

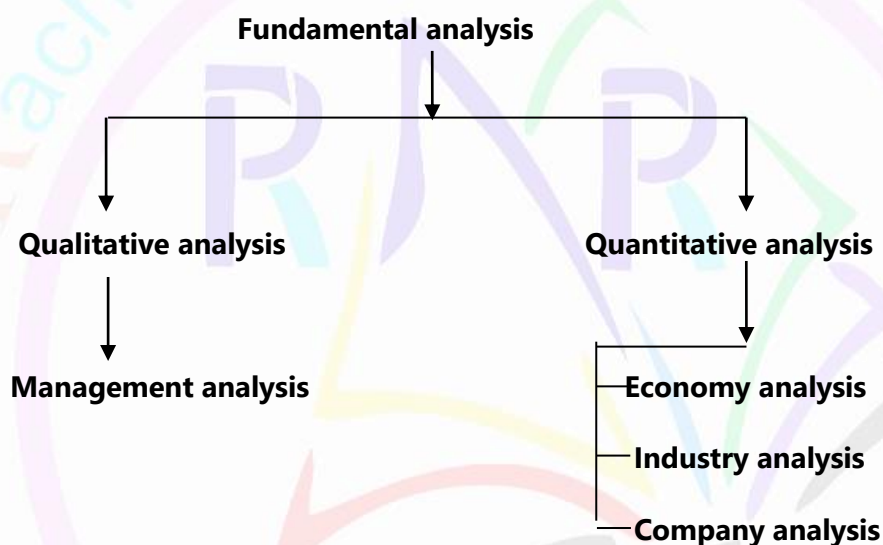
FUNDAMENTAL ANALYSIS

BY CA RACHANA PHADKE RANADE

1. Conceptual difference between Fundamental and Technical Analysis:

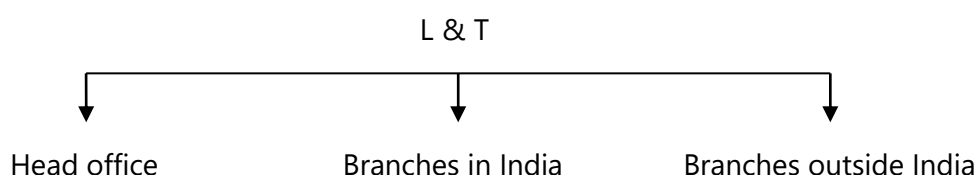
Fundamental analysis - Helps an investor to understand which stock to buy

Technical analysis - Helps to understand when to buy the stock.



2. Company Analysis:

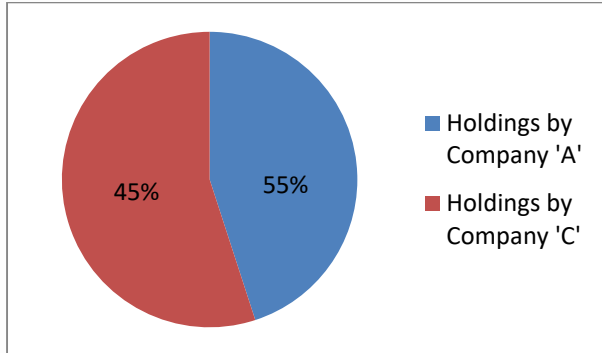
- Annual report of the company includes every single detail of the company.
- Financial statement includes the following:
 1. Balance sheet – Contains 'Assets' and 'Liabilities'
 2. Profit and loss account – Contains 'Incomes' and 'Expenses' of the existing year.
 3. Cash flow statement
 4. Notes to account
 5. Statement of changes in equity.
- Financial statement of the company includes standalone as well as consolidated financial statement.
 - ✓ Standalone financial statement



✓ Consolidated Financial Statements (CFS)

CFS includes Standalone financial statements, Subsidiary companies, associate companies and Joint ventures.

- **Subsidiary company:** A company in which a parent company (holding company) holds more than 50% stake is known as its subsidiary company. E.g. Company 'A' holds 55% share in the company C. Thus, Company 'C' is a subsidiary of the company 'A'.



