&E (Property, Plant and Equipment), proceeds from sale of PP&E, investments purchased, proceeds from sale of investments, payments for purchase of subsidiaries, proceeds from sale of subsidiaries, loans granted, loans repaid etc.
3. Financing activities are activities that result in changes in the size and contribution of the capital and borrowings of the equity. Proceeds from issues, proceeds from borrowings, repayment of borrowings dividends paid etc.

Another way to look at a business is to assess what I simply call company cashflow. I add the Net Operating Cashflow to the Net Investing Cashflow. This will give me a true idea of the company's cashflow position.

To estimate the cashflow for a business other than banks or insurance companies, start with the change in cash, which you will find in the current assets section of the balance sheet. Then subtract the change in borrowings, which you will find in both the current liabilities section and non-current liabilities sections then subtract the change in share capital. Finally, add back any dividends paid during the year. You will find this number in the notes to the balance sheet for retained earnings, also called 'dividends for or paid' in the statement of changes in equity, which usually appears directly after the balance sheet.



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	2015	2016	Difference	
Cash	100	150	50	Balance
Borrowings	20	25	5	Less
Share Capital	10	15	5	Less
Dividends Paid	5	7	2	Add
Result			42	

Company Write-down Calculation

Page 162

$$\text{Write Down} = \text{Capital Raised} + \text{Acquisition} + \text{Low Rate of Return on Equity}$$

How to Value a Business

Part Three

Benjamin Graham's Investing Approach

Page 175

Graham advocated mostly, if not purely, quantitative approach to finding bargains. He would begin with the current assets on the balance sheet of a company. These included the cash, the inventory and current debtors adjusted to better reflect economic realities such as collectability. These are the assets that are most able to be converted to cash in a short period of time.

From the adjusted current assets Graham would subtract absolutely everything the company owed. If there was a positive number, he would then divide the result by the number of shares on issue to get what he called his 'Net-Nets', the net current assets per share of a company. And finally, if a company's shares traded in the market at less than two-thirds of the net current assets figure, he would buy it.

Basic Intrinsic Value Calculation of a Company

Page 179

$$\begin{aligned} \text{Basic Intrinsic Value} &= \frac{\text{After Tax Return}}{(\text{Investors Required Return} \times \text{Equity in the Business})} \\ &= \frac{20\%}{(3.5\% \times \$10m)} \\ &= \$57.1m \end{aligned}$$

Or

$$\begin{aligned} \text{Basic Intrinsic Value} &= \frac{(\text{Return on Equity} \times \text{Equity in the Business})}{\text{Investors Required Return}} \\ &= \frac{(20\% \times \$10m)}{3.5\%} \\ &= \$57.1m \end{aligned}$$

Investors Required Return

Page 180

The investor required return should be based on a number that takes into account firstly, the real rate of return. Global output doubled in the 22 years from 1980 to 2002. This is a compounded growth rate of 3.2%. The investors required return should also take into account expectations of inflation, which has averaged 3% over several hundred years. At the conservative end, an inflation rate of 5% would be appropriate. Also, the investors required return should take into account a



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compensation for risk, or an 'equity risk premium'. Which could be say 4%, and then the total for the investors required return would be:

$$\begin{aligned} \text{Investors Required Return} &= \text{Global Rate of Return} + \text{Inflation} + \text{Risk Factor} \\ &= 3.2\% + 4\% + 4\% \\ &= 11.2\% \end{aligned}$$

In the stock market a minimum of 8 – 10 % return after tax is a good point to start. Keep in mind what returns are available elsewhere, for example, Bonds or a High Interest Bank Account which has hardly any risk as compared to the stock market.

Valuation Tables

Page 183 – 184

1. For companies which pay out its earnings (Dividends) multiplication table, Refer Table 11.1, Page 183
2. For companies that retain its earnings multiplication table, refer Table 11.2 Page 184

Applying the Valuation Table

Page 186 – 190

Hypothetical example of a company that has a \$5.00 return on equity per share, earning 27.5% return on that equity, retaining 25% of its profits and pays out the remaining 75% as a dividend.

Because the company is stable, has identifiable competitive advantages, a very long demonstrated track record of high returns on equity, has no debt and is the undisputed leader in its field, we have decided to adopt a 9% after-tax investor's return.

