Analysing a Company

By Michael Kemp

The stock market can be a daunting place for the first time investor. What shares to buy and why? With conflicting advice coming from all directions it can become rather confusing. The best way to sift through all this noise is to develop some sound investment principles of your own. This article explores what to look for before investing those hard-earned dollars.

Financial Health

Investing is not just about chasing good returns. It's also about not losing money. And the chance of losing money is magnified when you invest in companies which are in poor financial shape. There are a number of tools you can use to evaluate a company's financial health. The two below come close to the top of the list:

Debt to Equity Ratio (D/E Ratio)

Companies fund their operations in two main ways. The first is through equity. That is by issuing shares, which is effectively just selling off part of the business. The second is through debt. Debt is fine when economic times are good. But excessive levels can cause problems when business conditions turn sour. Lenders, unlike shareholders, demand payment whatever economic winds are blowing. They usually have the power to wind up a company unable to meet its debt obligations. When this happens lenders usually get their money back with little to nothing left over for shareholders.

So as a potential shareholder you should look for companies that can comfortably service their debt. A useful metric for assessing this is the debt/equity ratio. This is easily calculated. Look to the company's most recent financial report. You will find the information you need in the Statement of Financial Position. The total debt figure is calculated by adding short-term debt (listed under current liabilities) to the long-term debt (listed under non-current liabilities). Debt is likely to be given a fancy name like "interest bearing liabilities". The figure for equity can be found at the bottom of the same statement. It will be listed as "Total Equity". The D/E Ratio is calculated by dividing total debt by total equity.

It is best to invest in companies which own more than they owe. That is they have a D/E ratio less than 1. And while this is a useful rule of thumb there is another important consideration. Companies with reliable revenue streams are better placed to service debt in poor economic times. For example, Coca-Cola Amatil or Woolworths. Companies operating in cyclical business sectors, such as mining or discretionary retail, are worse placed. Their revenue streams are more variable. So if the company you are evaluating is exposed to the vagaries of the economic cycle demand more conservative debt levels (that is, a lower D/E ratio).

Cash Flow

To determine the profitability of a company most investors turn to the Income Statement. But it's important to realize Income Statements are the product of accounting concepts. The figures they contain are based on accounting assumptions, judgments and interpretations. This means they aren't always a true reflection of the cash flowing into or out of a business during the year.

This is an important point. The corporate graveyard is littered with companies which reported a profit in their income statement just before they were put in the hands of the receivers. Cash is king. And there is a way of checking how much cash the business generated during the course of the year. Annual reports contain a Cash Flow Statement. It is split into 3 sections: the cash relating to operating, investing and financing activities. Look for the section headed "Net Cash from Operating Activities". This can be used to check the relevance of the Income Statement.

It's comforting to see reported Net Profit after Tax (from the Income Statement) roughly agree with Net Cash from Operating Activities (from the Cash Flow Statement). Whilst they won't be exactly the same, start asking questions if the reported net profit figure is significantly higher.

Enduring Competitive Advantage

This is an important consideration. Companies that possess an advantage over their competitors often make great investments. For example: Coca-Cola, which has a highly recognised brand name, or BHP, which owns world-class ore deposits. Companies that don't possess a business advantage are more vulnerable to competition. This leaves the playing field wide open to new entrants. As an increasing number of competitors vie for a fixed revenue pie price, wars break out. Profitability for everyone suffers. For a good example think airlines.

Developing an understanding of the company's business helps in making this judgment. Things to look for include the dynamics of the sector, its future prospects, consumer preferences and the threat of new technology. There's no simple way to determine this. It requires some homework.

Company Performance

Earnings Growth

Now that you are starting to gain some comfort your investment dollar will be safe it's time to go to the next step in the analysis. You also want to achieve a good return on your investment. Start by looking for companies with a record of delivering growth in earnings per share. There are 3 important considerations here:

1. Look for a pattern of consistent growth.
2. The growth needs to be sustainable. This is difficult if the company faces an increasing level of competition. Under these circumstances high growth levels (>10% per annum) are unlikely to persist.
3. Other investors are seeking out earnings growth as well. This can inflate the share price. So don't overpay when you find it.

Return on Equity

Shareholders expect management to deliver a good return on the funds tied up in the business. The metric which measures this is Return on Equity (ROE). This, along with the other metrics mentioned in this article, is readily obtainable from broker's reports or websites. Alternatively you can calculate it yourself. ROE is calculated by dividing earnings per share (EPS) by the book value per share for the same period. As a guide it's nice to see a ROE figure consistently higher than 15 per cent.

Many investors new to the share market get confused by this metric. Return on equity does not measure the return on your share purchase. It refers to the return on shareholder's equity. Shareholder's equity represents the value buried in the company net of any debt. Another common term for this is book value. Return on equity measures the return management is achieving on the shareholder's funds it has at its disposal. In a sense it's both a measure of management effectiveness and the profitability of the business sector in which the company is operating.

Valuation

You've now found a financially solid company with good prospects being run by a management skilled at allocating capital. That's still not enough to declare it a buy. A great company can still be a lousy investment if the market is asking too high a price. So before you reach for your broker's phone number it's important to get a handle on what the shares you hope to buy are actually worth.

The biggest trap for unwary investors is to place too much faith in a metric called the PE multiple. It's calculated by dividing the current share price by the most recently reported earnings per share. You will commonly hear it stated that a low PE indicates value. But, this advice is ill founded. There's really only one way around this whole valuation issue. And that's by learning how to put your own price on the shares you are looking to buy. That's too big a topic for this article. But in the absence of further explanation here's a small tip that might help.

Add the dividend yield (annual dividend divided by the current share price) to the annual rate of earnings growth (geometric average for the last several years). If the sum is close to 10 then you are looking at about fair price, but remember this is only a rule of thumb. To become a fully-fledged investor you need to develop your own sense of value.

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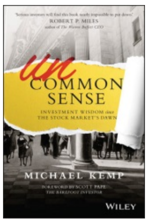

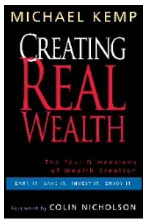

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.