ROGER MONTGOMERY

*Re-inventing the way you invest*

**A Montgomery White Paper**

MAY 2013

# Identifying A Good Company

## How to pick the best stocks and buy them for less than they're worth

While understanding enough to invest wisely and successfully in the stock market can take a little time and experience, at its heart there are really only two significant things you need to know.

Of all the things I have learned about investing so far (I expect I will keep learning more as the years pass, not to mention make every mistake there is to make along the way), I have formed the view that there really are only two truly 'essential' ingredients. The first is understanding the economics of a business and the second is learning to value that business. Think of the recipe for successful long term investing as one part Quality and one part Value.

This short paper provides some insights into how to go about investigating both the quality of a business and its estimated intrinsic value.

Before we get into some of the nuts and bolts, keep in mind that you also need to have the right mindset or the right framework. First, treat shares not as lines that wiggle on a screen but as pieces of businesses. Second, the business boat you get into is far more important than who is rowing it. Third, learn to identify great businesses; and four, only buy them when they are below their intrinsic value.

It may seem obvious to say that shares need to be treated as businesses, and yet professional investors might buy a company that is loaded with debt and a manufacturer of pet rocks because its inclusion in their portfolio reduces its overall volatility. The same professional might not buy the shares of a great business when they are truly cheap, waiting instead until the shares have risen sufficiently to cause them to be included in the S&P/ASX200. Buying shares this way, or simply buying in the hope that they will rise, is not the same as buying a piece of a business.

The purchase of shares on the baseless hope of a capital gain is no different to betting on black or red.

Perhaps, because it is seen as too difficult, few investors simply purchase a portfolio of 10 - 20 excellent businesses at attractive prices. This is despite the fact that such an approach produces substantial outperformance.

To prove that quality counts, take a look at Figure 1, which shows the quality history of a company like ARB Corporation. You can see that it has received the highest quality scores of A1 or A2 in most years. Look at that in contrast that with Gunns Timber in Figure 2, which regularly received the lowest possible score of C5.

In the last decade, ARB's share price has risen from $2.10 to over $11.50. A $100,000 investment in 2003 has grown to almost $550,000 (excluding the reinvestment of any dividends, which have amounted to $92,000). Conversely, Gunns Timber has turned $100,000 into something currently close to zero.

**Figure 1. ARB Corporation Quality Score since 2003 (Source: Skaffold.com)**

**Figure. 2. Gunns Timber Quality Score since 2003 (Source: Skaffold.com)**


Identifying a superior business is easy. Simply look at its economic performance and earnings power.

By way of example, suppose that in the year 2003 you commenced a business with $184 million of your own money and borrowed $139 million from the bank. Also suppose that at the end of that year, this new business generated a profit of $110 million, representing an encouraging 59 per cent return on your equity. So far, so good.

Fast–forward a decade or so and after some good years and bad years, the business this year (assume 2012) will produce a profit of just $43 million - less than half the profit of a decade ago. Now how do you feel? I suspect you would be thinking that this business isn't such a great one because your profits have more than halved over a decade of owning it.

Now let me heap burning coals onto your head by telling you that in order to keep the business running and help it 'grow' (an interesting word when you consider profits have not grown), you have had to inject, and retain, close to a further $700 million of your own money into the business. That's right, you have had to effectively write more cheques to maintain and 'grow' the business and you have foregone some dividends by reinvesting some of the profits. Not only that, but do you recall the $139 million you borrowed back in 2003? Well, you have now borrowed an additional $1.5 billion over the intervening ten years.

Your return on equity is now not much better than bank interest. Plus you owe the banks almost $1.67 billion.

My guess is that if you owned this business outright, you would not be a happy business owner. Of course, things may indeed turn up for the better, but I would prefer a business with a demonstrated track record of attractive and improving economics. You may be surprised to hear that this example is not a hypothetical one. For the example I have used, I extracted the reported numbers from the annual reports of Virgin Australia (ASX:VAH).

(The $184 million in 2003 is the total of contributed equity and retained earnings, as at 31 March 2003, for Virgin Blue Holdings and the $139 million of debt for 2003 is the total of interest bearing liabilities at the same time. The approximate $700 million of 'contributed' equity for 2012 represents the difference between the $184m of equity as at 2003 and the total of contributed equity ($633m) and retained earnings ($243m) as at 30 June 2012. The $1.67b of debt at 2012 represents the reported interest bearing liabilities at 30 June 2012.)

If you are a trader, as distinct from an investor, you may think this is not relevant to you. You'd be wrong. Think about this, if you are going to trade stocks, wouldn't it make more sense to only trade shares of good companies? As Warren Buffett famously quipped, "if you're not prepared to own the whole business for ten years, don't own a little piece of it for ten minutes".

Once you embark on an examination of businesses rather than stocks, from a business owner's perspective, using equity and return on equity, you can simply create a list of candidates worthy of inclusion in a portfolio.

Great businesses have high rates of return on equity, little or no debt, bright prospects, and sustainable competitive advantages. Over longer periods of time, and notwithstanding black swans, such business should increase in value. And you can boost your returns if you buy lots when they are at substantial discounts to intrinsic value.

The formula for estimating intrinsic value is just simple arithmetic. The valuation formula, assuming all earnings are taken out as dividends is: return on equity divided by your required return multiplied by equity. Then divide the answer by the number of shares on issue. Run the formula over any company in your portfolio that pays most of its earnings as a dividend. You may be in for a rude awakening.

Shares in great businesses are cheap when they are at discount to the appropriate multiple of equity based on the profitability of that equity. High dividend yields or low price-earnings ratios may exist, but these are not a pre-requisite to a bargain. Indeed, through the calculation of intrinsic value that I have shown, a company's shares could display a high price earnings ratio and a low dividend yield and still be cheap.

Finally, do not forego the opportunity to buy shares in wonderful businesses because of short-term concerns about the economy or because of fears that falling prices mean risks have increased. Having bought shares in JB Hi-Fi below $9.00 in the past, and Seek at half today's price, my view is that you should take advantage of other people's fears rather than listen to them.

***Roger Montgomery is the founder and Chief Investment Officer of The Montgomery Fund.**

**IMPORTANT NOTICE**