1. Using multiplication table 11.1 find the appropriate multiplier which is 3.056. We then times this by the \$5.00 of equity per share and we get a valuation if \$15.28 per share if the company were to pay out all of its profits as a dividend
2. Using multiplication table 11.2 find the appropriate multiplier which is 7.467. We then times this by the \$5.00 of equity per share and we get a valuation of \$37.34 per share if the company were to retain all of its profits
3. We now multiply the result of step one by the payout ratio of 75% which gives us \$11.46. We now multiply the result of step 2 by the retained earnings ratio of 25% which gives us \$9.34
4. Now add the two together to arrive at the estimated intrinsic value of \$20.80

Applying the formula to a real-life situation looks something like this.

A list of the information required:

- | | |
|--|-----------------|
| • Number of shares on issue | 105.8 Million |
| • End-of-year equity figure | \$302.3 Million |
| • Forecast Return on Equity (ROE) | 34 % |
| • Forecast earnings per share (to help determine the payout ratio) | 97.8c per share |
| • Forecast dividend (to help determine the payout ratio) | 34c per share |

Preparing the Data

1. Calculating the Equity per Share

Divide the end of year equity by the total shares on issue.

$$302.3 / 105.8 = \$2.86$$



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This figure of \$2.86 will be what we use to multiply by one of the figures from tables 11.1 and 11.2

2. Calculating the Payout Ratio

Divide the dividends per share by the earnings per share will give you a payout ratio.

$$34c / 97.8c = 34.8\% \text{ payout ratio}$$

It is important to satisfy yourself that the payout ratio you choose reasonably approximates what the board's policy will likely be for the company in the future

3. Return on Equity

Return on equity should be calculated by comparing net profit after tax to beginning equity, or average equity, but not ending equity. To calculate the return on equity you can divide the forecast net profit after tax by the ending equity.

$$\$102.78 / \$302.3 = 34\% \text{ ROE}$$

Use the average return on equity over the last two years as your return on equity figure for the calculation.

4. Choosing the Investors Required Return

Buffett suggests that an investor's required return after tax should be at least 10%.

Applying the Valuation Tables

1. Finding the Appropriate Multiplier in Table 11.1

Using 10% as the Investors Required Return and using a slightly lower ROE figure than the 34% to be more conservative, for example, 32.5% or 30%. Using 32.5% ROE and a 10% IRR we get a multiplier of 3.25. Ensure that you use the same ROE for both tables.

2. Finding the Appropriate Multiplier in Table 11.2

Using 10% as the Investors Required Return and using a slightly lower ROE figure than the 34% to be more conservative, for example, 32.5% or 30%. Using 32.5% ROE and a 10% IRR we get a multiplier of 8.344. Ensure that you use the same ROE for both tables.

3. Multiplying the Equity by the Multiplier from Steps 1 and 2

As we discovered in step 1 of 'Preparing the Data', we have an estimated equity per share of \$2.86. Multiplying \$2.86 by 3.25 (from Step 1) we get \$9.295. Then, multiplying again the \$2.86 of Equity per Share by the multiplier from step two of 8.344 we get \$23.864.

4. Applying the Payout Ratio then Adding Results Together to Obtain Valuation

The payout ratio was calculated in step 2 of 'Preparing the Data'. The result was 34.8%. We now multiply the result from table 11.1 of \$9.295 by 34.8% which equals \$3.235. Then for the remaining 65.2% of equity retained in the business we multiply this by our result of \$23.864 from table 11.2 which gives us \$15.559. Therefore, using a 10% required return gives us a valuation of $\$3.235 + \$15.559 = \$18.79$ per share.

Value is not Static

Page 210 – 211

Generally values will change when the company's prospects Change; when the dividend policy changes, when a company releases updated guidance for its future earnings, or when it announces a takeover, a share buy-back, a share issue, its annual results or a change in strategic direction, when interest rates change.

The basic inputs that are used to calculate the intrinsic value of a company are the equity per share, the return on equity, the investors required return, and the payout ratio. Therefore, anything that could have an impact on a company's value will be account for in the basic intrinsic valuation of the company.

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1. Factors that reduce the intrinsic value of companies with a high return on equity
 - a. Equity per share:
 - i. Shares issued at a price below equity per share
 - ii. Share buy-backs above equity per share
 - iii. Write-downs
 - iv. Losses reducing retained earnings
 - v. Dividends exceeding profits and reducing retained earnings
 - b. Return on equity:
 - i. Declining profits
 - ii. Overpriced acquisitions
 - iii. Losses
 - iv. Capital raisings to pay down debt
 - c. Payout ratio:
 - i. Where return on equity exceeds the required return there is an increased payout ratio

2. Factors that increase the intrinsic value of a company with a high return on equity
 - a. Equity per share:
 - i. Shares issued at a price above equity per share
 - ii. Share buy-backs at below equity per share
 - iii. Upward asset revaluations
 - iv. Retaining profits
 - b. Return on equity:
 - i. Increasing profits
 - ii. Cheap acquisitions
 - iii. Debt-funded acquisitions (be careful!)
 - c. Investors required return
 - i. Falling interest rates
 - d. Payout ratio
 - i. When return on equity exceeds the required return, there is a reduced payout ratio

Buy Businesses with Rising Values

Pages 211 – 212

It is imperative to buy a business with rising values as well over time, e.g. rising intrinsic values. As well as increasing earnings over a long period and consistent returns on equity is maintained.

