Stock Investing (Part 2)
Performance Variables and Screeners

Checklist of Performance Variables

Compare these variables below as metrics to other firms in the industry or to the S&P 500.

- 5-year and most recent year \textit{earnings growth}
- Trailing (ttm) and forward \textit{P/E ratios}
  - \textit{PE} is price per share divided by annual earnings
- 5-year and most recent year \textit{sales (revenue) growth}
  - especially for younger, growing companies
- \textit{Debt} relative to size (see ratios in a later slide)
- \textit{Dividend payout rate} (for value candidates)
Using online research sources ...

The Price to Earnings ratio at any moment is the price per share of a stock divided by its annual earnings (ttm), either actual, or the most recent quarter annualized (mrq).

Price to Earnings ratios are a good starting point for evaluating a stock, although not much information can be gleaned from a PE ratio.

High growth companies will typically have PE ratios that are higher, sometimes much higher, than value stocks.

Both trailing and forward (forecast, based upon earnings forecasts) PE ratios should be compared to the industry average. Probably the most useful application of the PE ratio is to determine if the stock is overpriced, yielding a PE that is much higher than the industry average.

Some samples (Sep 12): Intel: 10, Dendreon: none (no earnings), Ford: 2, Bank of America: 10, Target: 15, Exxon Mobile: 10 S&P 500: 14
Earnings, revenues, and earnings and revenue growth

When considering an individual stock earnings will normally matter more than any other variable. But in today’s sophisticated markets static earnings, how much the made last year, is only the starting point. In the eyes of many investors, earnings growth matters much more than the level of earnings. Many investors will prefer and pay a premium (in the form of a higher PE ratio for example) for a company with relatively low earnings per share but high projected growth in those earnings to a company with higher earnings per share but with lower projected earnings growth.

For younger companies, especially in emerging industries with ill-defined markets, sometimes revenue or sales growth matters more than earnings growth. This is because investors will place a high value on a company that is grabbing market share and increasing its share of the market, and especially so if it appears that the company in question might dominate the market. It is assumed that the profits will come later.

Example: GOOG vs. MSFT in 2005

As an example, in 2005, investors seemed to prefer upstart Google over stodgy Microsoft because Google was growing faster than Microsoft. At the end of the year, Google was trading at a PE of about 75 to 1, whereas Microsoft was trading at a PE of less than 25 to 1!

Although Microsoft had an earnings growth rate of 24%, the same for Google was 82%. Probably more important, revenue growth at Microsoft was only 6% compared to Google’s 86%!
Earnings projections, surprises, disappointments

When companies release their quarterly earnings reports, they almost always do so at the end of the business day after markets are closed. If a company makes an earnings announcement that far exceeds or fall short of the consensus earnings estimates made by analysts, the stock can rise or plunge severely, by more than 10% in some cases. Further, the price may exhibit a **discontinuity**, where the price does not smoothly move from the old price to the adjusted price, but instead opens the next morning at a price discretely higher or lower than the old price by many dollars.

Google missed consensus estimates by about 27 cents. This is the reaction. Note the discontinuity.

... and forward-looking statements

Often even though when a company reports quarterly earnings and those earnings meet expectations and are robust, the stock plunges. This may happen because when during the report the company makes a forward-looking statement, they may warn that because of changing business conditions, the same level of earnings growth is not expected to continue. And the opposite can happen when a report is unexpectedly optimistic.

Cisco shares fell $1.84, or 8 percent, to $21.24 in after-hours trading after the company posted second-quarter results that matched Wall Street’s subdued expectations but gave disappointing guidance. Excluding one-time charges, Cisco made a profit of 38 cents per share, matching the figure predicted by analysts polled by Thomson Financial.

yahoo news release 2/7/08
Debt and Liquidity Ratios

You should always check a company’s debt position by at least looking at its liquidity debt/equity ratio, which is the ratio of the company's total debt to its shareholder equity. A D/E ratio above 100% is high, 200% very high. For example, Hertz's (HTZ) debt-to-equity ratio is 550%, whereas Intel's is only 14% and Apple’s is zero! (Sep 2012).

A company may have a high D/E ratio if it is growing through acquisition, which is generally acceptable if the acquisition is working.

If a company has a D/E ratio above 2, then the company's credit and bond ratings should be checked through Standard and Poors. A downgrade of a credit or bond rating can very adversely affect a stock's price.

Another liquidity ratios is current ratio, the ratio of current assets to current liabilities, which should be a high number, at least above 1. This is a rough measure of a company’s near term capacity to pay bills and dividends without borrowing.

Cramer: Why Walgreen is "cheaper" than Rite Aid

The debt-to-equity (DE) ratio is determined by dividing total debt by shareholder's equity on the balance sheet. Average for the industry (drug stores) is 0.30. Data are from February 7, 2008

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<thead>
<tr>
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<th>RAD</th>
<th>WAG</th>
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<tbody>
<tr>
<td>Price</td>
<td>2.73</td>
<td>34.54</td>
</tr>
<tr>
<td>EPS</td>
<td>-0.22</td>
<td>2.06</td>
</tr>
<tr>
<td>PE</td>
<td>N/A</td>
<td>16.77</td>
</tr>
<tr>
<td>DE</td>
<td>2.29</td>
<td>0.10</td>
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Even if RAD was making a small profit, say $0.05 per share, its PE would be 55 (at that price). And it is making a loss. Industry average is about 20, so WAG is cheap. More important, because of an earlier leveraged buyout, RAD was choking on $5.4 b of debt. In their previous reporting quarter ending December 1, 2007, they were running an operating loss of $21m, but had to add an interest expense to that of $130m.
More questions to ask

- Does this company grow by M&A?
  - Will be a hi-growth candidate with heavy debt

- Is this company a possible takeover target?
  - Stock will pop on takeover announcement

- How do analysts rank this stock?
  - This ranking can be seen on any good financial website (such as yahoo)
  - IMHO not all that reliable

Using stock screeners to seek …

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Min</th>
<th>Company Distribution</th>
<th>Max</th>
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<tbody>
<tr>
<td>Market cap</td>
<td>275M</td>
<td></td>
<td>800M</td>
</tr>
<tr>
<td>P/E ratio</td>
<td>6</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>Dividend (%)</td>
<td>3</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Last price</td>
<td>5</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>5y EPS growth rate</td>
<td>6</td>
<td></td>
<td>20</td>
</tr>
</tbody>
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This is a sample … only 5 stocks (CPSI) fit these criteria (9/2010). See the homework where you are being asked to do this …