MONEY, MASTERED · THE ROADMAP

BOOK FOUR OF EIGHT

STATEMENTS · RATIOS · MOATS · VALUATION · WHAT A BUSINESS IS WORTH

READING A BUSINESS LIKE AN OWNER

Fundamental Analysis

Behind every share is a real business. This book teaches you to read it — its accounts, its strengths, its price tag — so you can answer the only question that matters: is this a good company, and is it worth what they're asking?

STATEMENTS · RATIOS · MOATS · VALUATION · FIVE PARTS · FIFTEEN CHAPTERS · BUILDS ON BOOKS 1–3

Fundamental Analysis. Book Four of *Money, Mastered — The Roadmap*. First Edition · 2026. It builds on Books 1–3 (what money is, the menu of investments, and how the market works) and assumes you know what a share and a stock market are.

A note on currency & accounting. Like the other foundation books, this one is global and uses the dollar sign **$** as a stand-in for any currency. The principles of reading a business are universal; specific accounting standards, line-item names and tax treatments vary by country, so always check the conventions where a company reports.

Education, not advice. This book teaches a method for analysing businesses; it is not investment advice and recommends no security. Any company traits described are illustrative, not real recommendations. Figures are simplified and rounded to teach the idea.

Set in Fraunces, Spectral & Archivo. Diagrams are original vector graphics; photographs are used under free licences and embedded so the book works offline.

A WORD ON WHAT ANALYSIS CAN AND CAN'T DO

Analysis improves your odds; it does not remove risk. Even a brilliant analysis can be wrong — the future is uncertain, and good businesses can be ruined by events no spreadsheet foresaw. That is exactly why this book ends where the great investors begin: demanding a *margin of safety*. Treat every valuation as an estimate, never a fact, and never bet more than you can afford to lose on being right.

THE ROADMAP

Where This Book Sits

You've learned why to invest, the menu of options, and how the market works. Now we go deep on one essential skill: judging the business behind a share.

STAGE 1 · FOUNDATIONS

Book 1 · Money, From Zero	DONE
Book 2 · Where to Put Your Money	DONE

STAGE 2 · THE MARKETS

Book 3 · How the Market Works	DONE
Book 4 · Fundamental Analysis	**YOU ARE HERE**
Book 5 · Technical Analysis	READING CHARTS
Book 6 · Funds, SIPs & Portfolios	PUTTING IT TOGETHER
Book 7 · Derivatives, Tax, Psychology & Safety	ADVANCED & PROTECTION

STAGE 3 · WEALTH

Book 8 · Building & Protecting Wealth	THE LONG GAME

A note: most people do perfectly well owning low-cost index funds (Book 2) and never analysing a single company. This book is for those who want to understand businesses deeply — out of interest, or to pick individual stocks with their eyes open.

CONTENTS · BOOK FOUR

What's Inside

Fifteen chapters in five parts. We start with the philosophy (price vs value), learn to read the three financial statements, turn them into ratios, judge the qualities numbers can't capture, and finally put a sensible number on a business.

PART IV · JUDGING THE BUSINESS

PART V · PUTTING A NUMBER ON IT

APPENDICES

BACK MATTER

WELCOME

How to Use This Book

A share price flashes on a screen, but it tells you almost nothing on its own. Fundamental analysis is the craft of looking behind the price — at the living business — to judge whether it's any good and whether the price is fair. This book teaches that craft from the ground up.

Books 1 and 2 taught you that, for most people, owning a broad low-cost fund is the wisest path. So why learn to analyse individual businesses at all? Two honest reasons: because some people genuinely want to understand how companies work and to own a few they've chosen themselves, and because even a fund investor is calmer and wiser for knowing what's inside the companies they own. If you've ever wanted to read a company the way an owner would, this is your book.

We'll build the skill in a deliberate order. First the **philosophy** — the all-important difference between a stock's *price* and a business's *value*. Then the **numbers** — how to read the three financial statements without an accounting degree. Then the **ratios** that turn raw numbers into judgment. Then the **qualities** numbers can't capture — moats, management, industry. And finally, how to **put a sensible number** on a business and buy it with a margin of safety.

How each chapter is built

Every chapter opens with **what you'll learn**, unfolds in numbered **sub-chapters**, and closes with **Key Takeaways** and a **Self-Check**. Watch for **In Plain Terms** explainers, **Worked Example** boxes with real numbers, and **Watch Out** warnings. The arithmetic never goes beyond a calculator, and every term is defined the first time it appears.

Price is what you pay; value is what you get. The whole of this book lives in the gap between the two.

Read in order — the parts build on each other, and the valuation in Part V only makes sense once you can read the statements in Part II. By the end you'll have a complete, repeatable checklist for sizing up any business on Earth.

❖ ❖ ❖

Let's begin with the single idea that separates investing from gambling: the difference between price and value.

RECALL · THE SEVEN PRINCIPLES FROM BOOK 1

The mental models this book leans on most.

1

Return follows risk

· no exceptions, anywhere, ever.

2

Time beats timing

· years invested > markets timed.

3

Costs compound

· every basis point against you

over
decades.

4

Diversification buys survival

.
survival
>
maximisation.

5

Price and value are different

.
market
quotes
prices,
not
values.

6

Behaviour dominates analysis

· your
discipline
> your

stock
picks.

7

Complexity is expensive

· if you need a paragraph to explain it, you don't own it.

I

PART ONE

The Idea of Value

Before any numbers, one idea governs everything: a stock's price and a business's value are two different things. The whole craft of fundamental analysis is estimating value and then waiting for price to offer it cheaply.

PRICE VS VALUE | MR. MARKET | MARGIN OF SAFETY | THE BUSINESS ENGINE

CHAPTER ONE

Price vs. Value

A share has a price, shouted at you every second. A business has a value, which changes slowly and quietly. Confusing the two is the root of most investing mistakes — and telling them apart is the root of all fundamental analysis.

IN THIS CHAPTER YOU WILL LEARN

- The crucial difference between price and value.
- How to treat the market as a moody business partner, not an oracle.
- What a "margin of safety" is and why it protects you.
- What fundamental analysis is — and what it is not.

Imagine you co-own a small shop with a partner. Every day this partner shouts a price at which he'll either buy your half or sell you his. Some days he's euphoric and names a wildly high price; other days he's gloomy and offers to sell his half for almost nothing. The shop itself hasn't changed — only his mood. Would you let his daily mood tell you what your shop is worth? Of course not. Yet that is exactly how most people treat the stock market.

> RAVI — READING HIS FIRST 10-K
>
> **Ravi, now 26 and four years into investing,** wants to understand *why* his S&P 500 index fund holds what it holds. He downloads Microsoft's annual 10-K and opens it for the first time. It's 200+ pages. He gives up at page 8.
>
> This book teaches him to start differently. Don't read the 10-K front-to-back. Read four things: (1) the income statement summary in the MD&A section, (2) the segment reporting (where the revenue actually comes from), (3) the risk factors (what management is officially worried about), and (4) the management discussion of competitive position. That's 25-30 pages, the durable content. The rest is mostly legal and accounting plumbing. By Chapter 16 of this book, Ravi can

> read a 10-K's important bits in an hour, and he understands — really understands — why his index fund holds Microsoft, what could go wrong, and what would have to be true for him to *not* own it.

1.1 The Difference Between Price and Value

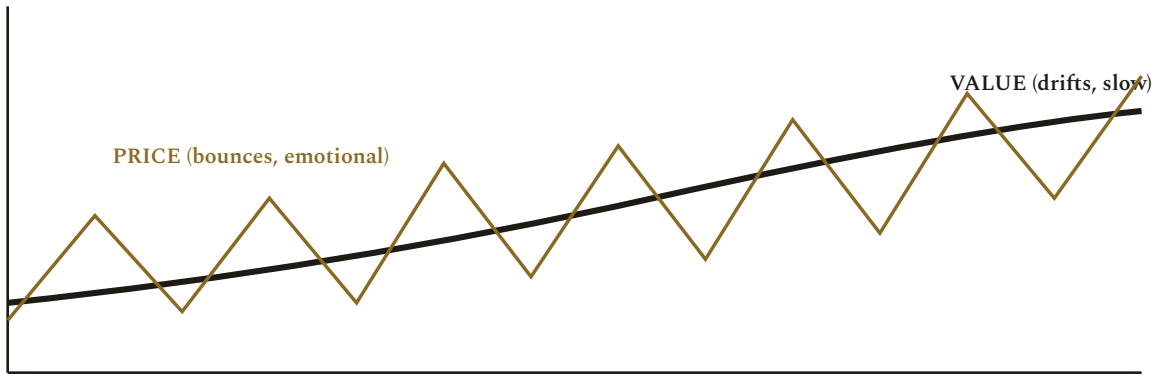
Price is what you pay for a share today — set, moment to moment, by the hopes and fears of millions of buyers and sellers. **Value** (often called *intrinsic value*) is what the underlying business is actually worth, based on the cash it can produce over its lifetime. The two are related but frequently far apart: a great business can be wildly overpriced, and a sound business can be irrationally cheap. Fundamental analysis exists to estimate *value*, so that you can judge whether today's *price* is a bargain, a fair deal, or a trap. As the famous line has it: price is what you pay; value is what you get.

PLATE 1.1 · THE MARKET QUOTES A PRICE — BUT PRICE IS NOT VALUE

Where price is quoted. *The market shouts a price every second; the value of the business behind it changes slowly and quietly. Fundamental analysis lives in the gap between the two.*

PHOTOGRAPH VIA WIKIMEDIA COMMONS, USED UNDER A FREE LICENCE.

FIGURE 1.1 · PRICE BOUNCES; VALUE DRIFTS



Over time, price swings wildly around value — and the gaps are where opportunity (and danger) live.

Two different things. *Value (the dark line) reflects the slow reality of the business; price (the gold line) lurches around it on emotion and news. The investor's edge is to know roughly where the value line is, so the price swings become opportunities — buy when price dips well below value — rather than a source of panic.*

PRIYA — EVALUATING AN ACTIVE FUND

Priya's bank suggests she switch from her index fund into the bank's "actively managed multi-cap" fund. The brochure shows 3-year returns of 18% per year — better than the index's 14%. The fee is 1.8%. Priya is tempted.

This book gives her the tools to actually evaluate it. She pulls the fund's portfolio: 60% of assets in three mega-cap stocks (concentration risk). She pulls the fund's full history: 7 of 10 years it underperformed the index after fees. She pulls the persistence data (Book 2 Ch 14): the fund's recent outperformance is not statistically distinguishable from luck. She calculates the fee compounding over her 20-year horizon: ~30% of the final pot. She declines politely. The bank's relationship manager is disappointed. Priya saves about $90,000 in expected future fees by reading one book.

1.2 Treat the Market as a Moody Partner

The shop-partner story is the famous parable of “Mr. Market,” and it's the healthiest mental model an investor can adopt. The market is not a wise oracle telling you what a business is worth; it is an

emotional partner offering you prices, which you are completely free to accept or ignore. When Mr. Market is euphoric and offers absurdly high prices, you may sell to him; when he's despairing and offers great businesses for a song, you may buy. Crucially, you are *never obliged to trade* just because he quoted a price. This reframing turns the market's volatility from a threat into a servant: its mood swings exist to occasionally offer *you* a good deal, not to tell you the truth about value.

1.3 The Margin of Safety

Because your estimate of value is just that — an estimate, which can be wrong — wise investors never pay *exactly* what they think a business is worth. They insist on a **margin of safety**: buying only when the price is comfortably *below* their estimate of value. If you reckon a business is worth $100 a share, you might refuse to pay more than $70. That $30 cushion does two jobs: it boosts your return if you're right, and — more importantly — it protects you if you're wrong, if the future turns out worse than expected, or if you simply made an error. The margin of safety is the single most important risk-management idea in all of value investing, and this whole book builds toward it.

In Plain Terms · why the gap is your friend

Think of buying a bridge rated to hold 30-tonne trucks, but only ever driving 10-tonne trucks across it. The 20-tonne gap is your margin of safety — room for error, for a heavier-than-expected load, for hidden weakness in the steel. In investing, the gap between a low price and a higher value is exactly that engineering buffer. It won't make every decision right, but it means being roughly right still works out, and being wrong rarely ruins you.

1.4 What Fundamental Analysis Is — and Isn't

Fundamental analysis studies the *business*: its profits, assets, debts, cash flows, competitive position and management, to estimate what the company is worth and whether it's healthy. Its cousin, **technical analysis** (the subject of Book 5), studies the *price chart* — patterns in how the price has moved — to guess

where it might go next. They answer different questions: fundamental analysis asks "is this a good business at a good price?", technical analysis asks "what is the price doing?" This book is wholly about the first. A fair warning, too: fundamental analysis is not a crystal ball. It improves your odds and protects your downside, but the future is genuinely uncertain — which is why everything here ends in humility and a margin of safety, never false certainty.

WATCH OUT

The price is not the verdict

Beginners constantly read the price as a judgment: "it's falling, so it must be bad," or "it's soaring, so it must be great." But price reflects the crowd's *current mood*, not the business's worth — and the crowd is often wrong, especially at extremes. A falling price can be a wonderful business going on sale; a soaring one can be a mediocre business inflated by hype. Your job is to estimate value independently, then let the price tell you only one thing: whether now is a good time to act.

KEY TAKEAWAYS

1. **Price** (**what you pay**) **and value** (**what the business is worth**) **are different** and often far apart.
2. **Treat the market as a moody partner** offering you prices — accept or ignore them; never be ruled by them.
3. **Demand a margin of safety:** buy well below your estimate of value, to protect against being wrong.
4. **Fundamental analysis judges the business;** it improves odds but is not a crystal ball.

SELF-CHECK

1. In your own words, distinguish a stock's price from a business's value.
2. How does the "moody partner" model change how you react to a market crash?
3. You value a business at $100/share. Explain how a margin of safety would shape what you'd pay.

4. How does fundamental analysis differ from technical analysis?

BEFORE WE BEGIN

The stock market quotes prices every second of every trading day. It quotes value never. That is the entire framework of this book, in one sentence. Price is what shows up on your screen. Value is what you have to work out — patiently, with a calculator, with public filings, and with a willingness to be wrong. *The market is wrong about specific businesses for years at a time.* That is the lived experience of every successful long-term investor, and it is the unspoken assumption of fundamental analysis. If you don't believe the market can be wrong, there is no point in this book; just buy an index fund and skip to Book 6. If you do believe it can be wrong, the question of *how to tell when* is what we are about to spend ninety pages answering.

CHAPTER TWO

A Business in One Picture

Before drowning in statements and ratios, step back and see what a business fundamentally is: a machine that turns inputs into something customers will pay more for. Hold that picture, and every number later in this book becomes a way of measuring one part of the machine.

IN THIS CHAPTER YOU WILL LEARN

- What every business does, reduced to one simple picture.
- How to look at a company as an owner, not a ticker-watcher.
- The two directions of analysis: top-down and bottom-up.

It's easy to lose sight of the forest for the financial trees. So before Part II buries us in income statements, let's fix in mind the simple thing all those numbers are describing — because if you understand the machine, the gauges make sense.

2.1 What a Business Actually Does

Strip any company down and it's a **value-creation machine**: it takes *inputs* (materials, labour, money, ideas), does something useful with them, and sells the result to customers for *more* than the inputs cost. That difference — what's left after paying for everything — is **profit**, the reason the business exists. A bakery buys flour and labour, turns them into bread, and sells it for more than the ingredients cost. A software firm turns engineers' time into a product millions pay for. The form differs; the engine is identical.

PLATE 2.1 · A BUSINESS TURNS INPUTS INTO SOMETHING WORTH MORE

A value-creation machine. *Inputs (materials, labour, capital) go in; something people will pay more for comes out. Every financial statement you'll read is just a way of measuring one part of this machine.*

PHOTOGRAPH VIA WIKIMEDIA COMMONS, USED UNDER A FREE LICENCE.

FIGURE 2.1 · EVERY BUSINESS, IN ONE PICTURE

Sales − all costs = PROFIT — the whole point of the machine.

The engine behind every number. *Inputs in, value added, sales out — and profit is what survives the journey. The income statement (Chapter 3) measures the flow through this machine; the balance sheet (Chapter 4) measures the machine itself; the cash-flow statement (Chapter 5) checks that the profit is real cash. Keep this picture in mind and the statements stop being abstract.*

2.2 The Owner's-Eye View

The single most powerful shift in fundamental analysis is to stop thinking like a trader ("will this ticker go up?") and start thinking like an **owner** ("is this a good business I'd be happy to own a piece of for years?"). An owner asks plain, sensible questions: Does it sell something people genuinely want? Does it make a healthy profit doing so? Is it growing? Does it have lots of debt? Could a competitor easily destroy it? Is it run by capable, honest people? Notice that none of these require a finance degree — they're the questions any sensible person would ask before buying a corner shop. Fundamental analysis is simply asking these owner's questions rigorously, using the numbers and disclosures companies must publish.

2.3 Two Directions: Top-Down and Bottom-Up

Analysts approach a company from two directions, and good ones use both. **Top-down** starts with the big picture and narrows: the overall economy → a promising industry → the best company within it. **Bottom-up** starts with the company itself — its numbers and qualities — and worries less about the macro weather. Bottom-up is the heart of this book (we're learning to read individual businesses), but

the top-down context matters too: even an excellent company can struggle in a dying industry, and a rising tide can lift a mediocre one. Think of bottom-up as examining the boat in detail, and top-down as checking which way the river is flowing.

DID YOU KNOW?

The best investors think in decades, not quarters

The most successful long-term investors famously buy shares intending to hold them for years or even "forever," treating each purchase as buying a piece of a business rather than a chip to trade. This owner's mindset changes everything: it makes you focus on the durability and quality of the business (Part IV) rather than next quarter's price wiggle, and it lets the compounding you learned in Book 1 do its slow, powerful work. Analysis is most rewarding when paired with patience.

> WATCH OUT
>
> ## Don't analyse what you don't understand
>
> If you can't explain, in plain words, how a business makes money and why customers choose it, you cannot sensibly value it — no spreadsheet will rescue you. The wisest investors deliberately stay within their "circle of competence," analysing only businesses they genuinely understand and cheerfully ignoring the rest. There's no shame in saying "this is too hard for me" and moving on; in fact, it's a sign of skill. Complexity you don't grasp is risk you can't see.

KEY TAKEAWAYS

1. **Every business is a value-creation machine:** inputs → value added → sales, with profit as what's left over.
2. **Think like an owner,** asking plain questions about the business — not like a trader watching a ticker.
3. **Top-down** (economy → industry → company) and **bottom-up** (company first) are two complementary directions.
4. **Stay within your circle of competence** — only analyse businesses you genuinely understand.

SELF-CHECK

1. Describe any business you know as an "inputs → value → sales → profit" machine.
2. List four plain questions an owner would ask before buying a business.
3. Contrast top-down and bottom-up analysis.
4. What does "circle of competence" mean, and why does it reduce risk?

II

PART TWO

Reading the Numbers

Every public company publishes three financial statements that, together, tell its whole story. They look intimidating, but each answers one plain question. Learn to read them and you can size up any business on Earth.

INCOME STATEMENT | BALANCE SHEET | CASH FLOW | HOW THEY CONNECT

CHAPTER THREE

The Income Statement

The income statement answers the most basic question about any business: did it make a profit, and how? It's simply the value-creation machine of Chapter 2, written out as a list — sales at the top, costs subtracted step by step, profit at the bottom.

IN THIS CHAPTER YOU WILL LEARN

- How an income statement flows from revenue down to profit.
- The three layers of profit: gross, operating, and net.
- What "margins" are and why they reveal quality.
- What earnings per share (EPS) tells you.