- **Associate company:** A company in which a parent company holds 20% - 50% (both included) stake, is known as an associate company. E.g. Company 'X' holds 25% share in the company Y. Thus, Company 'X' is a subsidiary of the company 'Y'.

3. Equity: Equity is the money with which the business is initially started. Investors who buy equity shares of a company become the owners of the company.

4. Regulator: Regulator is the one who regulates the operations of day to day working.

E.g. **RBI** for all the banks, **IRDA** (Insurance Regulatory Development Authority) for insurance companies, **SEBI** (Securities and Exchange Board of India) for stock market, **AMFI** (Association of Mutual Funds in India) for mutual funds.

5. Types of Business:

1. **Family owned business:** Here, promoter's shareholding will be the highest.

Also, in this type of business, if the promoter himself is selling shares on a regular basis and ends up having very less shares of his own company, the investor should stay away from such a company.

2. **Professionally run business:** Here, promoter's shareholding will be the lowest.

Also, in professionally run business if the promoter's shareholding is zero, it is not treated as problem.

6. Bulk Deal: Bulk deal is a deal where multiple number of shares are bought and sold within a second. If the promoter is on the selling side, an investor should stay away from such company and vice versa.

7. Auditor's report: Auditor's report discloses important facts of the audit to shareholders. When the report contains 'true and fair view' phrase, it is considered as reliable. 'Opinion paragraph' and 'Key audit matters' paragraph are very important in the auditor's report.

8. Format of Balance Sheet:

Balance Sheet as at 31st March, 2011			
Particulars	Note No	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
I. EQUITY AND LIABILITIES			
(1) Shareholder's Funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-Current Liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long term provisions			
(4) Current Liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
Total			
II.Assets			
(1) Non-current assets			
(a) <i>Fixed assets</i>			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long term loans and advances			
(e) Other non-current assets			
(2) Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
Total			

Some important balance sheet terms are explained as follows.

- **Shareholder's funds** - Promoter's money / core funds with which the business is started.
- **Reserves and surplus** – Profits generated from the business which are retained with the company is known as reserves and surplus. General reserves, retained earnings and Securities premium are the most important factors under reserves and surplus. The term Reserves & Surplus is also often called as Other Equity.
- **Non- current liability** – Liability which is payable after 1 year is known as non-current liability. Some common examples of Non-Current Liabilities are Debentures, Long term Bank Loan etc. It is also called as loan funds. If loan funds are excessively higher than own funds (equity), it is very risky to invest in such companies. For E.g. Suzlon, Jet Airways, Reliance Communications etc.
- **Current liability** –Liability (money) which is payable within 1 year is known as current liability.
- **Non-current assets** – Assets which are convertible into cash or cash equivalent **after 1 year** are known as non-current assets.
- **Current assets** – Assets which are convertible into cash or cash equivalent **before 1 year** are known as current assets.
- **Current investment** – E.g. 6 months FD, Gold and stocks.
- **Inventories** – Inventories are the items in which businessman deals i.e., they are bought with an intention to sell. E.g. Garment shopkeeper buys garments with an intention to sell.
- **Trade receivable** – A customer from whom the money is receivable. Trade receivable is increased only when there is a credit sale.
- **Cash and cash equivalent** - E.g. Saving Bank account balance, Cash etc.
- **Short term loans and advances** – E.g. Loan given to an employee.

9. Eight points to analyse (Very Important):

1. Current ratio
2. Debt : Equity
3. ROCE (Return on capital employed)
4. Free cash flow
5. Shareholder's pattern

6. Inventory turnover ratio
7. Reserves and surplus
8. P/E Ratio

1. **Current ratio** – Current ratio discusses the liquidity position of the company. An ideal current ratio is 2:1. A ratio below 1:1, where current assets are lower than current liabilities is dangerous for the company.
2. **Debt to Equity** – The ratio of Long-Term Debt (Loan Funds) - Equity (Share Capital + Reserves & Surplus) is known as Debt to Equity Ratio. A debt free company is an amazing position. The debt: equity ratio higher than 2:1 is considered to be dangerous.
3. **ROCE (Return on Capital Employed)** – It is calculated as Earnings Before Interest & Tax (EBIT) divided by capital employed multiplied by 100. (Capital Employed = Shareholder's fund + Non-current liabilities).

