Basic Investment Course

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Unit 4: What shares should I buy?

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4.1 Fundamental analysis: Industry and market sector analysis

4.1.1. Introduction

There is no right or wrong strategy in investment – only good timing and good share selection, and bad timing and bad share selection. Blind faith in one theory and dismissal of another is neither a sensible nor profitable strategy for all but the very lucky. Usually it is best to consider blending what is known as the top-down and bottom-up approaches to share valuation. Doing this will give you a better chance of knowing what shares to buy!

The top-down approach to share valuation is when we look at all the broad economic and political factors first before we look at a specific company. The bottom-up approach is when we look at the company's figures in detail. It is important that we first look at broad factors such as economy and sectors before we look at a specific company.

In this unit we introduce you to the basics of how to value shares and companies and to do this we look at markets, sectors and industries and the different types of shares available to us for investment.

4.1.2. The top-down approach to share valuation

To determine the value of a particular company, you must pay close attention to its operating environment as well as the operating strategy and performance of the company. The state of the global and South African economies, events in the political arena and changes in an industry sector can have profound effects on individual companies, over which they have no control. In buoyant markets all shares may rise, like a rising tide will float all ships, and the inverse is also true in a falling market.

You might think that a company has a good product and strong marketing strategy. But is this enough to ensure growth in the company's earnings? As an example of how an outside event can affect a company, consider the following:

The expansion of the Internet has brought with it fundamental changes in the way some industries operate. In particular, the Internet is increasingly used to provide financial services such as banking facilities and equity broking services. How is the company you are considering investing in, equipped to deal with the opportunities and challenges associated with the continued shift towards electronic commerce?

The key point from this example is that in analysing the outlook for a company's share price it is necessary to consider a wide range of factors that will impact on the company's current and future earnings. Some of these factors are 'internal' to the company in the sense that they are directly subject to the company's control. Examples of internal factors include management capability, marketing strategies and new product development.

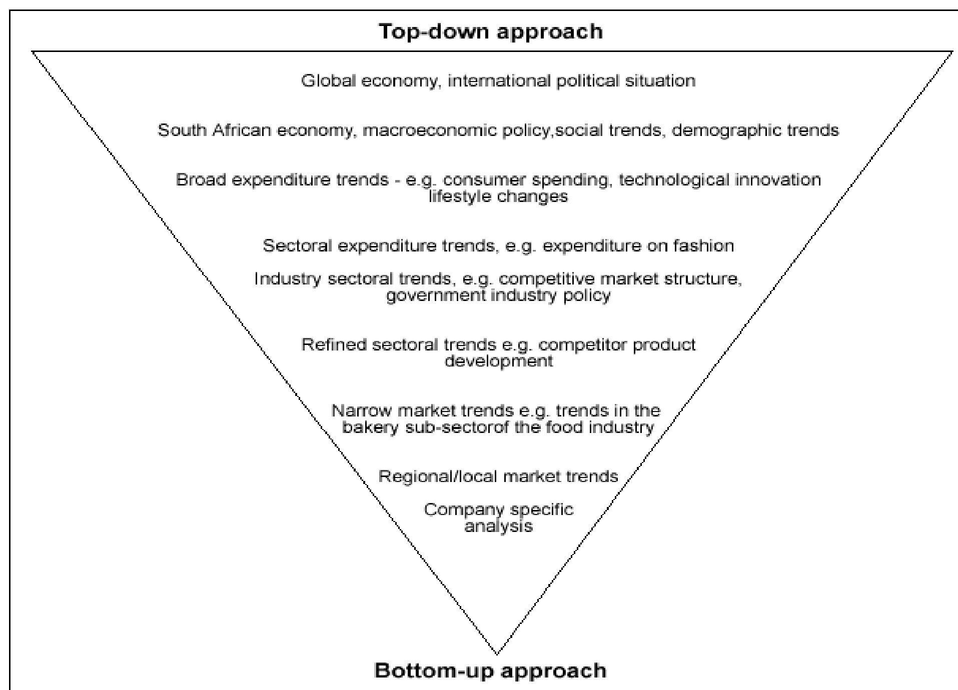
However there are many factors that will affect a company's earnings performance that are largely 'external' to the company in the sense that the management of the company has little or no control over them. Some of these factors may be broad developments that impact across the economy, such as the rate of economic growth, the level of interest rates, exchange rates and government fiscal policy.

Taking a top-down approach to analysing a company's prospects involves looking first at the broad macroeconomic, social and political environment. The focus of analysis is then progressively narrowed to consider the more industry specific or even regional influences on a company's earnings. This pattern of analysis has the benefit of ensuring that relevant information is included in a consistent way.

This also makes sure that important background information is fully taken into account so that the interactions between broad macro-economic conditions and more industry specific factors will be highlighted.

The diagram below shows the process of a top-down approach to share analysis and illustrates the narrowing focus.

In undertaking a top-down analysis it is also useful to consider alternative scenarios – for example, incorporating different assumptions about economic conditions, and what these different scenarios might mean for the performance of a particular company.



One point to remember is that equity market prices are largely a reflection of investor expectations of future company earnings. In other words, the prevailing share price for a company already factors in what investors are thinking about future economic conditions and company performance against this background. However, investor expectations are not stable; they constantly shift as new information becomes available. As investor expectations change so will the share price.