Also called the "profit-and-loss statement" (P&L), the income statement covers a *period* — a quarter or a year — and reads top to bottom like a story: here's what we sold, here's what it cost us, and here's what we kept. Master this one and the others come easily.

3.1 From Revenue Down to Profit

At the top sits **revenue** (also called sales or the "top line") — the total money the company brought in from customers. Below it, costs are subtracted in groups until we reach what's left. The very bottom figure — what remains after *all* costs, including taxes and interest — is **net profit** (the "bottom line"), the business's true earnings for the period. Everything in between explains *where the money went* on its way from the top line to the bottom line.

3.2 The Three Layers of Profit

Profit isn't one number; it's measured at three useful stages, each stripping away more costs:

FIGURE 3.1 · THE INCOME STATEMENT, AS A WATERFALL

Illustrative. Each step subtracts a group of costs — revenue narrows to the profit the owners actually keep.

A waterfall from sales to profit. Gross profit *= revenue minus the direct cost of making the product (shows how profitable the core product is).* **Operating profit** *= after running costs (shows how well the business is run).* **Net profit** *= after interest and tax (what owners actually keep). Reading all three tells you where a company makes — or loses — its money.*

3.3 Margins — the Quality Gauge

Raw profit figures are hard to compare across companies of different sizes, so we convert them into **margins** — profit as a percentage of revenue. In the example above, the net margin is $100 ÷ $1,000 = **10%**: the company keeps 10 cents of every sales dollar. Margins are one of the most revealing numbers in analysis. A high, *stable* margin often signals a strong business with pricing power (a sign of a moat, Chapter 10); a thin or shrinking margin signals fierce competition or trouble. Compare a company's margins to its own history and to its direct rivals — never across unrelated industries, since a supermarket and a software firm live in completely different margin worlds.

```
Net margin  =  Net profit  ÷  Revenue  ×  100%
```

WORKED CALCULATION · A REAL COMPANY (THE COCA-COLA COMPANY, APPROXIMATE RECENT-YEAR FIGURES)

```
Revenue          ≈  $46.0 billion
- Cost of goods  ≈ -$18.0 billion
= Gross profit   ≈  $28.0 billion  →  gross margin = 28.0 ÷ 46.0 = 61%
- Operating costs ≈ -$14.2 billion
= Operating profit ≈ $13.8 billion  →  operating margin = 13.8 ÷ 46.0 = 30%
- Interest & tax   ≈ -$3.3 billion
= Net profit     ≈  $10.5 billion  →  net margin = 10.5 ÷ 46.0 = 23%
```

Read it: keeping 61 cents of gross and 23 cents of net profit on every sales dollar is exceptional — a fingerprint of pricing power and a strong brand moat (Ch 10). A typical supermarket nets ~2–3%. Figures are rounded and approximate; a company's exact numbers change every year, so always check its current filings.

3.4 Earnings Per Share (EPS)

Finally, net profit is often expressed *per share*, so owners can see their slice. **Earnings per share** (**EPS**) = net profit ÷ the number of shares outstanding. If our company earned $100 (think millions) and has 100 shares (think millions), EPS = $1. EPS matters because it's profit on a *per-share* basis — exactly what you own a piece of — and it feeds directly into the most famous valuation ratio of all, the price-to-earnings (P/E) ratio, which we'll meet in Chapter 9. Watch EPS *growth* over several years: rising EPS, driven by a genuinely growing business (not financial trickery), is what ultimately drives long-term share value.

```
EPS  =  Net profit  ÷  Number of shares outstanding
```

WORKED CALCULATION · EPS (SAME COMPANY, APPROXIMATE)

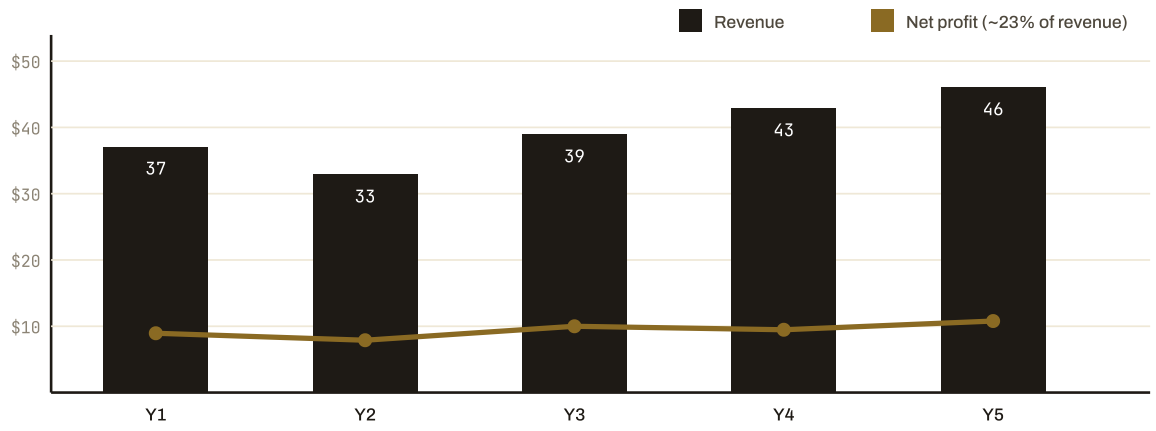
```
Net profit         ≈  $10.5 billion
Shares outstanding ≈   4.3 billion
```

`EPS = 10.5 ÷ 4.3 ≈ $2.44 per share`

So each share earned about $2.44 of profit that year. If the share traded at, say, $60, its P/E (Ch 9) would be 60 ÷ 2.44 ≈ 24.6×. Approximate, rounded figures.

Numbers in a table are abstract; a picture of them over several years tells the real story. Here is the same company's revenue and net profit across five years — exactly the kind of chart you should draw (most financial websites do it for you) before judging any business:

FIGURE 3.2 · REVENUE & NET PROFIT OVER FIVE YEARS (APPROXIMATE, $ BILLIONS)



The story in the bars. *Revenue dipped in Y2 (a tough year) then climbed to new highs; net profit (gold) tracks steadily at roughly 23% of revenue — a stable, fat margin year after year, the visual signature of a high-quality, moated business. Drawing this five-year picture is step one of analysing any company. (Approximate, illustrative figures for a real consumer-goods company; verify exact numbers in current filings.)*

In Plain Terms · don't be fooled by revenue alone

A common beginner error is to be impressed by a big "top line." But revenue is just money coming *in*; a company can have enormous sales and still lose money on every one of them. What matters is what survives the journey down the waterfall to the bottom line — and how much of each sales dollar that represents (the margin). "Revenue is vanity, profit is sanity" is an old accountant's saying for good reason. Always follow the money all the way down.

WATCH OUT

One-off items can flatter (or flatter to deceive)

A single year's net profit can be distorted by one-time events — selling a building, a legal settlement, a write-off. A company can look hugely profitable one year because it sold an asset, not because the business improved. Always look at *several* years, and focus on profit from the *core operations* (operating profit) rather than a single bottom line that might be inflated by one-offs. Trends across years tell the truth; a single number can lie.

KEY TAKEAWAYS

1. **The income statement flows from revenue (top line) down to net profit (bottom line)** over a period.
2. **Three layers of profit:** gross (core product), operating (how it's run), net (what owners keep).
3. **Margins** (profit ÷ revenue) reveal quality — compare to history and direct peers.
4. **EPS = profit per share;** watch its multi-year growth, and beware one-off distortions.

SELF-CHECK

1. Put these in order down the waterfall: net profit, revenue, gross profit, operating profit.
2. A company has $2,000 revenue and $300 net profit. What's its net margin?
3. Why is a high, stable margin a good sign?

4. Why should you look at several years of profit, not just one?

CHAPTER FOUR

The Balance Sheet

If the income statement is the story of a period, the balance sheet is a photograph of a single moment: everything the company owns, everything it owes, and what's left over for the owners. It rests on one equation that can never be broken.

IN THIS CHAPTER YOU WILL LEARN

- The one equation the balance sheet always obeys.
- What "assets" are, and the difference between current and long-term.
- What liabilities and debt reveal about safety.
- What "equity" (book value) means for an owner.

The income statement showed the *flow* through the machine; the balance sheet shows the *machine itself* at one instant — its parts, what was borrowed to build it, and how much truly belongs to the owners. It's the closest thing to a financial X-ray of a company's health.

