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Ratios Analysis

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Ratio Analysis

A technique used to examine a company's financial statements with regard to

- Liquidity position
- Profitability
- Solvency
- Financial Stability
- Quality of the management

Ratio analysis is crucial for investment decisions. It not only helps in knowing how the company has been performing but also makes it easy for investors to compare companies in the same industry and zero in on the best investment option.

Use of Ratios

- as an absolute standard
- as a comparative indicator
- as a trend over time
- in combination with technical analysis

Financial ratios could help you to pick the best stocks for your portfolio.

7 Financial ratios that one should look at before investing in a Stock

- P/E Ratio
- Price-To-Book value Ratio
- Debt-To- Equity Ratio
- Return on Equity
- Dividend Yield
- Operating Profit Margin
- EV/EBITDA

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Price to Earning (P/E) Ratio

P/E ratio shows how much stock investors are paying for each rupee of earnings. Helps in evaluating whether shares of the company are undervalued/overvalued

$$= \frac{\text{Market price per equity share}}{\text{Earning per share}}$$

- One can know the ideal P/E ratio by comparing the current P/E with the company's historical P/E, the average industry P/E and the market P/E. For instance, a company with a P/E of 15 may seem expensive when compared to its historical P/E, but may be a good buy if the industry P/E is 20.

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Price to Earning (P/E) Ratio

High P/E ratio may indicate that the stock is overpriced.

- A stock with a low P/E may have greater potential for rising.
- P/E ratios should be used in combination with other financial ratios for informed decision making.

Trailing P/E: EPS for the most recent 12 month period divided by number of shares outstanding

Forward P/E:Uses estimated net earnings over next 12 months

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Price to Book Value Ratio

The price-to-book value (P/BV) ratio is used to compare a company's market price to its book value. Book value, in simple terms, is the amount that will remain if the company liquidates its assets and repays all its liabilities.

$$= \frac{\text{Market price per equity share}}{\text{Book Value Per Share}}$$

A P/BV ratio of less than one shows the stock is undervalued (value of assets on the company's books is more than the value the market is assigning to the company)

P/BV ratio values shares of companies with large tangible assets on their balance sheets

Debt to Equity Ratio

This ratio shows how much a company is leveraged, that is, how much debt is involved in the business vis-a-vis promoters' capital (equity).

$$= \frac{\text{Total Debt}}{\text{Equity Capital}}$$

- A low figure is usually considered better. This ratio depends upon the type of business
- If the company's returns are higher than its interest cost, the debt will enhance value. However, if it is not, shareholders will lose

Capital intensive industries such as automobiles & power have higher Debt Equity ratio

Return on Equity Ratio

This ratio measures the return that shareholders get from the business and overall earnings

$$= \frac{\text{PAT} - \text{Preference dividend}}{\text{Net Worth}}$$

Net Worth = Equity Share capital + Reserves and Surplus

- Measures the business success and managerial efficiency
- ROE of 15-20% is generally considered good, though high-growth companies should have a higher ROE.

One would expect "a rise in debt will also reflect in a higher ROE". Because additional profits generated by deploying funds from debt should be more than cost of debt.

Dividend Yield

Amount company pays out in dividends each year relative to its share price

$$= \frac{\text{Annual Dividend Per Share}}{\text{Market Price Per Share}}$$

- Useful by investor interested in dividend income
- higher figure signals that the company is doing well
- a low dividend yield may not always imply a bad investment as companies (particularly at nascent or growth stages) may choose to reinvest all their earnings so that shareholders earn good returns in the long term.

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Operating Profit Margin Ratio

The OPM shows operational efficiency and pricing power. Higher the margin, the better it is for investors.

$$= \frac{\text{Operating Profit}}{\text{Net Sales}}$$

While analyzing a company, one must see whether its OPM has been rising over a period. Investors should also compare OPMs of other companies in the same industry.

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EV/EBITDA

Enterprise value (EV) by EBITDA is often used with the P/E ratio to value a company. It gives a much more accurate takeover valuation because it includes debt.

= EV(Market Capitalization Plus Debt minus Cash

EBITDA (**earnings before interest, tax, depreciation and amortization)**

- EV/EBITDA lower ratio indicates that a company is undervalued.
- This ratio is high for fast-growing industries and low for industries that are growing slowly.
- Stock selection based on EV/EBITDA outperforms P/E and price-to-book value methodologies on a risk-adjusted basis.

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Word of caution regarding ratio analysis

- Usefulness is dependent on accuracy of figures. Audited financial statements are more reliable than unaudited statements

- A single ratio rarely tells enough to make a sound judgment

- Financial statements used in ratio analysis must be from similar points in time.

- Window dressing techniques can make statements and ratios look better.

- Ratios are clues, not bases for immediate conclusion. They merely convey certain observations pointing to the probability of matters needing investigation.

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Thank You

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