$$\text{ROCE} = \text{EBIT} / \text{CE} * 100$$

4. **Free cash flow** – Free Cash Flow is calculated as cash flow from operation less Net Investments in Fixed Assets. Negative free cash flow for back to back 3-4 years is considered to be dangerous. Free cash flow can be calculated only after downloading the annual report because the figures related to purchase and sales of fixed assets are available as a separate line item under cash flow from investing activity.
 - **Depreciation** – Depreciation is the reduction in the value of assets due to wear 'n' tear and technological obsolescence.
 - **Amortisation** – Reduction in the value of intangible assets.

Key elements of a Cash Flow Statement

- **Cash flow from operating activities** – A negative cash flow from operating activities is a bad sign because; it means that the core operations of the company are not generating sufficient cash.
- **Cash flow from investing activities** - A negative cash flow from investing activities would not be necessarily treated as bad because it would mean that we have invested more and sold less.

- **Cash flow from financing activities** – A negative cash flow from financing activity means that we have repaid the money borrowed earlier. The negative could also be because of dividend payments and interest payments.

How to calculate Free Cash Flow?

Particulars	2018	2017
Net cash flow from operating activities	51,853	1,01,399
Cash flow from the purchase of fixed asset	(86,040)	(52,777)
Spectrum charges		(73,388)
Sale of property	363	356
Free cash flow	-33,824	-24,410

5. **Shareholder's pattern:** A part of this has been discussed in Types of Businesses covered in Point number 5. One more important point in this one is that if promoter's shares are pledged, it is considered as a negative point.
6. **Inventory turnover ratio** – This ratio determines the number of times inventory (goods) is manufactured or sold. For E.g. If the inventory turnover ratio for the company is 8, it means that the cycle of manufacturing and selling the entire inventory (goods) happened 8 times within 1 year.
7. **Reserves and Surplus:** A continuous growing Reserves and Surplus is considered to be a good sign. To do a good analysis at least 5 years data is to be checked.
8. **P/E ratio (Price to Earning)** - P/E ratio is calculated as market price per share divided by earnings per share. An investor should always compare company's PE with industry's PE. If company's PE is less than the industry's PE, then an investor may buy such a share. This is because we are getting the share at cheaper valuations as compared to the industry.
However, an investor must also understand the reason behind cheaper valuations. If all the other ratios are showing a negative picture, it means that the company does not deserve a good valuation and thus it is cheaper and thus the investor should not invest in the same.

PE ratio should always be checked towards the end of entire analysis.

P/E ratio = Market price per share /Earning per share

Earnings per share (EPS) = PAT/Total No. of shares.

10. Format of Profit & Loss account for the purpose of Financial Analysis:

Sales	100
(Less) Operating cost	-60
=EBITDA	40
(Less) D & A	-10
= EBIT	30
(Less) Interest	-10
=PBT/EBT	20
(Less)Tax (30%)	-6
=PAT	14

11. Book Value = Assets – External Liability:

Book value per share = total book value/total no. of shares

Existing liability = Current liability + non-current liability

12. Valuing shares using EV/EBITDA module:

1. Go to moneycontrol.com and then to financial ratios.
2. Valuation ratios – copy and paste the EV data and EV/EBITDA data for last 5 years.
3. Calculate EBITDA = EV/(EV/EBITDA)
4. Growth in EBITDA should be calculated.
5. Calculate average growth in EBITDA
6. Calculate expected EBITDA.

E.g. If EBITDA of 2019 is 67695.6 and average growth rate is 112.403, then expected EBITDA can be calculated as,

$$100/67695.6 = 112.403/x$$

Therefore, x = 76091.9

7. Calculate forecasted enterprise value

$$= [\text{Expected EBITDA} * (\text{EV/EBITDA of 2019})] - \text{Value of debt}$$
8. Calculate outstanding shares. (Find it from moneycontrol.com)
9. Target price(expected price) = Forecasted EV/Outstanding shares
10. Entry price should be at least 70% of expected price.