4.1 The Equation That Can't Be Broken

The whole balance sheet rests on one identity, true for every company that has ever existed:

```
Assets = Liabilities + Equity
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In plain words: everything a company *owns* (assets) was paid for either with money it *borrowed* (liabilities) or with money the *owners* put in or left in (equity). It must balance, by definition — which is why it's called a *balance* sheet. Rearranged, it gives the figure owners care about most: **Equity** = **Assets** –

Liabilities, or "what's left for us after everything we owe is paid." Your personal net worth works identically: what you own minus what you owe.

FIGURE 4.1 · THE TWO SIDES ALWAYS BALANCE

Owned = borrowed + owners'. *The left side lists what the company has; the right side shows who has a claim on it — lenders first (liabilities), owners last (equity). The owners' slice, equity, is simply what would remain if every debt were paid off. Illustrative figures.*

4.2 Assets — What It Owns

Assets are everything of value the company controls, and they're split by how quickly they turn into cash. **Current assets** are short-term — cash itself, money customers owe (receivables), and inventory (goods waiting to be sold) — expected to become cash within a year. **Non-current** (**long-term**) **assets** are the lasting machinery of the business: buildings, equipment, and intangible things like patents or brand value ("goodwill"). When you read the asset side, you're seeing *what the company has to work with* — and whether it's mostly liquid cash or tied up in factories and inventory.

4.3 Liabilities & Debt — the Safety Question

Liabilities are what the company owes others: bills to suppliers, wages due, taxes, and — most importantly for safety — **debt** (borrowed money it must repay with interest). Like assets, they split into short-term (due within a year) and long-term. Debt is the single most important thing to check on the

balance sheet, because it's what sinks companies: a business with modest, manageable debt can survive a bad year, while one drowning in borrowings can be tipped into collapse by a single shock. As you'll see in Chapter 8, comparing a company's debt to its equity and to its profits tells you how safe — or fragile — it really is.

4.4 Equity — the Owner's Slice

Equity (also called shareholders' equity or *book value*) is what's left for the owners after subtracting all liabilities from all assets. It represents the owners' genuine stake in the business — the accumulated money they put in, plus all the profits the company has kept and reinvested over the years rather than paying out. A company that steadily grows its equity year after year is building real, accumulated worth for its owners. Book value also anchors a valuation ratio you'll meet in Chapter 9 (price-to-book), and it gives a rough floor for asset-heavy businesses — though for many modern companies, the true value lies in things the balance sheet barely captures, like brand and know-how.

> WATCH OUT
>
> ### The balance sheet doesn't show everything valuable
>
> Accounting captures what can be measured, which means a balance sheet can badly understate a great company. The value of a beloved brand, a loyal customer base, brilliant engineers, or a network effect (Chapter 10) often appears nowhere, or only as a vague "goodwill" line. So don't dismiss a company just because its book value is small relative to its price — for the best modern businesses, the most valuable assets are precisely the ones the balance sheet can't see. (Equally, beware a bloated "goodwill" figure from overpriced acquisitions, which can later be written off.)

KEY TAKEAWAYS

1. **Assets** = **Liabilities** + **Equity** — a snapshot that always balances; equity = assets − liabilities.
2. **Assets** (**current vs long-term**) are what the company owns and has to work with.
3. **Debt is the key safety check** — modest debt survives shocks; heavy debt invites collapse.
4. **Equity** (**book value**) is the owners' slice — but it can't capture brands, talent or network effects.

SELF-CHECK

1. State the balance-sheet equation and rearrange it to find equity.
2. Give two examples each of a current asset and a long-term asset.
3. Why is debt the most important thing to check on the balance sheet?
4. Why can book value badly understate a great modern business?

CHAPTER FIVE

The Cash Flow Statement

Profit is an opinion; cash is a fact. The cash flow statement strips away accounting judgment and shows the plain truth: how much actual money flowed in and out. It's the statement seasoned investors trust most — and the one beginners ignore.

IN THIS CHAPTER YOU WILL LEARN

- Why a profitable company can still run out of money.
- The three buckets of cash flow: operating, investing, financing.
- What "free cash flow" is and why it's the prize number.
- Why cash is harder to fake than profit.

Here's a fact that surprises beginners: a company can report a healthy *profit* and still go bankrupt, because profit and cash are not the same thing. The cash flow statement exists to bridge that gap — to show whether the profit on the income statement actually turned into money in the bank.

5.1 Why Profit Isn't Cash

The income statement uses "accrual" accounting: it records a sale when it's *made*, even if the customer hasn't paid yet, and spreads some costs over time. That's reasonable for measuring performance, but it means reported profit can drift far from actual cash. A company might book a million-dollar sale as profit, yet not see the cash for months — meanwhile it still has to pay wages, rent and suppliers in real money, today. Fast-growing companies are especially prone to this: booming "profitable" sales while cash drains away. The cash flow statement cuts through all of it and answers the blunt question: *did real money actually come in?*

5.2 The Three Buckets of Cash

The statement sorts every dollar of cash movement into three groups:

FIGURE 5.1 · THE THREE BUCKETS OF CASH FLOW

Healthy pattern: strong positive OPERATING cash funds INVESTING in growth, with sensible FINANCING.

Three sources and uses of cash. Operating *cash flow — money generated by the actual business — is the one to watch; it should be strongly positive and ideally exceed reported profit.* **Investing** *shows money spent building the future (e.g. new equipment).* **Financing** *shows borrowing, repaying, dividends and buybacks. The pattern across the three tells you how the company really sustains itself.*

5.3 Free Cash Flow — the Prize Number

Combine two of the buckets and you get the figure many analysts prize above all others: **free cash flow** (**FCF**) — roughly, the operating cash a business generates *minus* the money it must spend to maintain and grow its assets. It's the genuinely "spare" cash the company produces — money it can use to pay dividends, buy back shares, pay down debt, or reinvest, without borrowing. A business that reliably gushes free cash flow is, almost by definition, a strong one: real cash, freely available, is the lifeblood of value (and, as we'll see in Chapter 13, the very thing a business is ultimately worth). Profit can be massaged; sustained free cash flow is hard to fake.

5.4 Why Cash Is King

The reason analysts lean so heavily on this statement is that **cash is much harder to manipulate than profit.** Accounting profit involves dozens of judgment calls — when to recognise a sale, how fast to depreciate equipment, how to value inventory — and those judgments can be stretched to flatter the bottom line. Cash in the bank is simply there or not. So when reported profit looks healthy but operating cash flow is weak or negative year after year, that mismatch is one of the loudest warning signals in all of analysis. Follow the cash, and you'll rarely be badly fooled.

DID YOU KNOW?

Many famous failures were "profitable" to the end

A striking number of corporate collapses involved companies still reporting accounting profits even as they ran out of cash — the profit was real on paper but never arrived as money, or was propped up by accounting choices, while the actual cash quietly drained away. Investors who watched only the income statement were blindsided; those who watched the cash flow statement often saw the danger coming. It's the clearest argument for why "profit is an opinion, cash is a fact."

WATCH OUT

Profit up, cash down = investigate

If you take one habit from this chapter, take this: whenever a company's reported profit is rising but its *operating cash flow* is flat, falling, or negative, stop and dig. The gap usually has an explanation — sometimes innocent (fast growth tying up cash), sometimes not (aggressive accounting, uncollectable "sales"). Either way, a persistent divergence between profit and cash is a red flag that has preceded a great many nasty surprises. Always compare the two.

KEY TAKEAWAYS

1. **Profit ≠ cash:** a profitable company can still run out of money, because profit records sales before cash arrives.
2. **Three buckets:** operating (the core — watch this most), investing (building the future), financing (debt & shareholders).
3. **Free cash flow** — operating cash minus needed investment — is the genuinely spare cash, and the prize number.
4. **Cash is hard to fake;** profit rising while cash falls is a major warning sign.

SELF-CHECK

1. How can a company be profitable yet go bankrupt?
2. Name the three buckets of cash flow and say which matters most.
3. What is free cash flow, and why do analysts prize it?
4. Why is cash harder to manipulate than profit?

CHAPTER SIX

How the Three Statements Connect

The three statements aren't separate documents — they're three views of one reality, locked together. Reading them as a connected system, rather than in isolation, is what turns number-reading into genuine understanding.

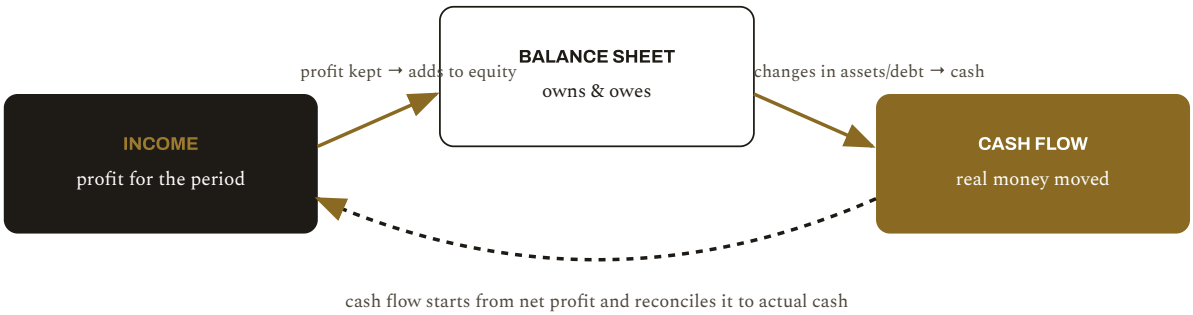
IN THIS CHAPTER YOU WILL LEARN

- How profit, the balance sheet and cash flow link together.
- Why reading all three together beats reading any one alone.
- The most common red flags and accounting games to watch for.

Each statement answers a different question — *did it profit?* (income), *what does it own and owe?* (balance sheet), *did real cash flow?* (cash flow) — but they describe the same business, so they must agree. Seeing how they interlock is the moment fundamental analysis "clicks."

6.1 The Links Between Them

FIGURE 6.1 · THREE STATEMENTS, ONE SYSTEM



One reality, three lenses. *Net profit from the income statement flows into the balance sheet (kept profit increases equity) and is the starting point of the cash flow statement (which then adjusts it to real cash). The ending cash on the cash flow statement equals the cash line on the balance sheet. They are bolted together — which is exactly why cross-checking them exposes inconsistencies.*

6.2 Reading Them Together

The power comes from triangulation. The income statement might say "great profit" — but the cash flow statement reveals whether that profit became money, and the balance sheet shows whether debt is quietly ballooning to keep the lights on. A truly strong company shows harmony across all three: healthy and growing profit, operating cash flow that matches or exceeds it, and a balance sheet with manageable debt and growing equity. When the three sing together, you can trust the picture. When one contradicts the others — profit up but cash down, or earnings rising while debt soars — that dissonance is your signal to dig deeper before trusting anything.

6.3 Red Flags & Accounting Games

Companies under pressure sometimes use accounting choices to flatter their numbers, and reading the statements together is your best defence. Common warning signs: **profit rising while operating cash flow lags** (the classic, from Chapter 5); **debt growing faster than the business; receivables or inventory ballooning** relative to sales (suggesting unsold goods or customers not paying); **frequent "one-off" charges** that somehow appear every year; and an **over-reliance on complicated, hard-to-explain items.** None of these alone proves wrongdoing — there are often innocent explanations — but a cluster of them, especially the profit-versus-cash gap, warrants real caution. The honest investor's instinct: if the accounts are confusing and the numbers don't reconcile cleanly, that *is* the finding.

In Plain Terms · clarity is itself a signal

Great businesses run by honest managers tend to have *clear, consistent, easy-to-follow* accounts — the story the numbers tell is simple and the three statements agree. When you find yourself unable to understand how a company makes money, or why its statements don't line up, resist the urge to assume you're just not clever enough. Often the complexity is the point — it's hiding something. As a rule, prefer businesses whose financials you can actually understand; clarity correlates with quality.

KEY TAKEAWAYS

1. **The three statements are one system:** profit feeds equity and starts the cash flow, which ends at the balance sheet's cash.
2. **Read them together;** a strong company shows harmony — growing profit, matching cash, sound balance sheet.
3. **Watch for red flags:** profit up but cash down, ballooning debt/receivables/inventory, recurring "one-offs."
4. **Confusing accounts are themselves a warning;** prefer businesses you can clearly understand.

SELF-CHECK

1. How does net profit connect the income statement to the balance sheet and cash flow statement?
2. What does "harmony across the three statements" look like?
3. List three red flags visible only when you read the statements together.
4. Why can confusing financials themselves be a reason for caution?

III

PART THREE

The Ratios

Raw numbers from the statements mean little in isolation. Ratios turn them into judgment — letting you compare a giant to a minnow, this year to last, one rival to another. A handful of ratios answers the three questions that matter: is it profitable, is it safe, and is it cheap?

PROFITABILITY | HEALTH & SAFETY | VALUATION

CHAPTER SEVEN

Profitability & Efficiency

A great business doesn't just make a profit — it makes a lot of profit on the money invested in it. These ratios reveal how efficiently a company turns capital into earnings, and they're among the strongest signals of quality there are.

IN THIS CHAPTER YOU WILL LEARN

- Why profit alone isn't enough — you must compare it to the capital used.
- The three key return ratios: ROE, ROA and ROCE.
- How margins fit in as a quality signal.
- What "good" looks like, and how to judge it fairly.

Two companies each earn $10 million in profit. One did it using $50 million of invested capital; the other needed $500 million. The first is ten times more *efficient* — and, all else equal, a far better business. Profitability ratios capture exactly this: not just *how much* a company earns, but how well it earns relative to what was put in.

7.1 The Return Ratios — ROE, ROA, ROCE

The headline question is: *for every dollar tied up in this business, how many cents of profit does it produce?* Three ratios answer it from slightly different angles. **Return on Equity** (**ROE**) = net profit ÷ shareholders' equity — how much profit the company generates on the *owners'* money. **Return on Assets** (**ROA**) = profit ÷ total assets — how well it uses *everything* it controls. **Return on Capital Employed** (**ROCE**) = operating profit ÷ (equity + debt) — how productively it uses all the long-term capital, debt included. Of the three, ROE is the most quoted and ROCE is often the most revealing, because it isn't flattered by piling on debt.

ROE = Net profit ÷ Equity · ROA = Net profit ÷ Total assets · ROCE = Operating profit ÷ (Equity + Debt)

WORKED CALCULATION · THE THREE RETURN RATIOS (SAME COMPANY, APPROXIMATE)

Net profit ≈ $10.5 B · Operating profit ≈ $13.8 B

Equity ≈ $27 B · Total assets ≈ $98 B · Debt ≈ $43 B

ROE = 10.5 ÷ 27 ≈ 39%

ROA = 10.5 ÷ 98 ≈ 11%

ROCE = 13.8 ÷ (27 + 43) ≈ 20%

*Notice ROE (39%) is far above ROCE (20%). That gap is the work of **debt**: with relatively little equity and a lot of borrowing, profits look enormous per dollar of owners' money — but the business actually earns ~20% on all the capital it uses. ROCE is the more honest gauge of operating quality; the high ROE is partly borrowed. (Approximate figures; verify in current filings.)*

FIGURE 7.1 · RETURN ON EQUITY, IN ONE PICTURE

ROE = $90 ÷ $500 = 18% — the owners' money earns 18 cents on the dollar.

How hard the owners' money works. *ROE measures profit produced per dollar of owners' equity. A consistently high ROE — say, persistently above ~15% without heavy debt — is a hallmark of a high-quality business that compounds owners' capital effectively. It's one of the first numbers great investors look at.*

7.2 Margins, Revisited

Margins (Chapter 3) belong here too, as the other half of profitability. Where return ratios ask "how much profit per dollar of *capital*?", margins ask "how much profit per dollar of *sales*?" The two combine to explain performance: a business can be highly profitable either by earning a fat margin on each sale (a luxury brand) or by earning a thin margin but turning over its capital very fast (a supermarket). Neither is inherently better — but high *and stable* margins usually point to pricing power and a defensible position (a moat, Chapter 10), while margins that are thin or steadily eroding warn of brutal competition.

7.3 What "Good" Looks Like

There are no universal magic numbers — "good" depends on the industry, the era and interest rates — but some sensible reference points help. A return on equity or capital that *consistently* beats ~15% is generally strong; single great years matter less than a long, steady record. The most powerful signal of all is **consistency over many years**: a business that earns high returns year after year, through good times and bad, almost certainly has something durable protecting it. Always judge these ratios three ways: against the company's own history, against its direct competitors, and with a healthy suspicion of any number that looks too good to be sustainable.

> WATCH OUT
>
> ### A high ROE can be borrowed, not earned
>
> Because ROE divides profit by *equity* only, a company can inflate it simply by loading up on debt (which shrinks equity's share and magnifies returns — until something goes wrong). A dazzling ROE built on a mountain of borrowing is fragile, not impressive. This is exactly why **ROCE** (which includes debt in the denominator) is often more honest, and why you must always read profitability ratios alongside the debt and safety ratios of the next chapter. High returns are only admirable if they're not bought with dangerous leverage.

KEY TAKEAWAYS

1. **Profitability ratios compare profit to the capital used** — efficiency, not just size.
2. **ROE** (on owners' money), **ROA** (on all assets), **ROCE** (on all long-term capital) are the key three.
3. **Margins** measure profit per sale; high & stable margins suggest pricing power.
4. **Consistency over years signals quality;** beware a high ROE inflated by heavy debt.

SELF-CHECK

1. Why is $10m profit on $50m of capital better than $10m on $500m?
2. Define ROE, ROA and ROCE in one line each.
3. How can two profitable companies get there in opposite ways (margin vs turnover)?
4. Why can a high ROE be misleading, and which ratio guards against that?

CHAPTER EIGHT

Health & Safety

A business can be wildly profitable and still go bankrupt — if it can't pay its debts when they fall due. These ratios are the financial health check: they tell you whether a company can survive a bad year, or whether one shock could topple it.

IN THIS CHAPTER YOU WILL LEARN

- How to measure whether a company has too much debt.
- Whether it can comfortably cover its interest payments.
- Whether it can pay its short-term bills (liquidity).
- How these checks help you avoid catastrophic "blow-ups."

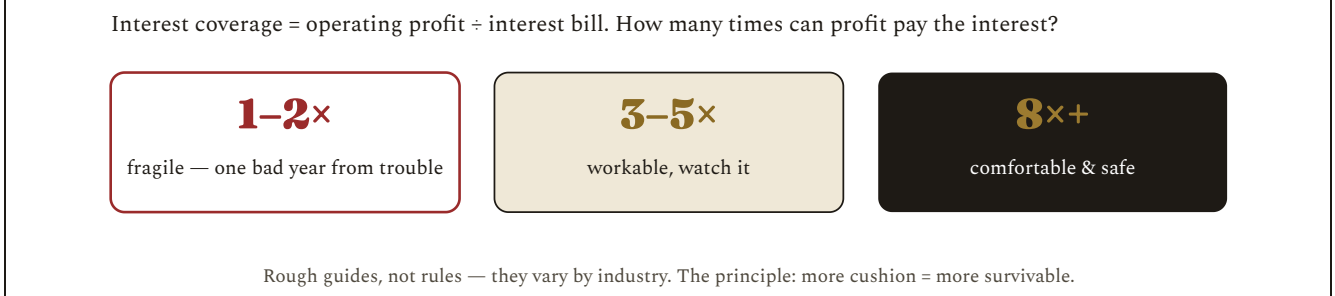
If profitability ratios tell you how *good* a business is, safety ratios tell you how *survivable* it is — and survival comes first. The single most common cause of permanent loss for investors isn't a company growing slowly; it's a company collapsing under debt. These ratios are your early-warning system.

8.1 How Much Debt? — Debt-to-Equity & Interest Coverage

Two ratios judge a company's debt burden. **Debt-to-equity** compares what it owes to what the owners have put in: a figure around or below 1 is generally comfortable for most industries (though banks and utilities differ), while a high and rising ratio means the business is leaning heavily on borrowed money. Even more telling is **interest coverage** = operating profit ÷ interest expense — how many times over the company's profits can cover its interest bill. A coverage of, say, 8× means profits would have to fall

dramatically before it couldn't pay its lenders; a coverage near 1–2× means the company is one bad year away from trouble. Coverage answers the live question debt-to-equity can't: *can it actually keep up the payments?*

FIGURE 8.1 · THE DEBT SAFETY GAUGE



Can it pay its lenders? *Interest coverage shows the cushion between a company's profits and its debt payments. Wide cushions survive recessions; thin ones don't. When you hear of a profitable company suddenly collapsing, weak interest coverage is very often the hidden cause.*

8.2 Can It Pay the Bills? — Liquidity

Separate from long-term debt is the short-term question: can the company pay the bills due *this year*? The **current ratio** = current assets ÷ current liabilities measures exactly that — whether the cash, receivables and inventory it can turn into money soon are enough to cover what it owes soon. A current ratio comfortably above 1 means short-term obligations are covered; below 1 can signal a cash squeeze. It's a quick pulse-check on near-term survival, complementing the longer-term debt view. A healthy business is solvent in both senses: it isn't drowning in long-term debt, and it can comfortably meet its immediate bills.

8.3 Avoiding the Blow-Ups

Here's why this unglamorous chapter may be the most valuable one for protecting your money. In investing, you don't need to be right about everything — but a single catastrophic loss can wipe out

years of good decisions. And catastrophic, *permanent* losses overwhelmingly come from companies that fail entirely, which overwhelmingly means companies that couldn't handle their debt. By simply avoiding businesses with dangerous debt levels and thin interest coverage, you sidestep the great majority of total wipeouts. As the old wisdom goes, the first rule is don't lose money — and these safety ratios are the most reliable way to obey it. Survival isn't the exciting part of analysis, but it's the part that lets you stay in the game long enough for everything else to work.

DID YOU KNOW?

Debt turns a setback into a catastrophe

A company with no debt that hits a rough patch simply earns less for a while and recovers. The *same* company loaded with debt can be pushed into bankruptcy by that identical rough patch, because it still owes its lenders regardless of how business is going — and missing payments can trigger collapse. Debt doesn't just add risk; it converts survivable problems into fatal ones. That asymmetry is why cautious investors treat heavy debt as the single biggest red flag in all of analysis.

> WATCH OUT
>
> ## High debt can hide behind high growth
>
> During good times, a fast-growing, heavily-indebted company can look unstoppable — rising sales easily cover the interest, and the debt seems harmless. But the test of debt is never the good year; it's the bad one. Always imagine the company through a serious downturn: if profits halved, could it still pay its interest and its bills? If the honest answer is “barely” or “no,” the debt is dangerous no matter how rosy things look today. Stress-test for the bad year, not the good one.

KEY TAKEAWAYS

1. **Profitable companies can still go bankrupt** if they can't service their debt — survival comes first.
2. **Debt-to-equity** shows the burden; **interest coverage** shows whether profits can comfortably pay the interest.
3. **The current ratio** checks whether short-term bills can be met (liquidity).
4. **Avoiding heavy-debt companies sidesteps most total wipeouts;** always stress-test for a bad year.

SELF-CHECK

1. Why can a profitable company still go bankrupt?
2. What does an interest coverage of 8× tell you, versus 1.5×?
3. What does the current ratio measure?
4. Why does debt turn a survivable setback into a potential catastrophe?

CHAPTER NINE

Valuation Ratios

You've judged whether a business is good (profitable) and safe (low debt). Now the final question of Part III: is it cheap? Valuation ratios connect the price you'd pay to the business behind it — turning "the stock costs $50" into "is $50 a bargain or a rip-off?"

IN THIS CHAPTER YOU WILL LEARN

- The most famous valuation ratio — the P/E — and what it really means.
- Other key multiples: P/B, P/S, EV/EBITDA, and dividend yield.
- Why a multiple means nothing without context.
- How to compare valuation to history and peers.

A great business at a terrible price is a terrible investment — this is the bridge back to Chapter 1. Valuation ratios are quick tools for judging whether today's price is sensible relative to what the business actually produces. They're not precise, but they're invaluable for sorting the cheap from the dear.

9.1 The P/E Ratio

The **price-to-earnings (P/E) ratio** is the most quoted number in all of investing: the share price divided by earnings per share (EPS, from Chapter 3). A P/E of 20 means you're paying $20 for every $1 of the company's annual profit — or, loosely, that at today's earnings it would take 20 years of profit to "buy back" your purchase price. A *high* P/E means the market expects strong growth (or is over-excited); a *low* P/E means the market is pessimistic (or has spotted a bargain). The P/E is wonderfully quick, but on its own it's almost meaningless — a P/E of 30 can be cheap for a fast-growing star and wildly expensive for a stagnant one. Its power comes entirely from *comparison*.

P/E = Price ÷ EPS · P/B = Price ÷ Book value per share · Dividend yield = Dividend ÷ Price

WORKED CALCULATION · THE VALUATION MULTIPLES (SAME COMPANY, SHARE PRICE ASSUMED $60)

EPS ≈ $2.44 · Book value/share = $27 B ÷ 4.3 B ≈ $6.28 · Dividend ≈ $1.94/sh

Market cap = $60 × 4.3 B ≈ $258 B · Debt ≈ $43 B · Cash ≈ $12 B · EBITDA ≈ $15.3 B

P/E = 60 ÷ 2.44 ≈ **24.6×** *$24.6 paid per $1 of yearly profit*

P/B = 60 ÷ 6.28 ≈ **9.6×** *high — the brand isn't on the balance sheet*

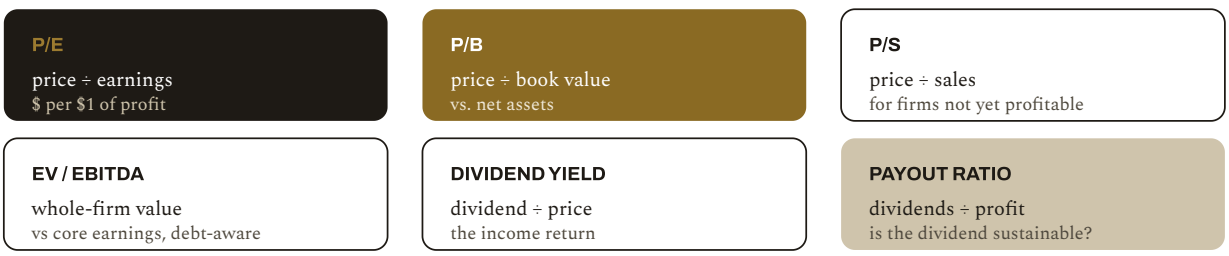
P/S = 258 ÷ 46 ≈ **5.6×**

EV/EBITDA = (258 + 43 - 12) ÷ 15.3 ≈ 18.9×

Dividend yield = 1.94 ÷ 60 ≈ 3.2% · payout = 1.94 ÷ 2.44 ≈ **80%**

On their own these say little. A P/E of ~25 and P/B of ~10 look "expensive" in the abstract — but for a business earning ~20% on capital with a fortress brand, the market is paying up for quality and durability. The 80% payout means most profit is returned as dividends (little reinvestment needed — a mature, cash-rich firm). Always compare to the company's own history and direct peers. Approximate figures.

FIGURE 9.1 · THE MAIN VALUATION MULTIPLES



Each compares price (or whole-firm value) to one measure of what the business produces.

No single multiple is "the" answer — use several, always in context.

