Key Issues in Company Analysis and Stock Valuation

- Differentiation between various types of company stocks
- Earnings per share (EPS) and earnings multiplier
Differentiation between various types of company stocks

• Good companies may be not so good stocks, if expensive (as seen currently). Hence, the need to understand valuations.

• Growth Company Vs. Growth stock
  – Growth company: Returns (risk adjusted) are higher in new projects.
  – Growth stock: is one which outperforms other stocks (rapidly growing earnings).
  – Growth companies growth may be factored in and may give poor returns.

• Defensive Company Vs. Defensive Stock
  – Defensive stock: is one which will not decline as much as overall market declines.

• Cyclical Company Vs. Cyclical Stock
  – Cyclical Company: Earnings follow business cycle. High levels of fixed assets and leverage.
  – Cyclical Stock: Betas > 1. Will outperform market in down & up turns.
Differentiation between various types of company stocks

• Speculative Company Vs. Speculative Stock
  – Speculative Company: Assets are risky with potential for high payoffs. Ex: Diamond miners, oil explorers, Dot Coms etc.
  – Speculative stock is one which is overpriced and has high probability of low returns and low probability of high returns (Ex: Capital goods, RE in India).

• Growth Stock Vs. Value Stock
  – Growth Stock: High earnings growth rate Vs. lower ones. Based on P/E or P/B criteria. Growth firms have high P/Es.
  – Value stocks: have low P/Es, low P/Bs and higher dividend yields.
Earnings per share (EPS) and earnings multiplier

- EPS is arrived at by forecasting the Sales and the profit margin of the company.
  \[ \text{EPS} = \left[ \text{Sales (EBITDA\%)} - \text{Depreciation} - \text{Interest} \right] \times (1 - \text{Tax Rate}) \]

- Two ways to determine appropriate P/E ratio:
  - Macro: Company P/E ratio is estimated by comparing it to industry and market P/E ratios.
  - Micro: Using the formula derived in DDM.
    - Estimate projected dividend payout ratio \((D/E)\)
    - Estimate ROE: \(k = RFR + \beta (R_{\text{market}} - RFR)\)
    - Estimate growth rate: \(g = \text{Retention Rate} \times \text{ROE} \) (Retention rate = 1 - D/E)
    - Estimated P/E = \((D/E)/ (k-g)\)

- CONCLUSION: The intrinsic value arrived at above should be compared with the market price and then a decision should be made whether the stock should be purchased or not...