Valuation Ratios

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Why Evaluate ?

- One of the cardinal principles of stock investing is ‘Buy low and sell high’.
- There are few benchmarks that can help you decide RIGHT price to Buy/Sell

Some Terms …Net Income

Sales

- Cost of goods sold (COGS)

Gross income

- Selling, general & admin (SG&A)

Operating income

- Net interest expense

Pretax income

- Taxes

<u>**Net income**</u>

Revenues-Sales growth

- Revenues are how much the company has sold over a given period
- Sales are the direct performance indicators for companies.
- The rate of growth of sales over the previous years indicates the forward momentum of the company

Bottom line growth

- The bottom-line is the net profit of a company
- The growth in net profit indicates the attractiveness of the stock.
- The expected growth rate might differ from industry to industry
- IT ~ 30 to 60%, Old Economy ~ 10 to 15%

ROI - Return on Investment

- Return on capital invested in business
- if you invest Rs 1 crore in men, machines, land and material to generate 25 lacs of net profit , then the ROI is 25%.
- Could differ form industry to industry
- IT ~ 20 to 30%, Old Economy ~ 10 to 15%

Key Ratios

- P/E – price / earnings
- D/E – debt/ equity
- FP/E – forward price/earnings
- P/Bv – price/ book value
- P/Sales – price/ sales

PSR (Price-to-Sales Ratio)

- This measures a company's stock price against the sales per share
- This is the number you want below 3, and preferably below 1

Debt-to-Equity Ratio

- This measures how much debt a company has compared to the equity
- Is arrived by dividing the total debt of the company with the equity capital.
- You're looking for a very low number here, not necessarily zero, but less than .5. If you see it at 1, then the company is still okay. A D/E ratio of more than 2 or greater is risky.

Earnings Per Share (EPS)

- Earnings, also known as net income or net profit, is the money that is left over after a company pays all of its bills.
- This ratio determines what the company is earning for every share
- By dividing the earnings (net profit) by the total number of equity shares. Thus, if AB ltd has 2 crore shares and has earned Rs 4 crore in the past 12 months, it has an EPS of Rs 2.

Price / Earnings Ratio (P/E)

- The P/E ratio takes the stock price and divides it by the last four quarters' worth of earnings. If AB ltd is currently trading at Rs. 20 a share with Rs. 4 of earnings per share (EPS), it would have a P/E of 5.
- When a stock's P-E ratio is high, the majority of investors consider it as pricey or overvalued.
- Stocks with low P-E's are typically considered a good value.

PE …

- Conceptually the P/E multiple represents the premium that the market is willing to pay on the earnings based on its future growth.
- One can obtain some idea of a reasonable price to pay for the stock by comparing its present P/E to its past levels of P/E ratio.

Finding P/E Ratios

- Three Methods
  - Use the Current P/E Ratio
  - Use the Average of P/E Ratios Over Previous Time Periods
  - Use the Company's Expected Dividend Growth Rate (Ignore % Sign)
- The Three Methods Can Lead to Quite Different Values

Book Value

- The current value of an asset on a company's balance sheet according to its accounting conventions
- Theoretically, what a company could be sold for (liquidation value)

Using Book Value

- A Company’s Book Value is Simply Its Net Worth (Assets minus Liabilities) Divided by the # of Shares Outstanding
- Book Value May Not Provide A Realistic Estimate of True Value Because:
  - Assets May Have Replacement Costs Much Higher then Book Value
  - Some Assets May Not Appear on the Company’s Books: eg., The Coca Cola Trademark

Price-to-Book Ratio

- Despite Book Value’s Limitations, Some Analysts Use the Price-to-Book Ratio
- This Ratio Divides the Stock’s Price by its Book Value. Example: if Price is 40/Share and Book Value is 10/Share, Price-to-Book = 4.0
- All Other Things Equal, Analysts Prefer Low Values for this Ratio

PEG Ratio

- Shows the Relationship between the PE Ratio and the Long-Term Growth Rate

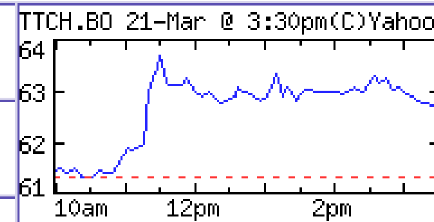
  PEG = (P/E)/Growth

- All Things Equal, Low Numbers Are Desirable--You’re Buying Growth at a Low Price

Dividend Yield

- A ratio of a company's annual cash dividends divided by its current stock price expressed in the form of a%age.
- For instance, if a Rs.10 (Price and not Face Value) stock is expected to pay a Rs.1 annual dividend then divide this by 10 to get a dividend yield of 10%.
- Dividend Yield = Ann. Div/ Price= 1/10= 0.10 = 10%

Yahoo ! Finance Example

TATA CHEM-A (Bombay:TTCH.BO)- More Info: Profile						
Last Trade 3:55pm · **62.75**	Change +1.40 (+2.28%)		Prev Cls 61.35	Volume 143,175	Div Date N/A	
Day's Range 61.05 - 63.85	Bid 62.75	Ask 62.85	Open 61.35	Avg Vol N/A	Ex-Div 19 Jul, 2002	
52-week Range 38.50 - 70.10	Earn/Shr 5.44	P/E 11.28	Mkt Cap N/A	Div/Shr 5.00	Yield 8.15	Small: **1d** 5d 1y none Big: 1d 5d 3m 6m 1y 2y 5y max

- EPS = Rs 5.44 per Share.
- Previous Close Price = 61.35, thus P/E = 61.35/5.44 = 11.28
- Volume = more than 1 lac,Very Liquid.
- Dividend = Rs 5 per share
- Yield = Div/Price = 5/61.35 =8.15%(More than PPF returns)

Thank you