A company which has sustained or decreasing valuations and earnings overtime will show in its share price. For example, Telstra and Qantas, both good companies but each have either static or declining intrinsic values.

Additionally, it is also just as important to look forward at the company's future prospects and growth. Obtain the analysts' reports for the company and use their forecasts to see where you think the future intrinsic value may be heading.

Diversification

Page 229

Owning shares of too many companies may indeed increase risk. This is due to the fact that it would be near impossible to keep track of all the companies in your portfolio. To only invest a few percent of a portfolio in an opportunity means that, even if you get it right and the share price doubles, the



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impact on your portfolio is insignificant and so you are forced to make a very great number of smart investments in order to outperform the market.

In order to receive the majority of the benefits of diversification and minimise the frictional costs associated with acquiring and storing a large number of shares is around 12 stocks. Buffet once said that you should take the approach that you only get to purchase 20 stocks over your lifetime, so you should be sure that it is the right one. It is probably a little restrictive, but the message has a good lesson to value your picks thoroughly.

It is reasonable for an investor who knows what they are doing to own no more than 20 stocks at one time.

Getting Out

Part Four

5 Reasons to Sell

Page 238 – 241

The five key reasons for sale are:

1. The performance of the business declines
2. The value of the business declines
3. The price rises well above their value
4. The value of the business is no longer expected to rise at a satisfactory rate
5. You are fully invested but have found something superior

Decline in Performance and Value

When the attractive characteristics of a company begin to fade it is time to exit the investment. When the return on equity begins to decline, the competitive advantage is destroyed or begins to erode, or the once-bright future prospects lose their lustre. Then it is time to sell.

Decline in Value

When a management makes an overpriced acquisition, adopts an imprudent capital management strategy – retaining capital at low rates of return or raising capital in a dilutive way – or it borrows too much or otherwise acts incompetently or dishonestly, it's time to sell.

Do not continue to own shares in a business with declining intrinsic values.

Price Rises Above Value

It may be sensible to set up some hard and fast rules about when to sell if the price rises above its intrinsic value. For example, when the price rises 20%, 30% or some greater percentage above its intrinsic value you could sell.

But be sure to take into account the future intrinsic valuations of the company before you make any decisions to sell.

Intrinsic Value Appreciation Slows

If the future intrinsic value is not rising as fast as the share price is it may be a good reason to sell.

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Before acting, think about and estimate what might happen to future valuations, and act accordingly. In other words, how long are you willing to wait for the intrinsic value of the company to catch up to the current price?

But take into account the yield you are receiving (based on your original purchase price) while you are waiting for the intrinsic value to catch the current price.

Found Something Superior

If you find a quality pick but are fully invested, you could look at selling your least attractive holding in order to raise funds for this new pick.

But be careful not to replace it with something less superior, or not as well backed over a period of time. Anything that you are considering of purchasing must be superior in terms of quality and/or value to the holding you seek to replace.

Otherwise you should just buy more of the things you already own when the opportunity is presented.

Capital Gains Tax

Page 243 – 244

When selling a company be sure to take into account the potential losses from capital gains tax first. Be sure to include the following formula when coming to sell, it will give you an estimated sale price after tax.

PP	=	Price you paid for the company minus brokerage costs
CG	=	Pre-Tax Capital Gain (sale price – purchase price)
T	=	your current tax bracket
D	=	50% (ATO has a 50% tax discount on shares held for longer than 12 months)

$$\text{Share Price After Tax} = PP + (CG - (CG \times T \times D))$$

Discount Rate to Replace Old Shares with New

Page 244

If you are looking to replace a holding in your portfolio with a more superior company, you would need to generate a return of around 16.6 % to cover the costs related to selling and purchasing shares.

In other words, you need to be satisfied that the new shares that you are considering purchasing are trading at a discount to their intrinsic value of greater than 16.6 %. And of course, the new opportunity must meet all of the quality requirements outlined.