

Activity 4

ROE and P/E Ratios

The purpose of this assignment is to give you practice using the DuPont equation to understand ROE, and to use company and industry price and earnings information to estimate stock price.

Group:

Section:

1. Imagine that you are a new employee in the financial analysis division of a large company. Last year, the company had an ROE of just 2%, but management has developed a new operating plan designed to improve performance. The new plan calls for a debt ratio of 60%, which will result in interest charges of \$300 million per year. Management also expects EBIT of \$500 million on sales of \$9 billion next year, and it expects to have total asset turnover of 3.0. Under these conditions, the company's tax rate will be 30%. What will be their ROE?
2. Continuing with the above scenario, assume now that the firm's *target* ROE is 15%. Also, assume that total assets, sales and net income all remain as above (these are big assumptions since leverage will be changing, but it simplifies your calculations). What leverage (debt) ratio does the company need in order to reach its target ROE?

3. Choose a peer from the list of competitors at Yahoo! Finance, and use it in your calculations below. Note that “ttm” means that the accounting number is measured over the trailing twelve months (or at the most recent fiscal year-end), while “mrq” implies it is measured over the most recent quarter (or at the end of the most recently finished fiscal quarter)—EPS and P/E are both “ttm”.

Ticker (Own)		Ticker (Peer)	
EPS (Own)		P/E (Peer)	

Using your company's EPS and a comparable company's P/E ratio, calculate what your firm's stock price would be if investors were willing to pay the same P/E ratio on your firm's earnings that they are willing to pay on the peer firm's earnings.

$$P_0 = EPS_{own} \left(\frac{P}{EPS} \right)_{peer} =$$

Is your firm's actual stock price higher or lower than the price you calculated? If the actual price is higher than the calculated one, can you take a guess at why this might be the case? Write a one sentence answer in the space provided below that describes your thinking. Similarly, if your firm's actual price is lower than the calculated one, write down why you think this happened in the space below.