Different lenses on price. *Each multiple relates what you'd pay to a different output of the business — profit (P/E), net assets (P/B), sales (P/S), core operating earnings including debt (EV/EBITDA), or income (yield). Using several together gives a rounder, more reliable read than leaning on any one.*

9.2 The Other Multiples

Each additional ratio shines in a particular situation. **Price-to-book** (**P/B**) compares price to the company's net assets (book value, Chapter 4) — useful for asset-heavy businesses like banks, less so for asset-light ones. **Price-to-sales** (**P/S**) compares price to revenue — handy for young, fast-growing companies that don't yet make a profit (so have no P/E). **EV/EBITDA** compares the whole firm's value (including its debt) to its core operating earnings — a favourite of professionals because it isn't distorted by how a company is financed or by accounting quirks. And **dividend yield** (dividend ÷ price) shows the income return, while the **payout ratio** (dividends ÷ profit) tells you whether that dividend is comfortably affordable or stretched. You don't need all of them every time — pick the ones that suit the business in front of you.

9.3 A Multiple Is Meaningless Without Context

This is the chapter's most important warning, so let it land: **a valuation ratio tells you almost nothing in isolation.** Is a P/E of 18 cheap or expensive? Impossible to say — until you compare it. Compare it to the company's *own history* (is it cheaper or dearer than usual?), to its *direct competitors* (cheaper or dearer than similar businesses?), and to its *growth prospects* (a fast grower deserves a higher multiple than a stagnant

one). A P/E of 18 might be a screaming bargain for a high-quality compounder and a dangerous over-payment for a declining one. The number is just the start of the question, never the answer.

WATCH OUT

The "cheap" trap — and the "growth at any price" trap

Two opposite errors. First, the **value trap**: a stock looks cheap on a low P/E, but it's cheap *for a reason* — the business is quietly dying, and the low multiple is the market's accurate warning. Second, **paying any price for growth**: a wonderful, fast-growing company can be a poor investment if you pay a sky-high multiple that already assumes years of perfection — any stumble, and the price collapses. Cheap isn't automatically good; expensive isn't automatically bad. Always ask *why* the multiple is what it is.

KEY TAKEAWAYS

1. **Valuation ratios relate price to what the business produces** — answering "cheap or dear?"
2. **P/E** (price per $1 of profit) is the headline; **P/B, P/S, EV/EBITDA, dividend yield & payout** each suit particular cases.
3. **A multiple means nothing alone** — compare to the company's history, its peers, and its growth.
4. **Beware both the value trap** (**cheap for a reason**) **and over-paying for growth.**

SELF-CHECK

1. What does a P/E of 25 mean in plain words?
2. Which multiple would you use for a fast-growing company that isn't yet profitable, and why?
3. Why is a P/E of 18 neither cheap nor expensive until you compare it?
4. Describe the value trap and the "growth at any price" trap.

IV

PART FOUR

Judging the Business

Numbers tell you what a business has done; they can't fully tell you whether it will keep winning. For that you need judgment about the things spreadsheets miss: its defences, its leaders, and its place in a changing world. This is where good analysis becomes wisdom.

THE MOAT | MANAGEMENT | GROWTH & INDUSTRY | THE NARRATIVE TRAP

CHAPTER TEN

The Moat

A profitable business attracts competitors the way honey attracts bees. What keeps the profits from being competed away is a "moat" — a durable advantage that protects the castle. Finding businesses with wide, lasting moats is perhaps the most important skill in fundamental analysis.

IN THIS CHAPTER YOU WILL LEARN

- What an economic "moat" is and why it matters more than this year's profit.
- The main types of moat — and how to recognise each.
- How to tell a real, durable moat from a temporary lead.

Here is a deep truth of capitalism: high profits are a magnet for competition. If a company earns wonderful returns, rivals will pour in to grab a share, driving prices and profits down — *unless* something protects it. That protective something is its moat, and a business without one, however profitable today, is living on borrowed time.

10.1 What a Moat Is — and Why It Matters Most

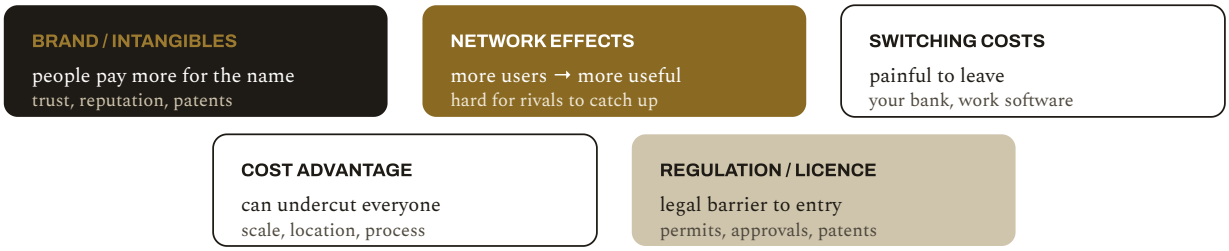
An **economic moat** is a durable competitive advantage that lets a business fend off rivals and keep earning high returns for many years. The name evokes a medieval castle: the castle is the profitable business; the moat is what stops attackers (competitors) from storming it. Why does this matter more than a single year's brilliant numbers? Because the whole point of fundamental analysis is to estimate *future* value, and future value depends entirely on whether today's profits can *last*. A company with a wide moat can compound owners' wealth for decades; one without a moat may see its lovely current

profits evaporate as soon as competition notices them. The greatest investors care less about "is it profitable now?" and more about "can it *stay* profitable, and for how long?"

10.2 The Types of Moat

Moats come in a handful of recognisable forms:

FIGURE 10.1 · THE FIVE KINDS OF MOAT



The test for all of them: what stops a well-funded rival from copying this and competing the profits away?

Five ways to keep competitors out. *A powerful* **brand** *commands loyalty and higher prices;* **network effects** *make a product better as more people use it (so newcomers can't compete);* **switching costs** *make leaving painful; a structural* **cost advantage** *lets a firm undercut everyone profitably; and* **regulation or patents** *raise legal walls. The best businesses often enjoy more than one.*

10.3 Spotting a Real Moat

How do you tell a genuine, durable moat from a fleeting lead? Look for two kinds of evidence. In the **numbers**: high returns on capital (Chapter 7) and fat, *stable* margins sustained over *many* years — if a company has kept earning great returns through good times and bad while competitors circled, something is clearly protecting it. In the **story**: ask the one decisive question — *"If I gave a smart, well-funded competitor a billion dollars, could they destroy this business?"* If the honest answer is "easily," there's no moat. If it's "not really — customers wouldn't switch / the network is too strong / they can't match

the cost," you've likely found one. Combine the quantitative evidence (durable high returns) with the qualitative test (resistance to a funded attacker), and you can judge a moat with real confidence.

DID YOU KNOW?

The greatest investors hunt for moats above all

The most celebrated long-term investors made the search for durable competitive advantage the centre of their entire approach, prizing a wide, lasting moat over almost any other quality — even being willing to pay a fair (not cheap) price for a truly moated business, rather than a cheap price for a fragile one. Their reasoning is simply the logic of this chapter: a moat is what allows a business to keep compounding for decades, and decades of compounding (Book 1) is where the real money is made.

WATCH OUT

A great product is not a moat

Beginners confuse a hot product, a clever idea, or rapid growth with a moat — but none of those, by itself, stops competitors. Brilliant products get copied; fast growth attracts a stampede of rivals. The question is never "is this impressive *now*?" but "what stops others from doing the same and competing the profits away?" Many a dazzling company with no real moat has watched its profits erode the moment competitors arrived. Demand a durable defence, not just a good year.

10.5 Moats, in Real Businesses

Abstract definitions of moats only become useful when you can identify them in real businesses you know. Four examples from companies the average reader has interacted with this week:

Coca-Cola — brand moat. Coca-Cola is mostly carbonated sugar water; the production cost is trivial. A competitor could match the formula in a week. So why has Coke earned 25%+ operating margins for a century? Because over 130 years the brand — the red can, the typography, the global ubiquity, the emotional association with celebration and refreshment — has been built into hundreds of millions of customers' habits. Pepsi has spent $50 billion trying to displace it and failed. The moat isn't the syrup;

it's the synapses in your head that fire when you see the logo. Warren Buffett bought 9% of Coke in 1988 for \$1.3 billion; that stake is worth \$25+ billion today and continues to pay him roughly \$700 million/year in dividends alone. The moat hasn't eroded in 35 years.

Costco — scale and culture moat. Costco's "moat" is something most people would not recognise as one: it sells groceries and household goods on the world's tightest margins (15% gross, vs 25-35% for typical grocers), pays its workers far more than competitors, and charges members \$60/year for the privilege of shopping there. The membership fee — roughly \$4 billion per year — is almost the entirety of operating profit. The merchandise pays for itself. The result: customers love it, employees stay, suppliers offer Costco better terms because of the predictable volume, and competitors (Sam's Club, BJ's) can't match the unit economics without sacrificing their own scale advantage elsewhere. Costco's stock has compounded at ~14% per year for thirty years on a business model that, on paper, looks unimpressive.

Visa — network effect moat. When you swipe a Visa card, four parties are involved: you, your bank, the merchant, and the merchant's bank. Visa earns roughly 0.15% of every transaction by sitting in the middle — not as a lender, not as a bank, but as the rail. Why can't a competitor build the same rail? Because the network is the moat. Visa is accepted at virtually every merchant in every country precisely because every consumer has a Visa card; consumers carry Visa cards precisely because every merchant takes them. A new entrant has to solve a chicken-and-egg problem so large that even American Express, JP Morgan, and PayPal have not displaced Visa in thirty years. Visa's gross margin: *97%*. It's the most profitable big business in the world that almost nobody thinks about.

ASML — technology moat. ASML, a Dutch company most consumers have never heard of, makes the only machines on Earth that can produce the most advanced semiconductors — the chips inside every modern phone, every AI accelerator, every advanced GPU. The machines cost roughly \$200 million each and take years to build. Competitors don't exist; the closest non-ASML technology is roughly a decade behind. The moat is twenty-plus years of cumulative scientific R&D, patent thickets, and tight relationships with TSMC, Samsung, and Intel. Without ASML, the modern semiconductor industry simply stops. ASML earns operating margins of 35% on \$30 billion of revenue, and the world's largest tech companies queue up to buy whatever ASML can produce.

The four moats — *brand*, *scale*, *network effect*, *technology* — map roughly onto the categories of Chapter 10.1. The point of seeing them in real businesses is not to memorise the examples; it is to learn to *look for moats* when you analyse any company. Most companies don't have one. The few that do are the ones worth owning at fair prices.

P5 The principle from Book 1: price and value are different. A moat is one of the few things that makes a business genuinely *more valuable* than its current earnings suggest — because the earnings will compound. Without a moat, today's high earnings get competed away.

KEY TAKEAWAYS

1. **High profits attract competition;** a moat is the durable advantage that protects them.
2. **Moats matter most** because future value depends on whether today's profits can *last*.
3. **Five main types:** brand/intangibles, network effects, switching costs, cost advantage, regulation/patents.
4. **Test a moat** by durable high returns plus the question: could a funded rival destroy this?

SELF-CHECK

1. What is an economic moat, and why does it matter more than this year's profit?
2. Name the five types of moat, with an example of each.
3. What two kinds of evidence reveal a real moat?
4. Why is a great product, on its own, not a moat?

CHAPTER ELEVEN

Management & Quality

When you buy a share, you're entrusting your money to the people running the company. Are they skilled stewards of capital, and are they honest and aligned with you? These questions don't fit neatly in a spreadsheet — but they can make or break your investment.

IN THIS CHAPTER YOU WILL LEARN

- What "capital allocation" is, and why it's a leader's most important job.
- How to judge whether management is honest and aligned with owners.
- How to read between the lines of an annual report.

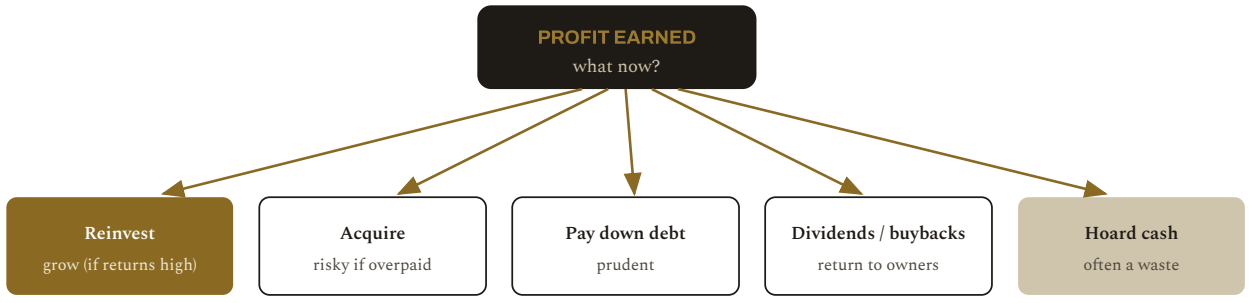
A wonderful business can be slowly wrecked by poor leaders, and a fair one elevated by great ones. As a part-owner, you're effectively hiring these people to look after your money — so it pays to size them up as you would any important hire: by their decisions, their honesty, and whether their interests line up with yours.

11.1 Capital Allocation — a Leader's Most Important Job

When a company earns a profit, its leaders face a defining decision: *what to do with the money?* This is **capital allocation**, and it's arguably management's single most important task. The choices are limited and revealing: **reinvest** it back into the business to grow (great, *if* the business earns high returns on that money — Chapter 7); **acquire** other companies (sometimes brilliant, often value-destroying if they overpay); **pay down debt** (prudent); **return it to owners** via dividends or share buybacks (sensible when there's no better use); or simply let cash pile up idly (often a waste). A great management team allocates capital like a skilled investor — putting each dollar where it earns the most — while a poor one

squanders it on empire-building or overpriced acquisitions. Over years, the quality of these decisions compounds enormously into the owners' returns.

FIGURE 11.1 · WHERE DOES THE PROFIT GO? — THE CAPITAL-ALLOCATION CHOICE



Five doors for every dollar of profit. *How management chooses among these — year after year — quietly determines much of your long-term return. Watch what they actually do with the cash: disciplined reinvestment and sensible returns to owners build wealth; serial overpriced acquisitions and idle hoarding destroy it.*

11.2 Honesty & Alignment

Skill isn't enough; you also want leaders who are **honest** and whose interests are **aligned** with yours as an owner. Honesty shows in how they communicate: do they admit mistakes plainly, or bury bad news in jargon and blame external factors? Do their past promises match later results? Alignment shows in their incentives: do the founders and executives own a meaningful stake themselves (so they win and lose alongside you), or are they mainly extracting large pay regardless of performance? You can learn a surprising amount from *tone* — candid, owner-minded leaders tend to write to shareholders as partners; evasive ones hide behind buzzwords. You're looking for people you'd trust to run your money even if you never checked on them.

11.3 Reading an Annual Report

The richest source for all of this is the company's **annual report** — and you don't have to read every page. Focus your attention: the **letter to shareholders** (does it speak candidly and like an owner, or in empty PR?); the **"risk factors"** section (the company's own legally-required confession of what could go wrong); the **capital-allocation track record** (what have they actually done with profits over the years?); and the consistency between **past statements and present results**. Read a few years of these and a clear picture emerges of whether management is candid and capable or slippery and self-serving. The qualitative checklist is simply this chapter's questions, asked deliberately: Is capital well allocated? Are they honest? Are they aligned with me? Can I trust them with my money?

> WATCH OUT
>
> ### Beware the empire-builder and the spin artist
>
> Two management types destroy more shareholder value than almost anything else. The **empire-builder** chases growth and acquisitions for the sake of running a bigger company — boosting their own prestige and pay while overpaying for deals that erode owners' returns. The **spin artist** relentlessly accentuates the positive, hides bad news, and invents flattering metrics to distract from poor real results. Both are visible if you read several years of reports and watch whether *actions and outcomes* match the *words*. Trust the track record, never the rhetoric.

KEY TAKEAWAYS

1. **Capital allocation** — what management does with profits — is their most important job and compounds into your returns.
2. **Seek honest, aligned leaders** who own a stake, admit mistakes, and communicate candidly.
3. **The annual report** (shareholder letter, risk factors, track record) is your main window into management quality.
4. **Trust the track record over the rhetoric;** beware empire-builders and spin artists.

SELF-CHECK

1. What is capital allocation, and what are the main choices a leader faces with profits?
2. Name two signs that management is honest and aligned with owners.
3. Which parts of an annual report reveal the most about management?
4. Describe the empire-builder and the spin artist, and how to spot them.

CHAPTER TWELVE

Growth, Industry & the Story

A business doesn't exist in a vacuum — it grows (or doesn't) within an industry, against rivals, on a tide of larger forces. This chapter zooms out to the company's world, and ends with a warning about the most seductive trap in all of investing: the story.

IN THIS CHAPTER YOU WILL LEARN

- Where genuine growth comes from — and which kinds are valuable.
- How to size up an industry and its competitive forces.
- How a compelling "story" can override good judgment — and how to resist it.

Numbers and moats describe a company today; growth and industry describe where it's heading. But this is also where analysis is most easily seduced — because the future is a story, and humans are suckers for a good one. We'll learn to weigh growth honestly, then guard against the narrative trap.

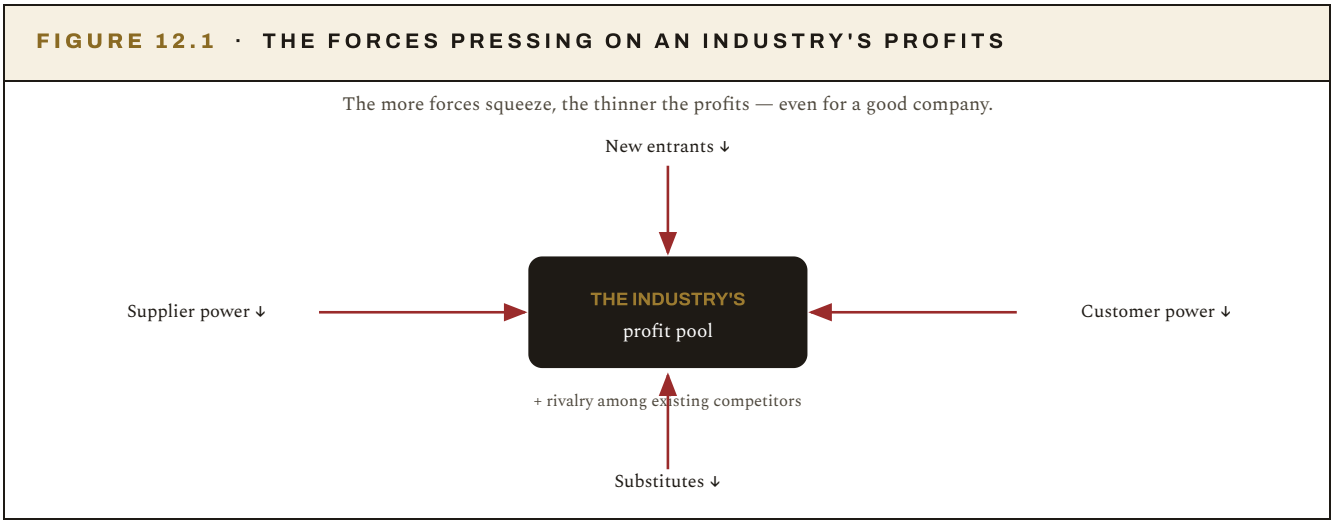
12.1 Where Growth Comes From

Growth is prized — but not all growth is equal, and it's worth knowing its sources. A company can grow by **selling more to existing markets**, by **raising prices** (a sign of pricing power and a moat), by **entering new markets or products**, or by **acquiring** other companies. The crucial question isn't just "is it growing?" but "is this growth *profitable* and *durable*?" Growth that earns high returns on the capital it consumes (Chapter 7) creates enormous value; growth that's bought by pouring in ever more money for thin or negative returns actually *destroys* value, even as revenue climbs. Beware especially growth fuelled by debt or constant acquisitions — it can flatter the headline numbers while quietly hollowing out the business. Profitable, organic, durable growth is the gold standard.

12.2 Sizing Up the Industry

A business is only as healthy as the industry it swims in, so step back and assess the competitive landscape. A useful way to think about an industry's attractiveness is to weigh the forces pressing on profits: **How fierce is rivalry** among existing competitors? **How easily can new competitors enter** (low barriers mean profits get competed away)? **How much power do customers have** to demand lower prices? **How much power do suppliers have** to raise their prices? And **are there substitutes** that could make the whole product obsolete? An industry where all these forces are intense — easy entry, fierce price wars, powerful customers — is a brutal place to make money, however good the individual company. An industry with high barriers and rational competition lets even ordinary companies prosper. Always ask not just "is this a good company?" but "is this a good *industry*, and is the company well-positioned within it?"

FIGURE 12.1 · THE FORCES PRESSING ON AN INDUSTRY'S PROFITS



Five squeezes on profit. *Rivalry, easy new entry, substitute products, and powerful customers or suppliers all press an industry's profits downward. A great moat (Chapter 10) is precisely what shields a company from these forces. Judge the arena, not just the gladiator.*

12.3 The Narrative Trap

Now the warning that ties Part IV together. Humans think in stories, and a compelling narrative — a visionary founder, a world-changing technology, a market "about to explode" — can be intoxicating enough to switch off our judgment entirely. The danger is that a great story makes us *assume* great future

numbers and ignore the boring evidence: the lack of profit, the absent moat, the brutal industry, the sky-high price. History is littered with thrilling stories attached to companies that never made a dollar — and with fortunes lost by investors who fell in love with the tale. The discipline is not to ignore stories (they point you to interesting businesses) but to *let the evidence decide*. Use the narrative to spark your interest, then demand that the moat, the numbers, the management and the price all justify it. If they don't, walk away — no matter how good the story sounds.

IN PLAIN TERMS

Why the best stories are the most dangerous

The more exciting and emotionally compelling a story, the *more* careful you should be — because excitement is precisely what overrides analysis and inflates prices. A genuinely great business with a dull story is often a far better investment than a mediocre one wrapped in a thrilling narrative, simply because the crowd's excitement has already pushed the exciting one's price too high. When you notice yourself feeling thrilled about an investment, treat that feeling as a cue to slow down and re-check the evidence, not to rush in.

KEY TAKEAWAYS

1. **Not all growth is equal:** profitable, organic, durable growth creates value; growth bought with thin returns or constant acquisitions can destroy it.
2. **Judge the industry,** weighing rivalry, new entrants, substitutes, and customer/supplier power.
3. **A moat shields a company** from these competitive forces.
4. **Beware the narrative trap:** let a story spark interest, but let the evidence — and the price — decide.

SELF-CHECK

1. Why isn't all growth valuable? What kind destroys value?
2. Name the forces that squeeze an industry's profits.
3. Why is a “good company” in a brutal industry still a hard place to make money?

4. What is the narrative trap, and how should you handle a compelling story?

V

PART FIVE

Putting a Number On It

You can now tell whether a business is good, safe and well-led. The final skill is the boldest: estimating what it's actually worth, so you know whether today's price is a bargain. We'll keep it honest — a sensible range, bought with a margin of safety, never false precision.

TIME VALUE & DCF | RELATIVE VALUATION | MARGIN OF SAFETY | THE CHECKLIST

CHAPTER THIRTEEN

The Time Value of Money & DCF

A business is ultimately worth the cash it will hand its owners over its lifetime. But a dollar arriving years from now is worth less than a dollar today — so to value a company, we must translate its future cash back into today's money. That idea is the bedrock of all valuation.

IN THIS CHAPTER YOU WILL LEARN

- Why a dollar today is worth more than a dollar tomorrow.
- What "discounting" means and why it's necessary.
- How discounted cash flow (DCF) values a business, in plain terms.
- Why DCF demands humility, not false precision.

Here is the deepest answer to "what is a business worth?": it is worth all the cash it will ever produce for its owners — adjusted for the fact that money in the future is worth less than money now. Grasp that single sentence and you understand the theoretical foundation beneath every valuation method, including the multiples of Chapter 9.

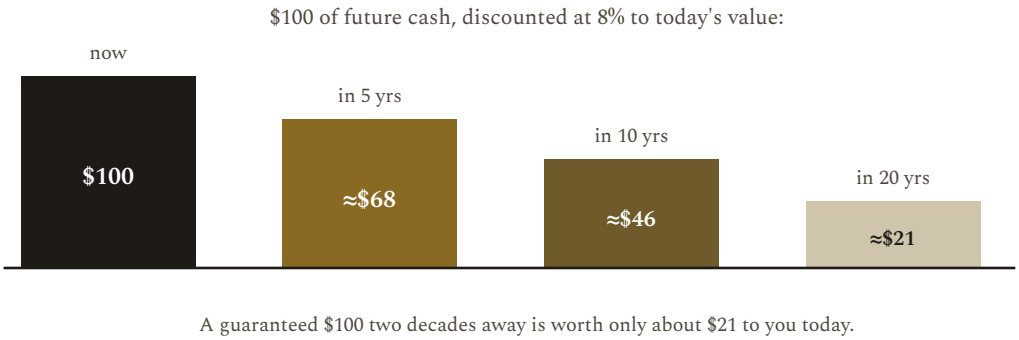
13.1 A Dollar Today vs. a Dollar Tomorrow

Would you rather have $100 today or $100 in five years? Obviously today — and not only out of impatience. The $100 today can be invested to grow; it isn't exposed to five years of uncertainty; and inflation (Book 1) will erode the future $100's purchasing power. So money has a **time value**: a sum in the future is worth *less* than the same sum now. The further away the future money, and the higher the available returns elsewhere, the less that future money is worth to you today. This isn't a trick of finance; it's simple common sense, made precise.

13.2 Discounting — Translating the Future Into Today

Because future money is worth less, to compare it fairly with today's money we shrink it down to its **present value** — a process called **discounting**. We apply a "discount rate" (reflecting the returns and risks involved): the higher the rate, the more we shrink distant cash. The effect is dramatic for money far in the future.

FIGURE 13.1 · WHY DISTANT MONEY IS WORTH LESS TODAY



Distance discounts value. *The same $100 is worth steadily less the further into the future it arrives. This is also why high interest rates hurt the valuations of growth companies most: their value lies in distant profits, which get discounted hardest. Discounting is the engine that turns a stream of future cash into one present number.*

13.3 Discounted Cash Flow, in Plain Terms

Put the pieces together and you get **discounted cash flow** (**DCF**), the textbook method for valuing a business. In plain terms, a DCF does three things: (**1**) estimate the cash the business will generate each year into the future; (**2**) discount each year's cash back to its present value; and (**3**) add them all up. That total is an estimate of the business's intrinsic value today. Divide by the number of shares and you get an estimated value per share — which you can then compare to the market price (Chapter 1). It is the most theoretically sound way to answer "what is it worth?", because it goes straight to the only thing that ultimately matters: the cash the business will actually produce for its owners.

Let's actually *do* one. Suppose a company is expected to produce **$100 million** of free cash flow next year, growing **8% a year** for five years, after which it settles into a steady **3% forever**. We'll discount at **10%**

(our required return). Here is the entire calculation laid bare:

FIGURE 13.2 · A DISCOUNTED CASH FLOW, WORKED IN FULL ($ MILLIONS)

YEAR	FREE CASH FLOW	DISCOUNT FACTOR @10%	PRESENT VALUE
Year 1	100.0	$1 \div 1.10 = 0.909$	90.9
Year 2	108.0	$1 \div 1.10^2 = 0.826$	89.2
Year 3	116.6	$1 \div 1.10^3 = 0.751$	87.6
Year 4	126.0	$1 \div 1.10^4 = 0.683$	86.1
Year 5	136.0	$1 \div 1.10^5 = 0.621$	84.5
Terminal value*	≈ 2,001	0.621	1,242.6

Every step, nothing hidden. *Each year's cash is shrunk to its present value by the discount factor, then all are summed. *The terminal value captures all cash beyond Year 5: $136m × 1.03 ÷ (0.10 − 0.03) = $2,001m, then discounted back. Notice how much of the total comes from the terminal value — a hallmark (and weakness) of DCF.*

WORKED CALCULATION · FROM CASH FLOWS TO A VALUE PER SHARE

