MODULE 5

What Makes A Good Stock?

Picking a good stock involves taking the time to research a company and understand its financials in order for investors to gain insight into a company's health. We don't just look look for companies with upcoming product launches or new partnerships. We examine the long-term potential of a company by looking at factors such as competitive advantages it may have, trends in its industry, or if it's poised to benefit from changing demographics or technology shifts.

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Key Takeaways From This Module

Guiding Questions

- What are dividends and why would a company issue them?
- Why do investors want to own companies that pay dividends?
- What types of companies pay dividends and why?
- What are some of the quantitative and qualitative ways to analyze different investments?
- How does a P/E ratio help you determine the value of a company's stock?

Enduring Understandings

- What dividends are any how they function.
- Where to find dividend information.
- How to qualitatively and quantitatively analyze a company and determine if it fits in your investment criteria.
- How to use a P/E ratio to compare companies in similar industries to determine future performance.
- How to calculate a P/E ratio, ROE, and D/E ratio and what these different ratios actually mean.

Understanding Stocks Means Understanding Cash Flow

Investors purchase stocks or other investments because they either provide cash over a period of time, or the investors believes they can sell it for more in the future.

Dividing Up Profits: Dividends

From the earliest days of investors, there has always been an idea that investors should share in a companies profits.

Today we call these dividends, which are a portion of a company's earnings distributed to its shareholders.

Dividends and typically paid in cash, but can also be in the form of additional shares of stock, and provide a way for companies to share their profits directly with investors.

Not all companies offer dividends because the company's Board of Directors may choose to keep the profits and reinvest them in the business.

How Dividends Work

Company's Perspective:

Companies with sufficient profits can distribute dividends to attract and retain investors.

The board of directors determines the amount of the dividend, on a per-share basis.

Investor's Perspective:

Dividends are typically distributed to shareholders on a per-share basis.

This means that for every share of stock you own, you'll receive some portion of the companies profits.

Dividend Yield & Coverage

Dividend Yield

Dividend Yield is a financial ratio that shows how much a company returns in dividends each year relative to its share price.

High dividend yield could be a sign of a generous company, or a company whose share price has fallen. It's a key indicator for income-focused investors.

$$\text{Dividend Yield} = \frac{\text{Annual Dividends (\$)}}{\text{Price Per Share}}$$

Dividend Coverage

The Dividend Coverage Ratio measures a company's ability to pay its current dividend.

A high dividend coverage ratio means the company comfortably covers its dividends with net income, which suggests the dividends are sustainable.

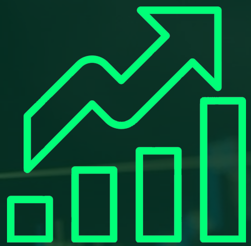
$$\text{Coverage Ratio} = \frac{\text{Net Income}}{\text{Annual Dividends}}$$

Not All Companies Pay Dividends!

Less Risky ⟷ Most Risky

Blue Chip Stocks

Blue Chip stocks are well-established, large companies with a history of stable earnings. **These companies often pay regular and growing dividends, providing a steady stream of income.**



Growth Stocks

Growth stocks are shares in **high-growth companies, which typically reinvest their profits back into their business,** rather than pay dividends. Investors buy these stocks for capital appreciation, not income.

Penny Stocks

Penny stocks are very low-priced shares of small, often speculative companies. **These stocks rarely pay dividends,** as these companies need to reinvest any profits to fuel growth.

Qualitative Factors To Consider

While consistent revenue growth is considered to be a factor, non-numerical aspects of the company are also important when analyzing a company as they are intangible, but nonetheless could impact the future values.

Senior Leadership
Leadership that has the right experience or reputation can be an indicator of future success

Pending Litigation
Lawsuits can hurt a company's bottom line and reputation, and may indicate an unworthy investment

Technology Innovation
Technology is a powerful advantage over competition and can signal a successful company

Customer Satisfaction
Ultimately the customer is king. The happier customers are, the more likely the company grows

Quantitative Factors To Consider

Here are some metrics that analyze earnings, which is the revenue a company keeps after paying expenses:

Earnings Per Share =

$$\frac{\text{Net Income - Preferred Dividends}}{\text{Equity}}$$

Value of company earnings per outstanding share of common stock.

