Company Analysis:

In company analysis different companies are considered and evaluated from the selected industry so that most attractive company can be identified. Company analysis is also referred to as security analysis in which stock picking activity is done. Different analysts have different approaches of conducting company analysis like

- Value Approach to Investing
- Growth Approach to Investing

Additionally in company analysis, the financial ratios of the companies are analyzed in order to ascertain the category of stock as value stock or growth stock. These ratios include price to book ratio and price-earnings ratio. Other ratios like return on equity etc. can also be analyzed to ascertain the potential company for making investment.

APPLIED VALUATION TECHNIQUES:

Although the raw data of the Financial Statement has some useful information, much more can be understood about the value of a stock by applying a variety of tools to the financial data.

1. Earnings per Share EPS
2. Price to Earnings Ratio P/E
3. Projected Earnings Growth PEG
4. Price to Sales P/S
5. Price to Book P/B
6. Dividend Payout Ratio
7. Dividend Yield
8. Book Value per share
9. Return on Equity

1. Earnings per Share

The overall earnings of a company is not in itself a useful indicator of a stock's worth. Low earnings coupled with low outstanding shares can be more valuable than high earnings with a high number of outstanding shares. Earnings per share is much more useful information than

earnings by itself. Earnings per share (EPS) is calculated by dividing the net earnings by the number of outstanding shares.

EPS = Net Earnings / Outstanding Shares

For example: ABC company had net earnings of $1 million and 100,000 outstanding shares for an EPS of 10 (1,000,000 / 100,000 = 10). This information is useful for comparing two companies in a certain industry but should not be the deciding factor when choosing stocks.

2. Price to Earnings Ratio

The Price to Earnings Ratio (P/E) shows the relationship between stock price and company earnings. It is calculated by dividing the share price by the Earnings per Share.

P/E = Stock Price / EPS

In our example above of ABC company the EPS is 10 so if it has a price per share of $50 the P/E is 5 (50 / 10 = 5). The P/E tells you how many investors are willing to pay for that particular company's earnings. P/E's can be read in a variety of ways. A high P/E could mean that the company is overpriced or it could mean that investors expect the company to continue to grow and generate profits. A low P/E could mean that investors are wary of the company or it could indicate a company that most investors have overlooked.

Either way, further analysis is needed to determine the true value of a particular stock.

3. Projected Earnings Growth Rate-PEG Ratio

A ratio used to determine a stock's value while taking into account earnings growth. The calculation is as follows:

PEG is a widely used indicator of a stock's potential value. It is favoured by many over the price/earnings ratio because it also accounts for growth. Similar to the P/E ratio, a lower PEG means that the stock is more undervalued.

4. Price to Sales Ratio

When a company has no earnings, there are other tools available to help investors judge its worth. New companies in particular often have no earnings, but that does not mean they are bad investments. The Price to Sales ratio (P/S) is a useful tool for judging new companies. It is calculated by dividing the market cap (stock price times number of outstanding shares) by total revenues. An alternate method is to divide current share price by sales per share. P/S indicates the value the market places on sales. The lower the P/S the better the value.

5. Price to Book Ratio

Book value is determined by subtracting liabilities from assets. The value of a growing company will always be more than book value because of the potential for future revenue. The price to

book ratio (P/B) is the value the market places on the book value of the company. It is calculated by dividing the current price per share by the book value per share (book value / number of outstanding shares). It is also known as the "price-equity ratio".

P/B = Share Price / Book Value per Share

6. Dividend Yield

Some investors are looking for stocks that can maximize dividend income. Dividend yield is useful for determining the percentage return a company pays in the form of dividends. It is calculated by dividing the annual dividend per share by the stock's price per share. Usually it is the older, well-established companies that pay a higher percentage, and these companies also usually have a more consistent dividend history than younger companies. Dividend yield is calculated as follows:

7. Dividend payout ratio

Dividend payout ratio is the fraction of net income a firm pays to its stockholders in dividends:

The part of the earnings not paid to investors is left for investment to provide for future earnings growth. Investors seeking high current income and limited capital growth prefer companies with high Dividend payout ratio. However investors seeking capital growth may prefer lower payout ratio because capital gains are taxed at a lower rate. High growth firms in early life generally have low or zero payout ratios. As they mature, they tend to return more of the earnings back to investors. Note that dividend payout ratio is calculated as EPS/DPS.

Calculated as:

The payout ratio provides an idea of how well earnings support the dividend payments. More mature companies tend to have a higher payout ratio. In the U.K. there is a similar ratio, which is known as dividend cover. It is calculated as earnings per share divided by dividends per share.

8. Return on Equity

Return on equity (ROE) is a measure of how much, in earnings a company generates in a time period compared to its shareholders' equity. It is typically calculated on a full-year basis (either the last fiscal year or the last four quarters).
Expanded Definition
When capital is tied up in a business, the owners of the capital want to see a good return on that capital. Looking at profit by itself is meaningless. I mean, if a company earns $1 million in net income, that's okay. But its great if the capital invested to earn that is only $2.5 million (40% return) and terrible if the capital invested is $25 million (4% return).

Return on investment measures how profitable the company is for the owner of the investment. In this case, return on equity measures how profitable the company is for the equity owners, a.k.a. the shareholders.

The "average" is taken over the time period being calculated and is equal to "the sum of the beginning equity balance and the ending equity balance, divided by two."

9. Book Value per Share

A measure used by owners of common shares in a firm to determine the level of safety associated with each individual share after all debts are paid accordingly.

Should the company decide to dissolve, the book value per common indicates the dollar value remaining for common shareholders after all assets are liquidated and all debtors are paid. In simple terms it would be the amount of money that a holder of a common share would get if a company were to liquidate.

Graham and Dodd's Investor ratios

Fundamental investment tactics founded by Benjamin Graham and David Dodd in the 1930s. They wrote about their strategy in a book entitled "Security Analysis." In it, the two advocate that investors should purchase stocks in corporations with undervalued assets because they will eventually reach true market value and give investors a positive return.

Criteria that investors should look for in a company are:

- more current assets than current liabilities,
- all long-term debt, and
- selling at a low price/earnings ratio.

The theory does not take into consideration the potential for earnings growth.
Followers of this approach may also look for stocks selling below their liquidating value.

GRAHAM DODD INVESTOR RATIO:

1. **The strategy of selecting stocks that trade for less than their intrinsic values.**
   Value investors actively seek stocks that are undervalued by the market. Typically, value investors select stocks with lower-than-average price-to-book or price-to- earnings ratios and/or high dividend yields.

2. **The Price to Earnings Ratio (PE ratio) is the primary valuation ratio used by most equity investors.**
   It is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. The Graham & Dodds price-to-earnings ratio, commonly known as CAPE or Shiller P/E, is a valuation measure usually applied to stocks or equity markets. It is defined as price divided by the average of ten years of earnings.

3. Compare prices with average earnings across multiple years (taking into account inflation) to derive a cyclically-adjusted P/E ratio (also known as CAPE).

4. **Value of a share is determined by its present value of its future income.**

Focus on: Operations, Financing and Earnings Models based on : Earnings model [RoI] and Market share Modern Methods: Applied valuation Techniques – Regression and Correlation analysis, Trend analysis, Decision Trees