```
Sum of Years 1–5 present values  = 90.9 + 89.2 + 87.6 + 86.1 + 84.5 ≈ $438 m
+ Present value of terminal value                                    ≈ $1,243 m
─────────────────────────────────────────────────────────────────────────────
Estimated business value ≈ $1,681 m
÷ shares outstanding (say 100 m)          →  ≈ $16.81 per share
```

*So our estimate of intrinsic value is ~$17/share. With a margin of safety (Ch 14) you might only buy below ~$12. **But change one assumption and watch it swing:** use a 12% discount rate instead of 10% and the value drops toward ~$12/share; assume 4% terminal growth instead of 3% and it*

```
jumps above ~$20. That sensitivity is exactly why a DCF gives a range,
never a precise truth.
```

13.4 The Danger of False Precision

Now the essential warning. A DCF *looks* rigorous — it produces a precise number like "$87.34 per share" — but that precision is an illusion, because the inputs are guesses about the future: how much cash, growing how fast, for how long, discounted at what rate. Change those assumptions slightly and the "precise" answer swings wildly. The great mistake beginners (and even professionals) make is to trust the exact output and forget the shaky inputs. The wise use of a DCF is the opposite: treat it as a way to *think clearly* about what a business must achieve to justify its price, and to produce a rough *range* of value — never a false-precision point estimate. As the saying goes, it's better to be roughly right than precisely wrong.

> **WATCH OUT**
>
> ### Garbage in, garbage out
>
> Because a DCF's answer depends entirely on its assumptions, it's dangerously easy to make a business look like whatever you want — just nudge the growth rate up a little and any price looks justified. In a bubble, this is exactly how investors talk themselves into absurd valuations: they plug in fantasy growth and point to the model as "proof." Always sanity-check a DCF against reality (is this growth plausible? has any company sustained it?) and against the simpler multiples of Chapter 9. A model is a tool for thinking, not a machine for manufacturing the answer you hoped for.

KEY TAKEAWAYS

1. **A business is worth the cash it will produce for owners** over its life, adjusted for the time value of money.
2. **Money has a time value:** future cash is worth less today, so we *discount* it to present value.
3. **A DCF** estimates, discounts and sums future cash to value a business — the most theoretically sound method.
4. **Beware false precision:** a DCF's output is only as good as its guesses — aim for a sensible range, "roughly right."

SELF-CHECK

1. Give two reasons a dollar today is worth more than a dollar in five years.
2. What does "discounting" do, and why is it necessary?
3. Describe the three steps of a DCF in plain words.
4. Why is a DCF's precise-looking answer potentially misleading?

CHAPTER FOURTEEN

Relative Valuation & Margin of Safety

In practice, most investors don't rely on a single DCF. They triangulate — using both the multiples of Chapter 9 and a rough DCF — to arrive at a sensible range of value, then insist on buying well below it. This is where the whole book comes together.

IN THIS CHAPTER YOU WILL LEARN

- How relative valuation (multiples) complements DCF.
- Why you should aim for a *range* of value, not a single number.
- How the margin of safety turns a value estimate into a buy decision.

Chapter 13 gave you the theory; this chapter gives you the practical, humble craft of actually putting a number on a business — and, crucially, of deciding when that number makes the price a buy.

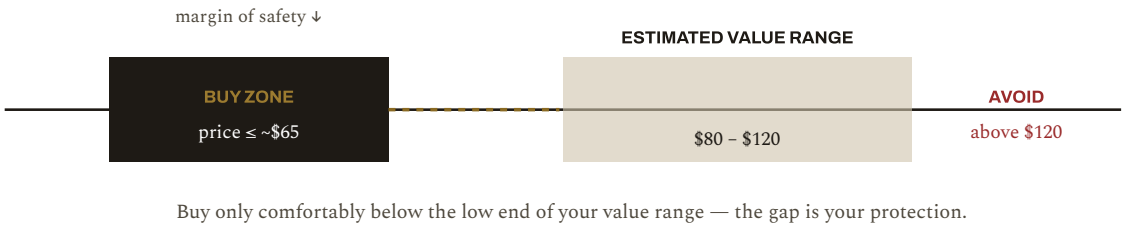
14.1 Two Roads to a Value: Multiples and DCF

There are two broad ways to estimate what a business is worth, and they work best together. **Relative valuation** uses the multiples of Chapter 9 — comparing the company's P/E, EV/EBITDA and so on to its peers and its own history, to judge whether it's priced reasonably *relative* to similar businesses. It's quick and grounded in real market prices, but it can be fooled if the whole peer group is over- or under-valued. **Intrinsic valuation** (the DCF of Chapter 13) works from the business's own cash flows, independent of what the crowd is paying — more fundamental, but more dependent on assumptions. Using both is like checking a measurement with two different instruments: when a quick multiple-based estimate and a rough DCF point to *similar* values, you can have far more confidence; when they wildly disagree, that's a signal to dig deeper.

14.2 Aim for a Range, Not a Point

Given how uncertain the future is, the honest output of valuation is never a single precise number — it's a **range**. Rather than "this business is worth exactly $100 a share," the realistic conclusion is "it's probably worth somewhere between $80 and $120, depending on how things play out." This isn't a weakness; it's intellectual honesty, and it's far more useful. A range tells you when a price is *clearly* attractive (well below the low end), *clearly* expensive (above the high end), or in the murky middle (where the sensible action is usually to do nothing and wait). Great investors are comfortable saying "I don't know exactly what it's worth, but I know this price is well below any reasonable estimate" — and that's all they need.

FIGURE 14.1 · VALUE AS A RANGE, BOUGHT WITH A MARGIN OF SAFETY



Buy only comfortably below the low end of your value range — the gap is your protection.

The whole book, in one picture. *Estimate a range of value, then buy only well below its low end — never at or above it. The cushion between your purchase price and your value estimate is the margin of safety: it rewards you if you're right and protects you if you're wrong.*

14.3 The Margin of Safety — Where It All Comes Together

And so we return to the idea that opened the book (Chapter 1), now fully earned. Because your value estimate is a range built on uncertain assumptions, you must never pay right up to it. Instead, you buy only when the market price sits **comfortably below the low end of your value range** — demanding a **margin of safety**. If you reckon a business is worth $80–$120, you might refuse to buy above $65. That gap is your protection against bad luck, bad assumptions, and your own errors — and it's the single most important discipline separating investing from speculation. Notice what this means: even with all the

analysis in this book, you will often conclude "it's a fine business, but not cheap enough — I'll wait." That patience, the willingness to do nothing until price offers value with a margin of safety, is the quiet heart of successful investing.

DID YOU KNOW?

The greatest investors say "no" far more than "yes"

A hallmark of the most successful investors is extreme selectivity: they analyse hundreds of businesses and buy very few, content to wait — sometimes for years — until a wonderful business is offered at a price with a real margin of safety. They treat investing less like a frantic activity and more like patient hunting, swinging only at the rare, fat pitch. For the rest of us, the lesson is liberating: you don't have to act often or be right about many things; you have to be patient and demand a margin of safety on the few decisions you do make.

KEY TAKEAWAYS

1. **Use both relative (multiples) and intrinsic (DCF) valuation;** agreement builds confidence, disagreement signals "dig deeper."
2. **Aim for a range of value, not a single number** — it's honest and more useful.
3. **Buy only well below the low end of your range** — the margin of safety protects you when you're wrong.
4. **Patience is the heart of it:** often the right answer is "good business, not cheap enough — wait."

SELF-CHECK

1. How do relative and intrinsic valuation complement each other?
2. Why is a range of value more honest (and useful) than a single number?
3. You value a business at $80–$120. With a margin of safety, roughly what price might you require?
4. Why do the best investors say "no" far more than "yes"?

CHAPTER FIFTEEN

Putting It All Together

Everything in this book now folds into a single, repeatable checklist for sizing up any business on Earth. Here it is, with a worked example, the mistakes to avoid, and — most importantly — permission to walk away.

IN THIS CHAPTER YOU WILL LEARN

- A complete fundamental-analysis checklist you can reuse forever.
- How it works on a simple, illustrative example.
- The most common analysis mistakes.
- When the wisest move is to walk away.

You've learned to read the philosophy, the statements, the ratios, the qualities and the valuation. Now we assemble them into one ordered process — a checklist that turns all this knowledge into a calm, repeatable habit.

15.1 The Complete Checklist

FIGURE 15.1 · THE FUNDAMENTAL-ANALYSIS CHECKLIST

1 · DO I UNDERSTAND IT?

Can I explain how it makes money? (circle of competence — Ch 2)

2 · IS IT A GOOD BUSINESS?

High, stable returns & margins (Ch 7); a durable moat (Ch 10)

3 · IS IT SAFE?

Manageable debt, strong cash flow, survives a bad year (Ch 5, 8)

4 · IS IT WELL RUN?

Honest, aligned managers who allocate capital well (Ch 11)

5 · IS THE PRICE RIGHT? — value range with a margin of safety (Ch 9, 13, 14)

Five questions, in order. *Understandable? Good? Safe? Well-run? Sensibly priced? A business must pass all five to be worth buying — and the order matters: there's no point valuing a business you don't understand, or one drowning in debt. This single checklist is the distilled essence of the whole book.*

15.2 A Worked Example

WORKED EXAMPLE · RUNNING THE CHECKLIST (ILLUSTRATIVE)

Let's run the checklist on a *real* business everyone knows — **The Coca-Cola Company** — using the approximate figures we computed through this book. *(This is a teaching exercise, not a recommendation; figures are rounded and change every year — always check current filings.)*

1) Do I understand it? Easily — it makes and sells beverage concentrate and branded drinks worldwide. A child could explain the business.

2) Is it a good business? Outstanding. Gross margin ~61%, net margin ~23% (Ch 3); ROCE ~20%, ROE ~39% (Ch 7) — and, crucially, these have been high and *stable for decades*. That durability points to a powerful **brand moat** (Ch 10): people the world over reach for the name and will pay a premium for it.

3) Is it safe? Reasonably — it carries meaningful debt (~$43 B), but interest coverage is comfortably high and operating cash flow is huge and reliable, easily covering interest, dividends and reinvestment. It would sail through a bad year (Ch 8).

4) Is it well run? Generally regarded as a disciplined capital allocator — modest reinvestment needs (a mature business), steadily rising dividends and buybacks returning cash to owners, rather than reckless empire-building (Ch 11). Its ~80% payout ratio fits a cash-rich, slow-growth giant.

5) Is the price right? Here is the catch. At a P/E of ~25, P/B ~10 and EV/EBITDA ~19 (Ch 9), and on a rough DCF, the market is already paying a full price for this quality — a value range of, say, $50–$65 against a market price around $60 leaves *little or no margin of safety*. **Verdict:** a genuinely wonderful business that passes checks 1–4 with flying colours — but quality alone doesn't make it a buy. Without a clear discount to value (Ch 14), the disciplined move is to admire it, add it to a watch-list, and *wait* for the market's mood (Ch 1) to offer it cheaper. A great company is only a great *investment* at the right price.

15.3 Common Mistakes

COMPARE & UNDERSTAND · THE ANALYST'S TRAPS — AND THE FIX

THE MISTAKE	THE FIX
Falling for the story, ignoring the numbers	Let evidence decide; the story only sparks interest (Ch 12)
Judging by one year, or one ratio	Look at multi-year trends and several ratios together
Ignoring debt because growth looks great	Stress-test for a bad year (Ch 8)
Trusting a precise DCF number	Aim for a range; sanity-check the assumptions (Ch 13)
Buying a great business at any price	Demand a margin of safety (Ch 14)
Analysing what you don't understand	Stay in your circle of competence (Ch 2)

15.4 When to Walk Away

Perhaps the most valuable skill of all is knowing when *not* to invest — and it's a skill the whole checklist is designed to support. Walk away when you can't understand the business; when the numbers don't reconcile or the accounts are confusing (Chapter 6); when debt is dangerous; when there's no durable moat; when management seems dishonest or self-serving; or — even after everything checks out — when the price simply offers no margin of safety. Saying "no," or "not yet," is not a failure of analysis; it *is* analysis, and good analysis at that. Remember: you don't have to swing at every pitch. The discipline to walk away from all but the clearest opportunities is what keeps you safe and, paradoxically, is what makes the rare "yes" so rewarding. With this checklist and that discipline, you're now equipped to read any business in the world like an owner.

Understand it. Make sure it's good, safe and well-run. Then — and only then — buy it cheaply, with a margin of safety. That is the whole of fundamental analysis.

KEY TAKEAWAYS

1. **The checklist:** understandable? good? safe? well-run? sensibly priced? — in that order.
2. **Passing the quality checks makes a business a candidate;** only a fair price with a margin of safety makes it a buy.
3. **Avoid the classic traps:** the story, single-year/single-ratio thinking, ignoring debt, false DCF precision, over-paying.
4. **Knowing when to walk away is itself a skill** — you don't have to swing at every pitch.

SELF-CHECK

1. List the five checklist questions in order, and say why the order matters.

2. In the worked example, why was a wonderful business still *not* a buy at $96?

3. Name three common analysis mistakes and their fixes.

4. Give four good reasons to walk away from an investment.

APPENDIX A

A Real Company, Fully Worked

Everything in this book, applied to one real, public company using its actual reported numbers — Apple Inc., fiscal year 2023, straight from its official filing with the U.S. Securities and Exchange Commission. This is what the whole method looks like in the real world.

All figures below come from Apple's **Form 10-K for the fiscal year ended 30 September 2023**, filed with the SEC (source linked in the back matter). The numbers are facts on the public record; the analysis is ours. This is a teaching exercise, **not** a recommendation to buy or sell — and figures change every year, so always pull the latest filing yourself (the appendix shows you exactly how).

A.1 The Real Income Statement

Here is Apple's actual income statement, lightly simplified, for fiscal 2023 — with the two prior years so you can see the *trend* (Chapter 3):

APPLE INC. · INCOME STATEMENT ($ MILLIONS) · SOURCE: FY2023 FORM 10-K (SEC)

LINE	FY2023	FY2022	FY2021
Net sales (revenue)	383,285	394,328	365,817
Cost of sales	(214,137)	(223,546)	(212,981)
Gross margin	169,148	170,782	152,836
Operating expenses (R&D + SG&A)	(54,847)	(51,345)	(43,887)
Operating income	114,301	119,437	108,949
Net income	96,995	99,803	94,680
Diluted earnings per share	$6.13	$6.11	$5.61

WORKED CALCULATION · MARGINS, FROM APPLE'S REAL FY2023 FIGURES