Return on Equity =

$$\frac{\text{Net Income}}{\text{Equity}}$$

Measure of business profitability in relation to equity. The higher the ratio, the better

Price to Earning Ratio =

$$\frac{\text{Share Price}}{\text{Earning per share}}$$

The higher the ratio the more investors are willing to pay for its earnings

Look At Competitors For Relative Value

Investment Multiples

There are a variety of investment multiples that can tell us about a company's profitability, potential bankruptcy, cash position and operational efficiency.

However, these don't mean much without considering industry standards since they vary wildly between industries. Here are some multiples to look out for:

Price to Earnings Ratio (P/E)

Debt to Equity Ratio (D/E)

Price to Earnings Growth (PEG)

Return On Equity (ROE)

Industry Position

You also want to consider how much market power a company has in its industry. A monopolist is more likely to be profitable than a company in a highly competitive space, however, eventually companies with dominant market share face regulatory risk, like Amazon and Facebook as people ask to "Break Up Big Tech.".

In more competitive industries, understanding what makes your company unique is important. This could be in terms of product, marketing, cost structure, distribution channels etc.

DETERMINING A STOCK'S VALUE

Understanding PE Ratios

The **price to earnings** ratio is thought to be a good metric when valuing a company

Price

The P in the P/E ratio stands for the **stock price per share**, a value determined by the number of people buying and selling a certain stock and controlled by supply and demand.

Earnings

The E in the P/E ratio stands for the **earnings per share**, or the actual amount of money the company has earned for every share that is currently trading.

It is commonly accepted that the **lower the P/E ratio the better value on the stock** for investors.

On the other hand, a **high P/E ratio is seen as an overpriced stock** since you are paying more than the company is making. .

Recapping Ratios: Good & Bad

Overvalued	Smart With Money	High Leverage
P/E Price To Earnings	**ROE** Return On Equity	**D/E** Debt To Equity
Undervalued	Not Efficient With $$$	Low Leverage

The P/E Ratio

1. Calculate the P/E ratio for the Hanna Banana Company. Their earnings report indicates they earn $7.84 a share. The current stock price is trading at $9.28.

2. The current P/E ratio from Apple Corporation is at 13.77. If the current stock price is $565.25 per share, what is Apple's current earnings per share?

3. You are evaluating the following three companies stocks:

a) Megatron Corporation Stock Price = $52.14 Earnings Per Share = $28.93
b) Xsail Corporation Stock Price = $8.69 Earnings Per Share = $7.82
c) iMoved Corporation Stock Price = $9.68 Earnings Per Share = $11.28

Traditionally, which stock has the best value?

Other Important Ratios To Know

Ratios provide a benchmark to compare different companies across industries and the overall market. Investors care how much money a company earns, so price-to-earnings (PE) ratios are the most common, but there are two others which are important.

Return On Equity (ROE)

Investors use this ratio to see how effective a company is at making money with the money they already have. The higher the ROE the more efficient a company is at creating income from equity, which indicates that a company uses their money more efficiently.

Debt-To-Equity Ratio (D/E)

This ratio is used to evaluate a company's leverage (how much it was borrowed) and is calculated by dividing a company's outstanding liabilities by the company's equity. This a good way to understand if a company has too much debt and if their business model is sustainable.

Key Takeaways From This Module

CORE & FUNDAMENTALS

- Dividends are payments made to shareholders by a company that allows the company to share its profits with investors.
- Dividends are an important way to build a passive income stream from investing.
- Analyzing companies quantitatively requires you to compare other companies in the same industry to figure out the true value of the company.

APPLIED KNOWLEDGE

- Dividends can provide passive income for investors without needing to make any sales.
- Companies that are stable and pay dividends can be good investments as they typically are more established companies.
- Financial ratios mean very little without comparing them to competitors or other companies in the same industry.

RELEVANCE FOR YOU

- Dividends are a great way to see return from your investment without needing to sell it.
- Dividends when reinvested allow your investment to grow much faster than just from prices increasing.