13. Basic parameters for industry analysis:

1. Cyclical Industry

It is a type of industry which performs well when the country's GDP growth is high.
 E.g. Automobile industry.

2. Subset of an industry. E.g. manufacturing batteries for electrical vehicles.

3. Lifecycles: A company goes through various phases. E.g. Birth phase, Growth phase, Saturation and Decline. E.g. Birth phase of a company E.g. Zomato

4. Government policies.

a. Real estate ancillaries

Housing finance companies. E.g. HDFC
 Cement. E.g. ACC, Ultra-tech cement
 Paints. E.g. Berger Paints, Asian paints

b. Infrastructure E.g. L&T

c. Insurance.

d. Automobiles E.g. Ashok Leyland, Tata motors, Maruti Suzuki

e. Banks E.g. HDFC banks, Kotak Mahindra Bank

f. Demographic factors

5. Sector wise key points to consider

A. Banks and NBFC

1. Don't check Debt: Equity ratio.
2. Operating cash flows can be negative.
3. Inventory turnover ratio is irrelevant.

Points to consider.

Growth in CASA (Current Account Saving Account)
 NIM (Net Interest Margin) Growth
 NPAs (Non-Performing Assets)

B. FMCGs (Fast Moving Consumer Goods)

Inventory Turnover ratio

C. Telecom

ARPU (Average Revenue Per User)

D. Infrastructure

Check order book – Order book is a book that includes information about the orders received which are yet to be executed. The higher is the order book, the good it is for the company.

E. Automobiles

Automobiles sector companies have to publish monthly data in the newspapers. This gives an idea of number of vehicles sold every month.

F. Oil and gas

Crude oil prices and government policies affect the profitability of this sector.

14. Economy analysis:

1. GDP (Gross Domestic Product)

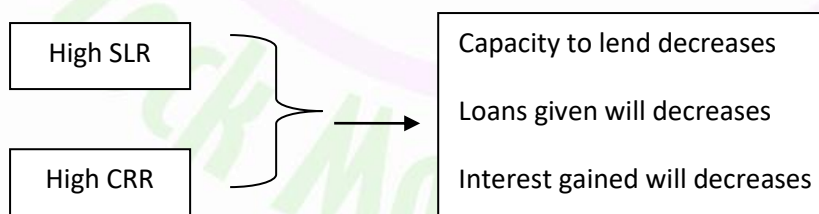
It is the aggregate value of the final goods produced or services rendered in the country.

2. CRR and SLR

CRR stands for Cash reserve ratio and SLR stands for Statutory Liquidity Ratio deal with money that has to be kept aside by the banks as required by RBI.

SLR – Money which banks have to keep aside with themselves.

CRR – Money which has to be deposited with RBI as a reserve.



3. Repo rate

It is the rate at which RBI lends money to banks.

When repo rate increases,

1. Loans become costly
2. Production decreases
3. It creates a negative impact on GDP

4. It also creates a negative impact on stock market.

Parameters like monsoon, balance of payment also impact on stock market. Balance of payment is a difference of export vs. import.

Surplus BOP (Exports > Imports) → Rise in foreign currency reserve → Good for the economy
↓
Good for stock market

15. Qualitative analysis: Management analysis:

Various parameters to analyse the honesty of a businessmen are:

1. Search the company name on Google and the add the search term as 'fraud' or 'cases'.
2. Check the Linked In profile of the businessmen. E.g. Qualification, experience, net profit, remuneration.
3. Management discussion and analysis. (Annual report). Here, we can get to know about the company's existing projects and upcoming projects, punishments and penalties borne by the company.
4. Investor conference call – Transcript analysis of your quarterly earnings conference calls.
5. Insider trading charges against the management.

IMPORTANT LINKS

- **Website:** <https://rachanaranade.in/>
- **Email:** rachanaranade01@gmail.com
- **YouTube:** <https://www.youtube.com/rachanaphadke>
- **Facebook:** <https://www.facebook.com/CARachanaRanade>
- **Twitter:** https://twitter.com/rachana_ranade
- **WhatsApp:** +91 9022196678

HAPPY INVESTING!

- **CA Rachana Ranade**