```
Gross margin     = 169,148 ÷ 383,285 = 44.1%
Operating margin = 114,301 ÷ 383,285 = 29.8%
Net margin       =  96,995 ÷ 383,285 = 25.3%
```

Read it (Ch 3, 7): a ~44% gross and ~25% net margin, sustained for years, is the fingerprint of huge pricing power — a brand-and-ecosystem moat (Ch 10). Note revenue actually dipped from FY2022 to FY2023 (394.3 → 383.3) while profit stayed enormous — a mature giant, not a fast grower.

A.2 The Real Balance Sheet

And here is Apple's actual balance sheet at 30 September 2023 (simplified to the essentials — Chapter 4). Notice it obeys the equation exactly:

APPLE INC. · BALANCE SHEET AT 30 SEP 2023 ($ MILLIONS) · SOURCE: FY2023 FORM 10-K (SEC)

	AMOUNT	NOTES
Total current assets	143,566	incl. cash & equivalents of 29,965
Total non-current assets	209,017	incl. long-term investments, property, plant & equipment
Total assets	**352,583**	everything Apple owns
Total current liabilities	145,308	incl. short-term debt & payables
Total non-current liabilities	145,129	incl. long-term debt of 95,281
Total liabilities	**290,437**	everything Apple owes
Shareholders' equity	**62,146**	the owners' slice

CHECK · THE BALANCE-SHEET EQUATION HOLDS (CH 4)

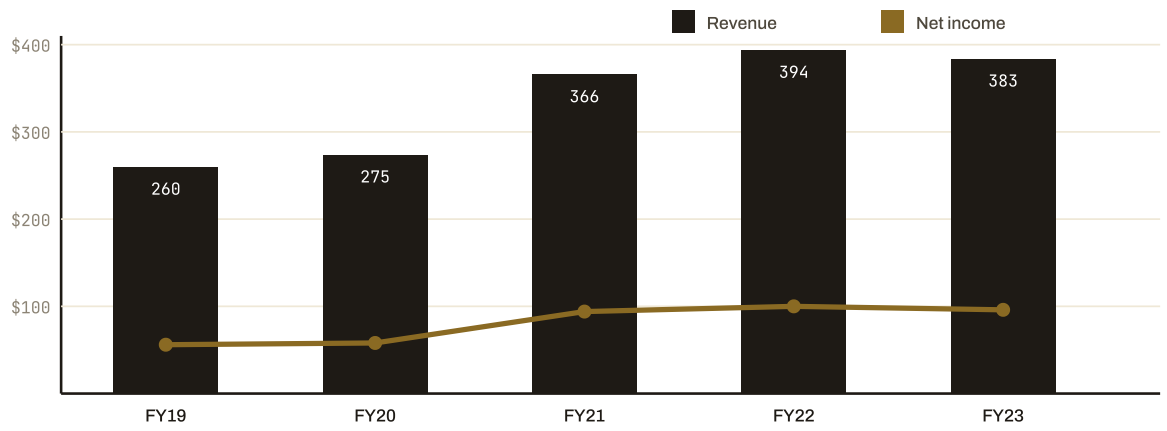
```
Liabilities + Equity = 290,437 + 62,146 = 352,583 = Total assets  ✓
```

*Total debt (term debt 105,103 + commercial paper 5,985) ≈ **111,088**.*
Striking: Apple owes more in debt alone than its entire $62 bn book

*equity — debt-to-equity ≈ 111,088 ÷ 62,146 ≈ **1.8**. Why so little equity for such a giant? Because Apple has spent hundreds of billions buying back its own shares, which shrinks book equity (Ch 11). Hold that thought — it explains the astonishing ROE below.*

A.3 Five Years, in a Picture

FIGURE A.1 · APPLE — REVENUE & NET INCOME, FY2019–FY2023 ($ BILLIONS, ACTUAL)



Real data, real story. *Explosive growth in FY2021 (the pandemic device boom), a peak in FY2022, then a slight dip in FY2023 — with net income holding near $97–100 bn throughout. Net income runs around a quarter of revenue every year: the steady, fat margin of a moated business. (Figures: Apple FY2019–FY2023, from SEC filings / company data.)*

A.4 The Real Ratios — and a DuPont Surprise

Now run the profitability ratios (Chapter 7) on the actual numbers:

WORKED CALCULATION · APPLE'S REAL RETURNS (FY2023)

```
ROE = Net income ÷ Equity    = 96,995 ÷ 62,146  = 156%  (!)
ROA = Net income ÷ Assets    = 96,995 ÷ 352,583 = 27.5%
```

A 156% ROE looks impossible — does Apple earn $1.56 of profit per $1 of equity? DuPont decomposition reveals why:

```
ROE = Net margin × Asset turnover × Equity multiplier
      = (96,995÷383,285) × (383,285÷352,583) × (352,583÷62,146)
      = 0.253 × 1.09 × 5.67
      ≈ 1.56 = 156%  ✓
```

*The lesson (Ch 7): Apple's ROE isn't 156% because it's six times more profitable than a great business. Its net margin (25%) and asset use (turnover ~1.1) are excellent but normal-great. The rocket fuel is the **equity multiplier of 5.7** — the result of years of huge buybacks shrinking book equity. This is exactly why we warned that a dazzling ROE can be manufactured by a small equity base, and why ROA (27.5%) and operating returns give a more grounded read. Real data, real lesson.*

A.5 Putting a Price On It

Finally, valuation (Chapter 9). With around **15.8 billion** diluted shares and a share price of roughly **$190** (as at late 2023 — share prices move daily, so treat this as a snapshot):

WORKED CALCULATION · APPLE'S REAL VALUATION (SNAPSHOT)

```
Market capitalisation = $190 × 15.8 bn  ≈ $3.0 trillion
P/E = Price ÷ EPS = 190 ÷ 6.13      ≈ 31×
Net margin 25.3% · ROA 27.5% · Debt/equity ≈ 1.8
```

Verdict (Ch 14–15): a magnificent business — fortress brand, 25% margins, gushing cash — but at a P/E of ~31 on a giant whose revenue is barely growing, the market is paying a premium price for quality and durability, leaving little obvious margin of safety. A textbook case of "wonderful

company, full price.” Whether that's a buy depends entirely on the price you can get it at, and your own estimate of its future — which is the whole point of this book.

Now do it yourself — for free

Everything above came from public sources you can use this minute, for nothing: search **SEC EDGAR** for any U.S. company's 10-K, read its three statements, and run this exact checklist. The data is free; the skill is yours now. Pick a company you understand and try it — that single act of practice will teach you more than re-reading any chapter. (Direct links in the back matter.)

APPENDIX B

Going Further — Advanced Topics

This book gives you a complete working method. To go from competent to professional, here are the deeper topics worth studying next — introduced plainly, so you know what each is and why it matters.

Honesty matters: no single book makes you a master, and this one doesn't claim to. What follows is a map of the more advanced terrain — the tools serious analysts add on top of everything you've learned. Each deserves its own deep study; this is your orientation.

B.1 DuPont Analysis

You met this in the Apple appendix: **DuPont** breaks ROE into three drivers — *net margin × asset turnover × equity multiplier* — to reveal *why* returns are high or low. Is a great ROE driven by fat margins (pricing power), efficient asset use (a lean operation), or just heavy leverage (risky)? Decomposing it tells you which, and a leverage-driven ROE is far more fragile than a margin-driven one. It's the first advanced tool every analyst learns, and it costs nothing but arithmetic.

B.2 Working Capital & the Cash Conversion Cycle

Beyond profit lies the question of how efficiently a business turns activity into *cash*. **Working capital** (current assets minus current liabilities) and the **cash conversion cycle** (how many days cash is tied up in inventory and unpaid customer bills, less the time the company takes to pay its own suppliers) reveal operational quality the income statement hides. The best businesses collect cash *before* they pay it out — a negative cycle that funds growth for free; weak ones bleed cash into bloated inventory and slow-paying customers (a classic early warning, Chapter 6).

B.3 The Cost of Capital (WACC)

In our DCF (Chapter 13) we simply *assumed* a 10% discount rate. Professionals derive it: the **weighted average cost of capital** (**WACC**) blends the return shareholders demand (cost of equity) and the after-tax cost of the company's debt, weighted by how much of each it uses. It's the hurdle rate a business must beat to create value, and the engine of any serious DCF. Estimating it well — especially the cost of equity — is part art, which is yet another reason valuations are ranges, not points.

B.4 Other Valuation Models

DCF and multiples are the workhorses, but the toolkit is larger. The **dividend discount model** values a stock purely on its future dividends (useful for stable payers). **Residual income** models value the profit earned *above* the cost of capital. **Sum-of-the-parts** values a conglomerate by valuing each division separately. A **reverse DCF** flips the logic — instead of computing value, it asks "what growth must the current price already assume?", a brilliant reality-check on whether the market's expectations are sane. Each suits particular situations; mastering several lets you triangulate (Chapter 14) with more confidence.

B.5 Reading the Footnotes & the MD&A

The three statements are only the headline; the real story often hides in the **footnotes** and the management discussion (the "MD&A") of an annual report. There you find how revenue is really recognised, the details of debt and lease obligations, pension and stock-based-compensation costs, legal risks, segment-by-segment performance, and any aggressive accounting choices. Analysts who skip the notes miss exactly the things that later blow up. Learning to read them — patiently, with skepticism — is what separates surface analysis from genuine understanding.

B.6 Industry-Specific Analysis

Finally, the biggest caveat to this entire book: **different industries must be analysed differently.** A bank's "revenue" and balance sheet mean something completely different from a software firm's — for banks you study net interest margin, loan quality and capital ratios, not gross margin. Insurers, REITs, miners, airlines, utilities and tech companies each have their own key metrics, accounting quirks and risks. The universal method in this book — understand it, judge quality and safety, value it, demand a margin of safety — always applies; but the *specific* ratios and red flags you focus on must be tailored to the industry. Learning those industry playbooks is the natural next step after this volume.

An honest closing word on "completeness"

No book — this one included — contains everything about fundamental analysis, and you shouldn't trust one that claims to. What this volume *does* give you is a complete, repeatable *method*, the math to apply it, a real worked example, and a map of where to go deeper. The fastest way to truly learn is now in your hands: open a real company's filing (back matter), run the checklist, and keep studying the advanced topics above. Reading teaches the method; *practice* on real companies makes you good.

APPENDIX · CASES

More Worked Companies — Four Real Cases

Apple was the worked example in Appendix A. Here are four more — each chosen to illustrate a different fundamental-analysis lesson. The cases are real, the numbers come from public filings (10-K / 10-Q / equivalent), and the charts are real long-history prices through 2026.

IN THIS APPENDIX YOU WILL WORK THROUGH

- **Microsoft** (**MSFT**) — the mature compounder: how a great moat and competent capital allocation produce decades of steady value creation.
- **Berkshire Hathaway** (**BRK-B**) — the holding company / insurance-float framework: how to value a business that *owns* businesses.
- **General Electric** (**GE**) — the value trap: how a "blue chip" can destroy two decades of investor capital.
- **NVIDIA** (**NVDA**) — the growth story: when extraordinary revenue growth justifies extraordinary multiples — and when it doesn't.

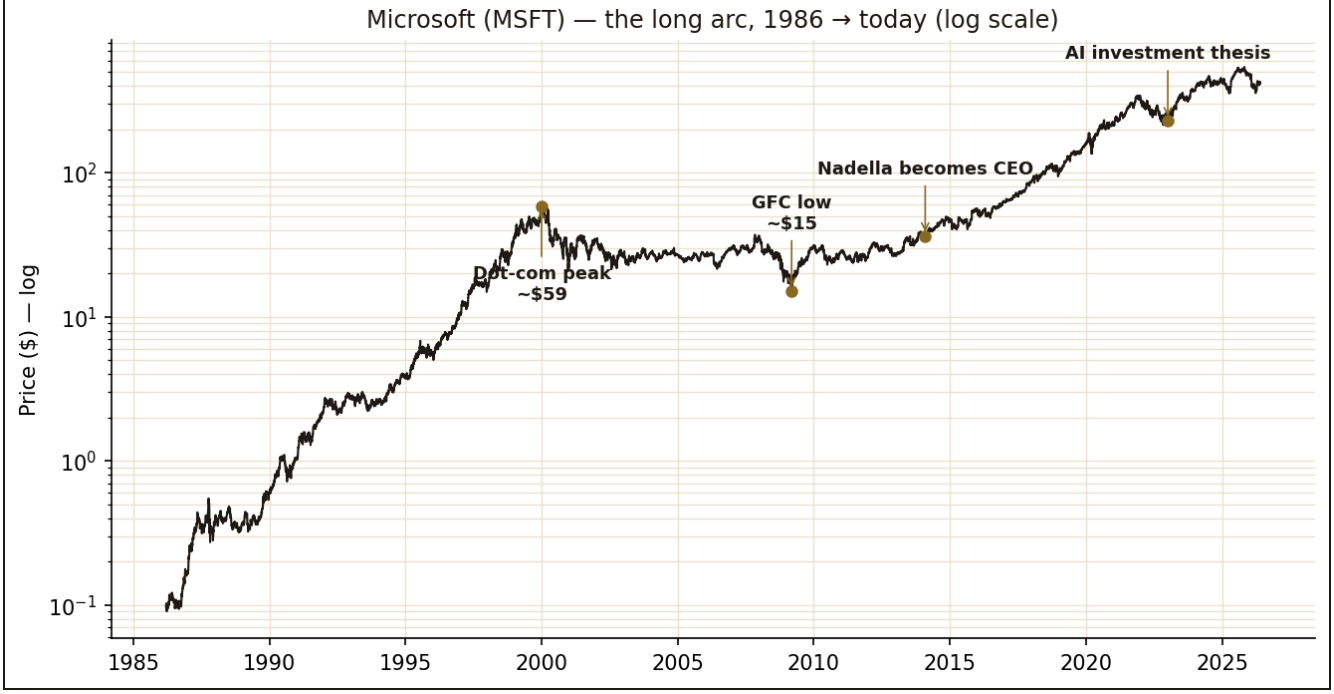
Reading these four cases against the toolkit of Chapters 1–15 is the best way to internalise the difference between *knowing* fundamental analysis and being able to *do* it. Each case ends with a one-line "what this teaches" so you can return to the lesson without re-reading the case.

CASE C

Microsoft — the Mature Compounder

For two decades after the dot-com peak, Microsoft was the cautionary tale of "great business, dead stock." Then, over the next decade, it became the textbook of how a mature business with a wide moat compounds shareholder value when capital is allocated well. The chart tells half the story; the financials tell the rest.

FIGURE C.1 · MICROSOFT — THE LONG ARC, 1986 → TODAY



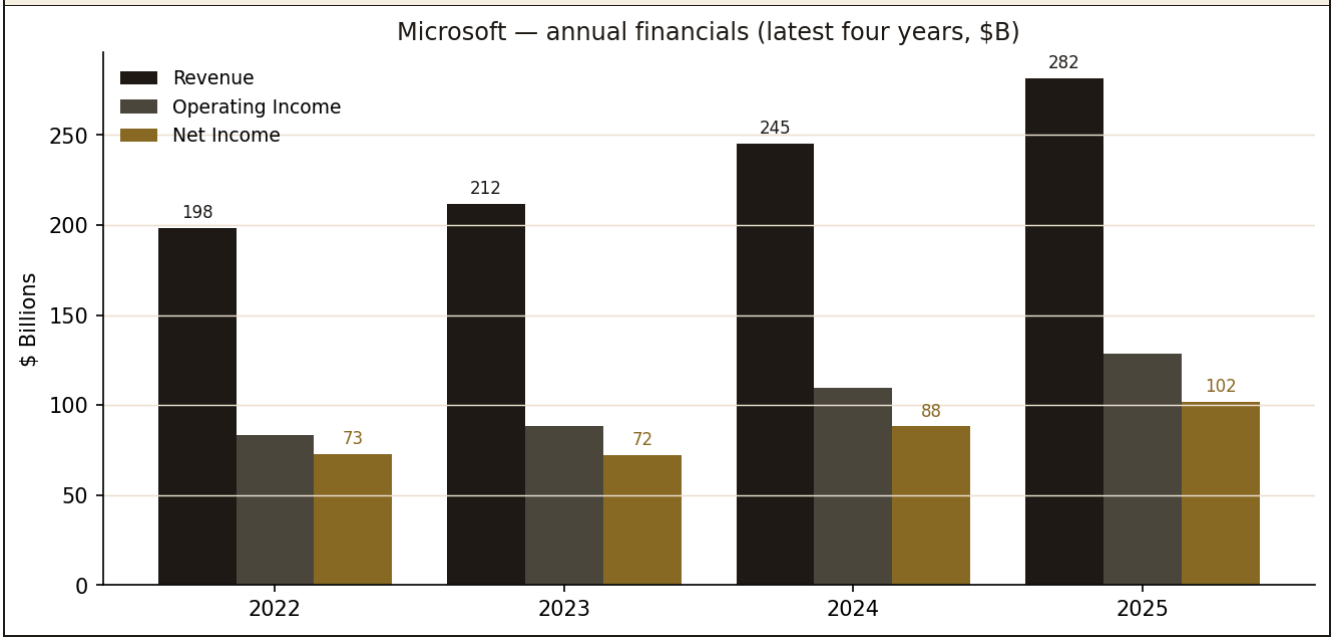
Forty years of Microsoft. *Real MSFT data on a log scale. Note the 1999 peak near $59 and the fourteen-year wait to break it. The Nadella inflection in early 2014 starts the second up-leg; the AI investment thesis from late 2022 powers the third.*

C.1 The Business

Microsoft is roughly three businesses fused together: **Productivity & Business Processes** (Office, Teams, LinkedIn, Dynamics), **Intelligent Cloud** (Azure, server software, services), and **More Personal Computing** (Windows, devices, gaming). The 2014 strategic shift to "cloud-first, mobile-first" — credited to incoming CEO Satya Nadella — re-oriented the company toward subscription revenue (Office 365) and cloud infrastructure (Azure), where the unit economics are dramatically better than the boxed-software business of the 1990s.

C.2 The Numbers

FIGURE C.2 · MICROSOFT ANNUAL FINANCIALS, LATEST FOUR YEARS



Operating leverage at scale. *Revenue grew from $198 B (FY 2022) to $282 B (FY 2025), about 12% per year. Operating income grew faster (operating leverage); net income grew from $73 B to $102 B. Profitability margins are extraordinary for a business at this scale.*

Pulling the FY 2025 numbers into the framework of Chapters 7–9:

WORKED CALCULATION · MICROSOFT FY 2025 (YEAR ENDED 30 JUN 2025)

```
Revenue: $281.7 B
Operating Income: $128.5 B → operating margin = 45.6%
Net Income: $101.8 B → net margin = 36.1%
```

```
Shares outstanding (diluted): ~7.5 B
EPS = 101.8 / 7.5 = ~$13.6
```

```
Stock price (late 2026): roughly $410
P/E = 410 / 13.6 = ~30x
```

A 30x P/E for a business compounding earnings at ~15% with 45% operating margins and a wide moat is, by historical standards, expensive but not unreasonable. The "fair" multiple depends on assumptions about growth duration (the DuPont sensitivity exercise of Chapter 7 applies).

C.3 The Moat

Using the moat taxonomy of Chapter 10:

- **Switching costs** (**very high**) — enterprises do not casually migrate off Office, Active Directory, or Azure once embedded. The cost is dozens of person-years of integration work, retraining, and risk.
- **Network effects** (**high in some segments**) — Teams, LinkedIn, GitHub all benefit from network effects. Each additional user makes the platform more valuable to the others.
- **Scale economies** (**very high**) — Azure's per-unit cost of compute falls with scale; competitors at smaller scale cannot match the unit economics.
- **Brand / intangibles** (**high**) — "no one ever got fired for buying Microsoft" remains operative in enterprise procurement.

Microsoft scores high on three of the four classic moat sources, which is exceptional. The moat is also *widening* with cloud and AI investment, not eroding — a critical distinction from a static moat.

C.4 Capital Allocation

Microsoft generates roughly $90+ billion of free cash flow per year. What it does with that cash determines whether shareholders compound their capital alongside the business, or watch it evaporate. The FY 2025 split, approximately:

- **Capex** (~**$50 B**) — almost entirely on AI compute and Azure infrastructure. This is the bet that AI demand sustains.
- **Dividends** (~**$22 B**) — yield of about 0.7%; a modest but growing payout.
- **Buybacks** (~**$18 B**) — reducing share count, which mechanically lifts EPS.
- **M&A** — large but episodic (LinkedIn 2016, GitHub 2018, Activision 2023).

The capex-heavy allocation in 2025 represents a real shift: Microsoft is investing in the next leg rather than returning all cash to shareholders. Whether this earns its cost of capital is the question the next five years will answer.

C.5 A Quick DCF

Applying the DCF framework of Chapter 13 to a simplified Microsoft model:

WORKED CALCULATION · MICROSOFT DCF (ILLUSTRATIVE)

```
Year 0 FCF: ~$90 B
Growth Years 1–5: 12% p.a.
Growth Years 6–10: 8% p.a.
Terminal growth: 3% p.a.
Discount rate (WACC): 9%
```

```
PV of explicit cash flows (10 years): ~$1.05 trillion
Terminal value: $90 × (1.12)^5 × (1.08)^5 × 1.03 ÷ (0.09 - 0.03)
    = 90 × 1.762 × 1.469 × 1.03 ÷ 0.06 ≈ $4.0 trillion (undiscounted)
PV of terminal value = 4.0T ÷ (1.09)^10 ≈ $1.69 trillion
```

```
Total intrinsic equity value ≈ $1.05T + $1.69T = ~$2.74 trillion
Per share (÷ 7.5 B shares) = ~$365
```

Compared with a market price of ~$410 in late 2026, this simplified model suggests Microsoft is trading at about a 10–15% premium to a 9%-WACC DCF. The price implies the market is using a lower discount rate (closer to 7.5–8%) or higher growth assumptions. Both can be argued; neither is unreasonable.

C.6 What This Case Teaches

Microsoft is the textbook example of **moat plus capital allocation**. The business has been excellent for decades — but the stock was dead from 2000 to 2014 because (a) the entry multiple at the 2000 peak was absurd (P/E in the 70s), and (b) the cash was returned through buybacks rather than reinvested in genuinely new growth areas. From 2014 onwards, the moat held, the capital was deployed into cloud and (later) AI, and the result was a decade of 20%+ annualised stock returns. **The lesson:** a wide moat is necessary but not sufficient; the business must also have *somewhere productive to deploy capital*, and the entry valuation must be reasonable. Microsoft at the 2000 peak failed test 2 (no new growth deployment) and test 3 (absurd valuation); Microsoft from 2014 passed all three.

KEY TAKEAWAYS · MICROSOFT

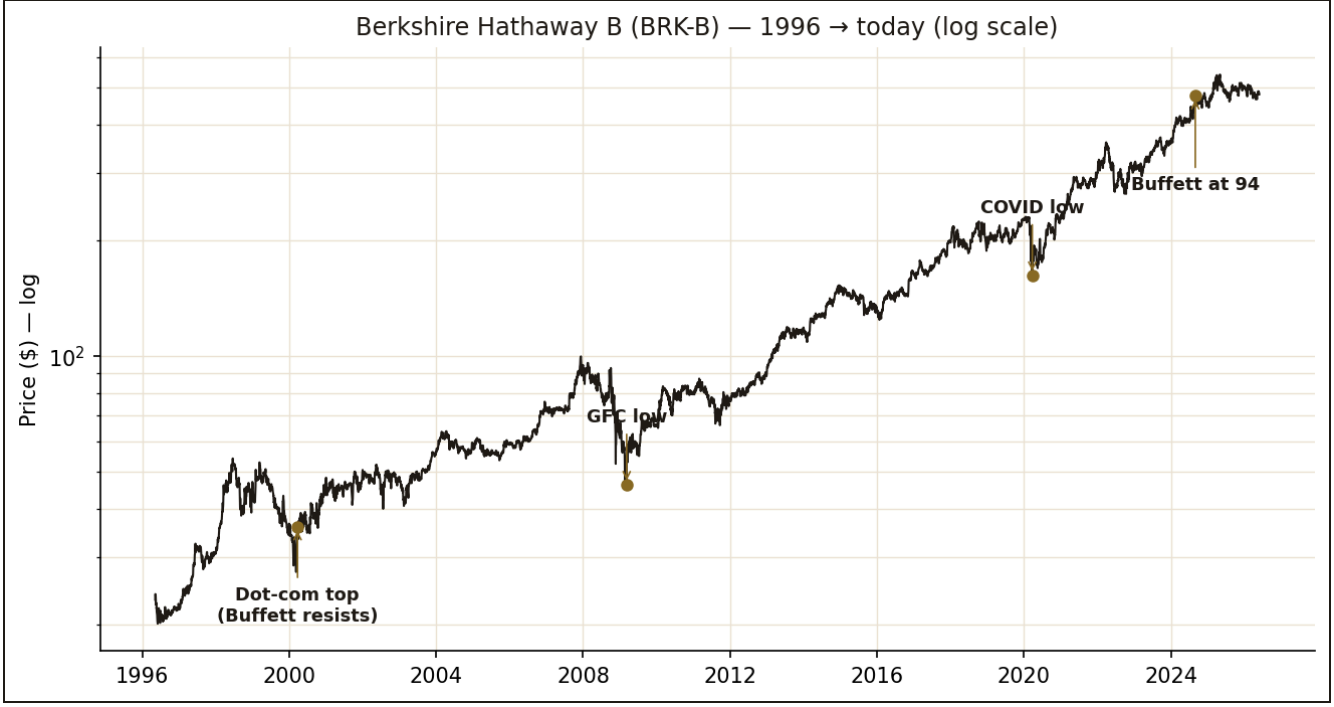
1. **A great business with a 70x P/E is a bad investment.** The 2000 buyer waited 14 years to break even.
2. **Capital allocation is the second moat.** The Nadella-era cloud and AI investments turned slow into fast.
3. **Three high-rated moat sources** (switching costs, network effects, scale economies) plus competent management is the textbook combination.
4. **The current 30x P/E** requires AI capex to earn its cost of capital. That is the falsifiable thesis of the next five years.

CASE D

Berkshire Hathaway — the Holding Company

A textile mill that became an insurance company that became one of the largest holding companies on Earth, run by an unusual investor who held it for sixty years. Berkshire is the rare case where the management was the moat, and where standard valuation frameworks need real adjustment.

FIGURE D.1 · BERKSHIRE B-SHARES, 1996 → TODAY (LOG SCALE)



The compounder. *Real BRK-B data from the 1996 introduction of the B-shares through 2026. Note the relative shallowness of the dot-com drawdown and the 2009 GFC recovery; Berkshire's diversification and cash-rich balance sheet meant it gave up less in crashes than its peers.*

D.1 The Three Parts of Berkshire

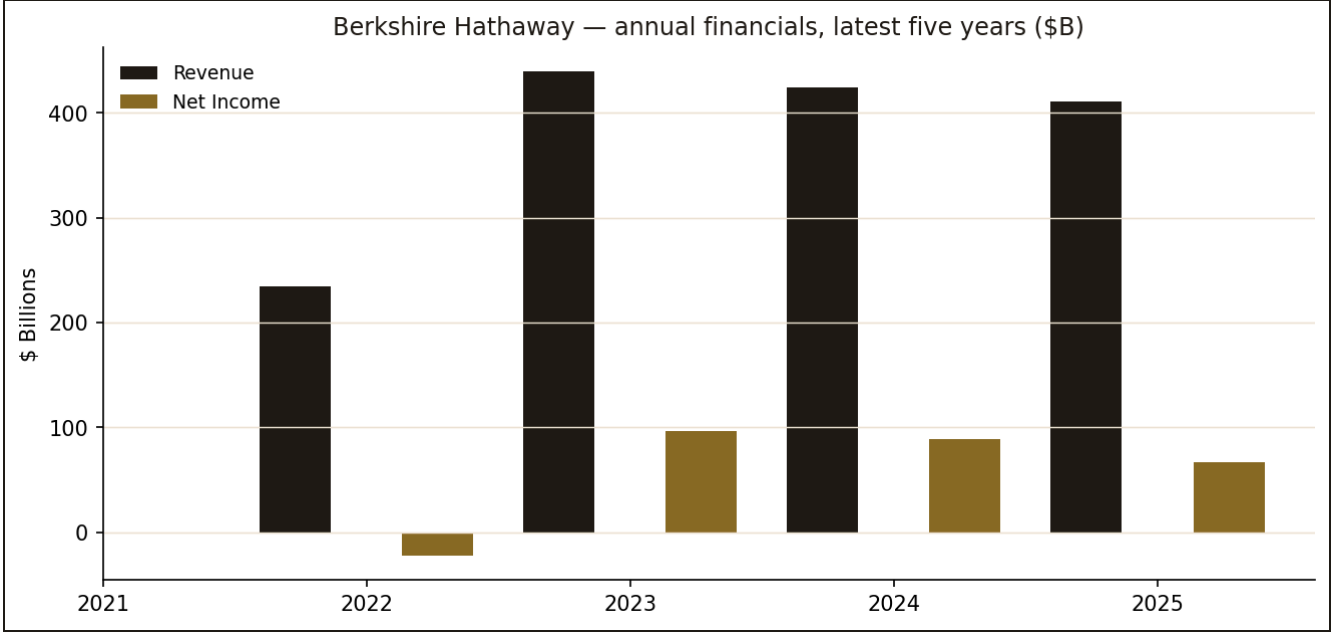
Berkshire is not one business; it's three layered on top of each other:

1. **The insurance group** (GEICO, Berkshire Hathaway Reinsurance, primary insurance) — this generates *float*, the money policyholders have paid in but Berkshire hasn't yet paid out as claims. As of 2025 this float is roughly $170 billion. Float is, in effect, an interest-free loan from the insured to Berkshire, available to invest.
2. **The wholly-owned non-insurance operating businesses** — BNSF Railway, Berkshire Hathaway Energy, Precision Castparts, See's Candies, Dairy Queen, dozens more. These together produce roughly $30+ billion of pre-tax operating earnings per year.
3. **The equity investment portfolio** — stakes in Apple, Bank of America, American Express, Coca-Cola, Chevron, Occidental, dozens more. Worth roughly $300+ billion at market.

Valuing Berkshire requires summing all three plus the cash pile (roughly $150–200 billion at end-2025) — the classic "sum of the parts" approach to a conglomerate.

D.2 The Numbers

FIGURE D.2 · BERKSHIRE — ANNUAL FINANCIALS (LATEST FIVE YEARS, $B)



Revenue volatility hides the structural truth. *Net income swings dramatically year-to-year because GAAP requires Berkshire to mark its equity portfolio to market each quarter. The underlying operating earnings (cash from the operating businesses, plus interest and dividends from the portfolio) are far steadier than the headline net income suggests.*

Buffett himself argues that GAAP net income for Berkshire is largely meaningless — it mostly reflects unrealised gains and losses on the equity portfolio. The meaningful metric is **operating earnings** (which strips out portfolio marks):

WORKED CALCULATION · BERKSHIRE 2024 (LATEST FULL-YEAR OPERATING EARNINGS)

```
Insurance underwriting: $11.2 B
Insurance investment income: $13.7 B
Railroad (BNSF): $5.0 B
Utilities (BHE): $3.7 B
Other operating businesses: ~$13 B
Other & adjustments: ~$1 B
```

Operating earnings ≈ **$47.6 B**

This is the "real" earnings power of Berkshire's wholly-owned businesses. It excludes the portfolio's unrealised gains/losses (which add volatility but not steady-state earnings power). It also excludes dividends received on the public-equity portfolio, which add roughly $5-6 B more.

D.3 Sum-of-the-Parts Valuation

Applying the holding-company SOTP approach:

WORKED CALCULATION · BERKSHIRE SUM-OF-THE-PARTS (ILLUSTRATIVE, LATE 2026)

Equity investment portfolio (market value): ~$310 B
Cash & short-term Treasuries: ~$190 B
Operating businesses (15x $48B ops): ~$720 B
Insurance float (counted as zero-cost): not added (already in book)

Gross asset value: ~$1.22 trillion
Less: minority interests, deferred tax, etc.: ~$50 B

Estimated intrinsic equity value: ~$1.17 trillion
Per B-share (÷ ~2.16 B B-equivalent shares): ~$540

Compared with a BRK-B market price of ~$480 in late 2026, this rough SOTP suggests Berkshire is trading at about a 11% discount to intrinsic — historically, that's a reasonable entry point. The result is highly sensitive to the multiple applied to operating earnings (we used 15x; a bull would argue 18x, a bear 12x).

D.4 The Buffett Effect — and What Comes Next

For 60 years, the implicit assumption baked into Berkshire's valuation was Warren Buffett's continued capital-allocation skill. With Buffett now 94 and chairman Greg Abel positioned as his successor, the post-Buffett era is approaching. Two reasonable views:

- **The bear case.** Berkshire's outperformance came largely from Buffett's idiosyncratic deal-making (the financial-crisis preferred-stock deals with Goldman, BofA; the See's Candies acquisition; the Apple position). Without him, Berkshire is "just" a well-diversified holding company that should trade at book value, not 1.5x book.
- **The bull case.** The wholly-owned businesses are excellent and have their own management depth; the insurance float is structural; the cash pile and conservative balance sheet give Abel optionality. Berkshire's culture of conservatism and decentralised management transcends any individual.

The right answer is probably between the two. The fundamental analyst's job is to size the position to reflect both the strength of the underlying businesses and the irreducible uncertainty about the post-Buffett era.

D.5 What This Case Teaches

Berkshire is the masterclass in **sum-of-the-parts** valuation and the **conglomerate discount/premium**. Standard P/E or DCF analysis fails on Berkshire because the company is structurally three different businesses with different valuation methods (insurance: book value adjusted for float quality; operating businesses: earnings multiple; equity portfolio: market value). The **lesson**: when a company doesn't fit a single valuation framework, build a sum-of-the-parts; explicitly state the multiple you're applying to each piece and the assumptions behind it; and recognise that succession risk in management-dependent businesses is a real valuation discount.

KEY TAKEAWAYS · BERKSHIRE

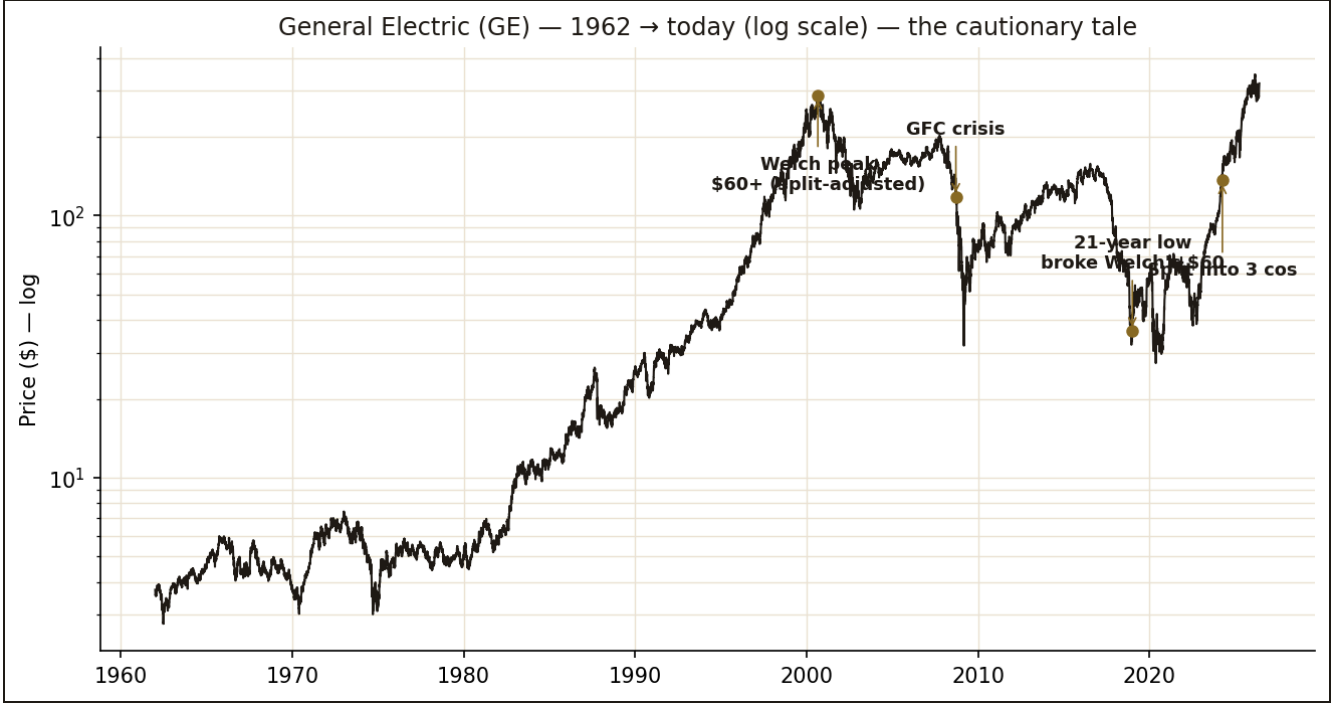
1. **Holding companies need sum-of-the-parts** — earnings multiples or DCFs alone mislead.
2. **Insurance float** is an enormous, often under-appreciated source of Berkshire's edge.
3. **GAAP earnings can be misleading** for mark-to-market businesses; use operating earnings.
4. **Management-dependent businesses carry succession risk**; size the discount honestly.

CASE E

General Electric — the Value Trap

In August 2000, General Electric was the most valuable company in the world. By 2018 it had lost 80% of its peak value, been removed from the Dow Jones Industrial Average (after 110 years of continuous membership), and was in the middle of a forced break-up into three separate companies. There is no harder lesson in fundamental analysis than this one.

FIGURE E.1 · GE — SIXTY YEARS OF CAUTIONARY TALE



From triumph to break-up. *Real GE data 1962 → 2026 on a log scale. The Welch peak in 2000 above $60 (split-adjusted), the 2008 collapse, the further decline through 2018, and the eventual 2024 split into three independent companies (GE Aerospace, GE Vernova, GE HealthCare). Two full decades of cumulative shareholder wealth destruction.*

E.1 The Welch Years (1981–2001)

Under Jack Welch, GE grew from a $14 billion industrial company into a $400 billion global conglomerate spanning jet engines, power generation, medical equipment, plastics, lighting, broadcasting (NBC), appliances, and — critically — a massive financial-services arm called GE Capital. Welch was canonised as the greatest manager of his generation; GE shares compounded at roughly 23% per year through the 1990s.

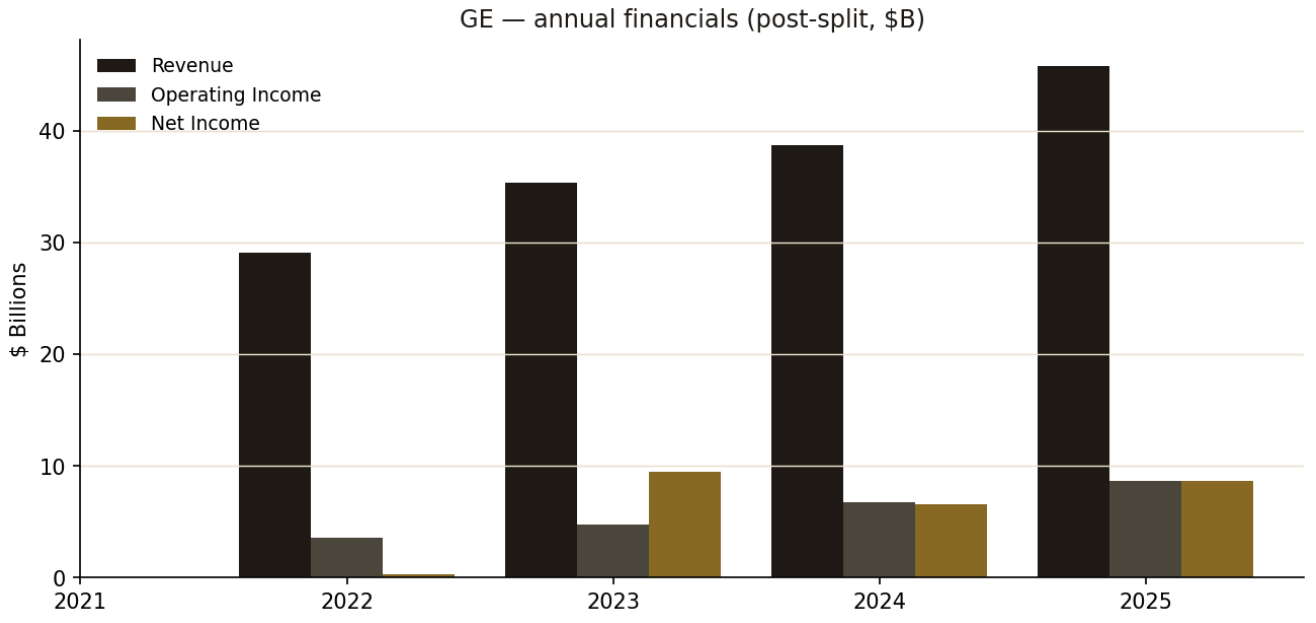
The financial-analyst's lesson, with twenty-five years of hindsight, is that much of this miraculous growth was unsustainable. GE Capital made up an increasing share of profits (peaking near 50%); the conglomerate structure allowed earnings management; and the acquisitions papered over weakness in individual segments. The reported financial statements told a very different story than the underlying economic reality.

E.2 The Cracks (2001–2008)

Jeff Immelt took over from Welch on 7 September 2001, four days before 9/11. The decade that followed was a study in *fundamental decay hidden by clever accounting*. By the time the 2008 financial crisis hit, GE Capital had grown so large that the parent company faced potential bankruptcy when credit markets froze. The federal government's TLGP debt-guarantee program saved GE Capital — and saved GE itself — but the company's image of unstoppable success was permanently broken.

E.3 The Numbers — and What They Hid

FIGURE E.2 · GE — POST-RESTRUCTURING FINANCIALS



A much smaller company today. *Real GE financials (after the 2024 split into Aerospace, Vernova, and HealthCare). Today's "GE" (technically GE Aerospace) is a focused, profitable jet-engines business — but it is a fraction of the size of the 2000 conglomerate.*

The historical lesson is best illustrated by the **quality of earnings** framework of Chapter 6:

- Throughout the 1990s and 2000s, GE's **net income** tracked Wall Street estimates with uncanny precision — almost always beating consensus by exactly 1 cent. This is statistically improbable in legitimately reported earnings.
- The company's **cash from operations** diverged from reported net income for years. Reported earnings rose; operating cash flow lagged. Quality of earnings was deteriorating.
- **GE Capital's leverage ratios** in 2007 were comparable to a major bank — but GE was sold to investors as an industrial company with a "financing arm."
- Massive **off-balance-sheet exposures** through commercial paper, securitisation conduits, and special-purpose entities were invisible in the consolidated balance sheet.

E.4 The Warnings That Were There

For the fundamental analyst, the question is not "could GE's collapse have been predicted?" — it's "could the deteriorating quality of GE's business have been seen in the financial statements before the price collapse?" The honest answer is *yes*:

1. **The cash-flow-to-net-income ratio** (Chapter 6) had been below 1.0 for years — meaning reported earnings were not converting fully to cash.
2. **The GE Capital leverage** was visible in the 10-K to anyone who read past the consolidated balance sheet — but the company was sold as an industrial.
3. **The pension obligations** were large and underfunded.
4. **The acquisition pace** meant organic growth was hard to disentangle from acquired growth.

None of this was hidden. It was buried in 200+ pages of regulatory filings. The fundamental analyst's job is to read those pages.

E.5 What This Case Teaches

GE is the textbook example of the **value trap** — a stock that looks cheap on traditional metrics (low P/E, dividend yield) but is cheap because the underlying business is deteriorating. The **lesson**: a low multiple is not in itself a buy signal; it must be cross-checked against earnings quality, balance-sheet honesty, and the structural prospects of the business. *The market is usually right about which businesses are deteriorating, even when individual analysts disagree.* When everyone says "GE will recover" and the chart keeps making new lows, the chart is almost always telling the truer story. Combine that with the Chapter 11 moat analysis: **did the moat actually deteriorate?** For GE, yes — competitors caught up in every segment except aerospace.

WATCH OUT

The "blue chip" label has no informational content

For most of GE's decline, the company was still rated investment-grade by the credit-rating agencies, still in every major equity index, still held by every major institutional investor, and still labelled "blue chip" in financial media. None of that protected shareholders. The label "blue chip" tells you what the past looked like, not what the future will. Read the financials.

KEY TAKEAWAYS · GE

1. **A low P/E plus a falling stock is the signature of a value trap.** Investigate before buying.
2. **Quality of earnings** (**CFO/NI ratio**) often diverges from reported earnings long before the price tells you something is wrong.
3. **Conglomerate accounting** permits earnings management; a focused, single-segment business is harder to obfuscate.
4. "**Blue chip**" **is a marketing label, not analysis.** Read the 10-K.

CASE F

NVIDIA — the Growth Story

A graphics-chip company that built a parallel-processing platform that turned out to be exactly what artificial intelligence needed. NVIDIA between 2022 and 2026 produced one of the most extraordinary fundamental shifts in modern equity history — and the fundamental analyst's question now is which part of that is sustainable.

FIGURE F.1 · NVIDIA — 1999 → TODAY (LOG SCALE, THE AI GROWTH STORY)

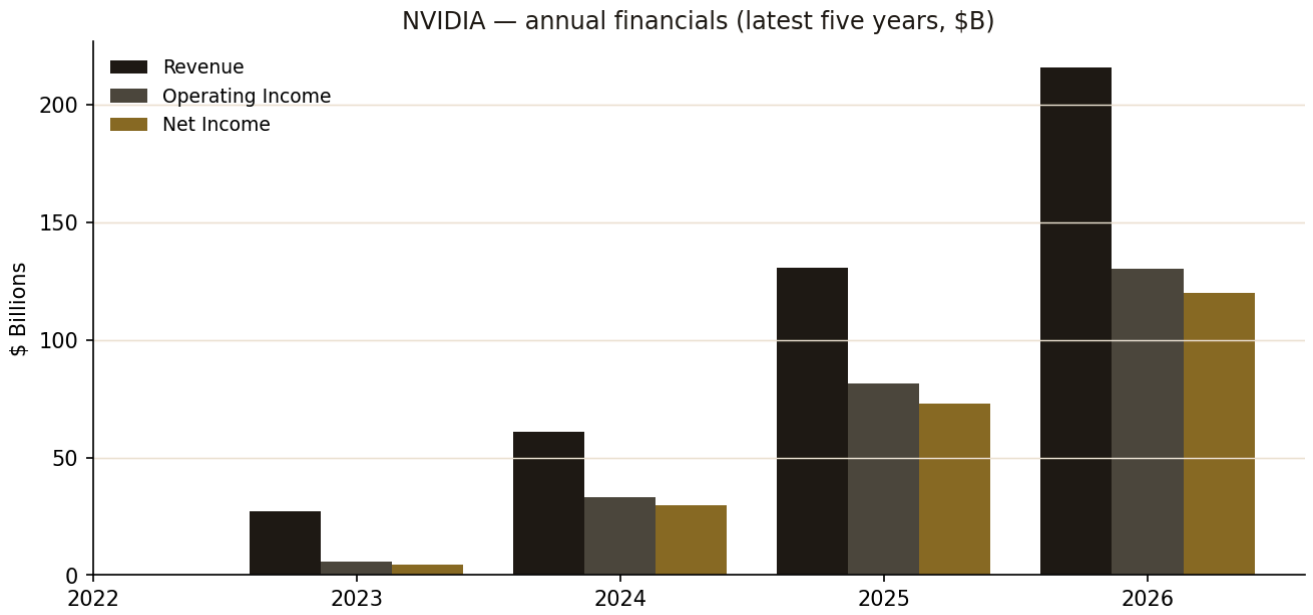
From $0.20 to several hundred dollars. *Real NVDA data 1999–2026 on a log scale. Note the dot-com low around 20 cents, the long climb through the GPU era, the 2018 crypto boom and bust, and the steepening rally from late 2022 as the AI thesis became reality.*

F.1 The Business

NVIDIA designs graphics processing units (GPUs) and the software stack (CUDA) that lets developers use those GPUs for general-purpose parallel computing. The original use case was gaming graphics; the parallel architecture turned out to be ideal for cryptocurrency mining (briefly), molecular simulation, and — overwhelmingly — for training and inference of large neural networks. By 2024, NVIDIA's data-center GPUs had become the dominant hardware for AI workloads worldwide.

F.2 The Numbers

FIGURE F.2 · NVIDIA — ANNUAL FINANCIALS (LATEST FIVE YEARS, $B)



One of the steepest revenue-growth curves in equity history. *Real NVIDIA financials. From FY 2022 revenue of $27 B to FY 2026 revenue of $216 B — an eightfold increase in four years, almost entirely from data-center AI sales.*

Applying the framework of Chapters 7–13 to NVIDIA's FY 2026:

WORKED CALCULATION · NVIDIA FY 2026 (YEAR ENDED LATE JAN 2026)

```
Revenue: $215.9 B
Operating Income: ~$140 B → operating margin = ~65%
Net Income: $120.1 B → net margin = ~56%

Shares outstanding (diluted): ~24.5 B
EPS = 120.1 / 24.5 = ~$4.90

Stock price (late 2026): roughly $135
P/E = 135 / 4.90 = ~28x

A 28x P/E on $120 B of net income at 56% margins is, by any historical
standard, extraordinary — but it's not the screaming bubble it would have
looked like before the earnings actually materialised. The market is
pricing roughly 8-12% continued earnings growth plus terminal stability —
both arguable and uncertain.
```

F.3 The Moat — Real or Cyclical?

The fundamental question for NVIDIA is whether the moat is *structural* (Chapter 10) or *cyclical*. The structural case:

- **CUDA software ecosystem.** Developers have written billions of lines of CUDA code. Re-writing for a competitor's hardware (AMD's ROCm, custom silicon) is expensive and time-consuming.
- **Scale economies in chip design.** NVIDIA's per-die R&D spend is amortised over enormous unit volumes.
- **Networking integration.** Mellanox acquisition (2020) and NVLink interconnect give NVIDIA an architectural advantage at the rack-and-data-center scale, not just per-chip.

The cyclical case:

- **Hyperscaler customer concentration.** A handful of buyers (Microsoft, Meta, Google, Amazon, x.AI) account for the majority of revenue. They each have strategic reasons to develop in-house alternatives.
- **The AI capex cycle could pause.** If AI returns disappoint, the buy-out phase slows dramatically.

- **Competition is real.** Custom silicon (Google's TPU, AWS Trainium, in-house chips from Microsoft and Meta) is improving fast; AMD's MI series is gaining traction.

The honest answer is that the moat is real but the customer-concentration risk and capex-cycle risk are also real. Neither the bull nor the bear case is obviously wrong; the truth depends on assumptions about AI demand durability that nobody knows yet.

F.4 The Valuation Range

Rather than a single DCF, the honest analyst should build a *range* based on different growth-duration scenarios:

COMPARE & UNDERSTAND · NVIDIA VALUATION RANGE

SCENARIO	5-YR REVENUE GROWTH	TERMINAL MARGIN	IMPLIED FAIR VALUE
Bull — AI capex persists, share holds	20% p.a.	50%	~$180
Base — Growth moderates, share holds	10% p.a.	40%	~$120
Bear — Customers in-source, growth stalls	0% p.a.	30%	~$70
Crash — AI capex collapses	−10% p.a. for 3 years	25%	~$45

At ~$135, NVIDIA is roughly priced between the bull and base case. Buying here requires believing the bull case is more likely than the bear; buying meaningfully below ~$80 would offer real margin of safety

even in the bear scenario.

F.5 What This Case Teaches

NVIDIA is the case study for **extraordinary growth and the difficulty of valuing it**. The textbook fundamental-analysis framework (DCF, comparable multiples, margin of safety) needs to be applied with *scenario ranges*, not point estimates, because the growth rate has a uncertainty range so wide that a single number is intellectually dishonest. The **lesson**: when a business is in the middle of a structural shift, the analyst's job is to identify the scenarios that bound the outcome, assign rough probabilities, and recognise that the entry price implies a specific bet on which scenarios are likely. Compare that bet with the available evidence. Position-size accordingly.

KEY TAKEAWAYS · NVIDIA

1. **For high-growth stocks, build scenario ranges, not point estimates.** The single number hides the uncertainty.
2. **Customer concentration** is a fundamental risk even when the moat looks strong.
3. **The capex cycle is a fundamental, not just technical, variable** — when buyers can pause, growth can collapse.
4. **A 28x P/E at 56% margins on $120B of earnings** is unusual; whether it's a bubble depends entirely on what comes next.

Across all four cases

Microsoft, Berkshire, GE, and NVIDIA together demonstrate the four kinds of analysis you'll do as a fundamental analyst. **Microsoft** is straightforward DCF with sensitivity. **Berkshire** is sum-of-the-parts on a holding company. **GE** is the value trap — read the quality of earnings before the price tells you. **NVIDIA** is scenario analysis when growth is the dominant variable. Master those four cases and you can value almost any business that comes across your desk.

APPENDIX A

Glossary

Every key term from this book, in plain English.

Balance sheet — a snapshot of what a company owns, owes, and is worth to owners.

Book value (**equity**) — assets minus liabilities; the owners' accounting stake.

Capital allocation — how management deploys profits (reinvest, acquire, repay, return).

Cash flow statement — shows actual cash in and out (operating, investing, financing).

Circle of competence — the businesses you genuinely understand.

DCF — discounted cash flow; valuing a business by its future cash, discounted to today.

Discounting — shrinking future money to its present value.

EPS — earnings per share; net profit divided by shares.

EV/EBITDA — whole-firm value vs core operating earnings; a debt-aware multiple.

Free cash flow — operating cash minus needed investment; the genuinely spare cash.

Gross / operating / net profit — the three layers of profit on the income statement.

Income statement — revenue minus costs, down to profit, over a period.

Interest coverage — operating profit ÷ interest; how safely debt is serviced.

Intrinsic value — what a business is truly worth, vs its market price.

Margin — profit as a percentage of revenue.

Margin of safety — buying well below your value estimate, for protection.

Moat — a durable competitive advantage protecting profits.

P/B — price-to-book; price vs net assets.

P/E — price-to-earnings; price per $1 of annual profit.

P/S — price-to-sales; price vs revenue.

Present value — today's worth of a future sum.

ROA / ROCE — return on assets / on capital employed.

ROE — return on equity; profit per $1 of owners' money.

Time value of money — a dollar today is worth more than a dollar tomorrow.

APPENDIX B

Index

Where each idea is explained, by chapter.

APPENDIX C

Resources & What's Next

A few classics to go deeper — and your next step on the roadmap.

To Go Deeper

— *The Intelligent Investor* — Benjamin Graham · the origin of "Mr. Market" and the margin of safety.

— *The Little Book That Builds Wealth* — Pat Dorsey · a clear, focused guide to economic moats.

— *Financial Statements* — Thomas Ittelson · the clearest plain-English guide to the three statements.

— *The Little Book of Valuation* — Aswath Damodaran · valuation, by a master teacher.

— Company annual reports themselves — the best (and free) way to practise everything in this book.

Sources & Where to Get the Data (all free)

Everything you need to analyse a real company is publicly available at no cost. These are the genuine sources used for the Apple appendix and the ones to use for your own research:

— **SEC EDGAR** — official U.S. filings (10-K annual & 10-Q quarterly reports): sec.gov/edgar/search

— **Apple's FY2023 10-K** (the exact source for the appendix): sec.gov · aapl-20230930.htm

— **Company investor-relations pages** — e.g. Apple: investor.apple.com (every public company has one)

— **Aswath Damodaran** (NYU) — free valuation data, spreadsheets & lectures: pages.stern.nyu.edu/~adamodar

— **Macrotrends** — free multi-year financial history & charts: macrotrends.net

— **StockAnalysis** — clean free statements & ratios: stockanalysis.com

— **Investor.gov** (US SEC) — how to use EDGAR, plain-English basics: investor.gov · EDGAR

Your Next Step

You can now judge a business and estimate what it's worth. The roadmap continues with **Book 5** — ***Technical Analysis***, which studies the other half of the picture: not the business, but the price *chart* — candlestick patterns, trends and indicators — and, importantly, an honest account of what charts can and can't do. Where this book asked "is this a good business at a good price?", the next asks "what is the price actually doing?" Together they round out your view of any stock.

Source Notes

This book teaches universal principles of business analysis. The fully-worked real example (Appendix A) uses **Apple Inc.'s actual reported figures from its FY2023 Form 10-K filed with the U.S. SEC** (linked above); those numbers are facts on the public record, used here purely to demonstrate the method — **not** as a recommendation, and they change every year, so always pull the latest filing. The earlier Coca-Cola illustration uses **approximate, rounded** figures for the same teaching purpose. All numeric examples (margins, ratios, the DCF) are simplified to teach the calculation; share prices are dated snapshots that move daily — they are used purely to demonstrate the *method*, are **not** a recommendation to buy or sell any security, and should be re-checked against current filings before any real decision. All numeric examples (margins, ratios, the DCF) are simplified to teach the calculation. Currency is shown as "$" as a stand-in for any currency. Accounting standards, statement formats, line-item names and tax treatments vary by country — always check the conventions a real company reports under. Concepts here — price vs value, the financial statements, profitability/solvency/valuation ratios, moats, capital allocation, competitive forces, the time value of money and discounted cash flow — reflect mainstream, well-established financial analysis. Nothing here is investment advice or a recommendation of any security; verify specifics and do your own research before acting.

❖ ❖ ❖

“It is far better to buy a wonderful company at a fair price than a fair company at a wonderful price.”

— A GUIDING PRINCIPLE OF QUALITY INVESTING

You can now read any business like an owner. Use the skill with patience, humility, and always a margin of safety.

Fundamental Analysis

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Education, not advice. Analysis improves your odds; it never removes risk. Understand it, judge it, and buy it cheaply — with a margin of safety.