Share prices are very sensitive to whether investor expectations for the economy or company are realised. For this reason, share prices can sometimes appear to move differently to what might be expected. For example, a company might announce a

12% increase in profits. This would seem to be good news. However, if investors thought increased sales would increase the company's profits by 22%, these expectations would have been disappointed. If investors then lower their expectations for the company's future earnings, the company's share price might fall.

4.1.3. International economic and political climate

Trends in the international economy can have important direct and indirect effects on the South African economy and South African companies. For companies with overseas operations or trade links with other countries, the impact of overseas developments can be very direct. However, even companies with only domestic operations can still be affected by global developments. As a small economy, South Africa's economic prospects are often affected by global influences through a wide range of economic and financial linkages. However, try not to over-react to short-term events. While they may have an immediate impact on markets, the long-term trends in major overseas economies are much more worthy of attention.

Keeping track of the global economy and predicting how the global economy will develop are obviously very difficult tasks, particularly as circumstances can change very quickly. However there is a great deal of useful information available. The research departments of banks and share brokers may provide regular publications that incorporate information on international economic developments. Newspapers and magazines are other useful information sources.

4.1.4. The South African economy

South African economic conditions will often be an important influence on corporate performance.

Some of the many ***broad economic factors*** that may impact on a company include the rate of economic growth, the rate of inflation, the rate of employment growth, the level of interest rates, the exchange rate and the various arms of government economic policy.

We discuss this in greater detail in unit 5.

The key pieces of data to monitor are the following economic statistics:

- Gross domestic product (GDP)
- Unemployment
- Inflation
- The South African Rand exchange rate
- The balance of payments
- The current account deficit
- Interest rates

It is also necessary to monitor a range of other factors relating to specific sectors. While this might seem daunting, you don't have to be an economist to analyse this data. In fact, it may help not to be one. You are merely looking to identify an overall trend and make a judgement on its impact on market sentiment – you're not analysing what happened last year or prescribing solutions for economic problems. You can access this information on www.securities.co.za.

It is also important to think about how you should adapt your investment strategy to take advantage of changes in the South African economy.

4.1.5. The top-down approach to market sectors

Having developed an understanding of factors that will impact on broad economic conditions, it is useful to narrow the analysis and begin focusing on trends in different sectors of the economy. Different sectors of the economy do not grow evenly. The performance of individual sectors depends on a wide range of factors peculiar to that sector's output.

For example, trends in the residential construction sectors are affected by employment and household income (which affects the ability of people to buy houses), demographic factors, the level of rents, the level of mortgage interest rates, and the attitude of investors towards property.

Structural factors can also cause the performance of different sectors of the economy to diverge markedly over time. The communications sector grew very strongly over the past decade influenced by structural shifts in technology. However – note that strong growth in sectoral activity does not always equate to strong corporate earnings. Competition can be vigorous in strongly growing segments of the economy.

4.1.5.1. Share sectors

A sector is a group of companies that loosely belong to the same industry and provide the same product or service. Examples of share sectors include airlines, software, chemicals, oil, retail, automobiles, and pharmaceuticals, to name just a few. Understanding sectors is important if you want to make money in the share market. The reason is simple: No matter how the market is doing and no matter what the condition of the economy, there are always sectors that are doing well and sectors that are struggling.

For example, during the recent bear market, the IT sector was going down on a regular basis.

Some professional traders shift their money into and out of sectors every day. Once they identify the strongest sectors for the day, they pick what they think is the most profitable share in each of these sectors. Like anything connected to the share market, shifting in and out of sectors sounds easier on paper than it is in real life. It is always easier to look in the rear-view mirror to figure out what sectors were most profitable.

It’s very easy for me to say that you should have shifted out of IT in March 2000 and moved into the housing sector. But now, right now, how confident are you that housing shares will continue to go up in price? It’s a lot harder to pick successful sectors than many people think. Nevertheless it is worth taking the time to understand and identify the various sectors and to be aware of which sectors are strong and which are weak. This could give you a clue as to where the economy is headed.

4.1.5.2. Categories

From a share standpoint, the following main categories stand out:

- Blue chips
- Growth shares
- Income shares
- Value shares
- Cyclical shares
- Smaller companies
- Penny shares
- Commodity shares
- Unit trusts
- Exchange traded funds

Let's consider each of these categories separately and look at their characteristics.

Blue chips

They are called blue chip because they are supposed to be the most valuable in the casino. These are large, financially solid companies that have been around for years and their shares are widely held by both professional and private investors. They may be household names like Standard Bank or Pick n Pay, or more obscure industrial companies such as Richemont and Bidvest. No investor is going to go radically wrong buying them for the long term, but equally their performance is unlikely to be racy and, there can be surprises.

Growth shares

Often more highly prized by investors, these are companies that have managed to produce consistent above-average growth in revenue and profits for several years, and look likely to continue to do so. The reason is usually good management

methods or else a strong presence in a growing market. Ultimately companies like this can end up being blue chips.

Examples include:

- Spar
- Lewis Stores
- Peermont

Income shares

We have spoken about investing for income earlier on and to do this, you would buy income shares.

Income shares are those whose price may be unexciting but which continue to pay out generous dividends and as a result yield very good returns to investors. Provided that companies like this have sound finances, the high dividend stream can continue for years. Companies of this type are usually conservatively managed, operating in mature industries that generate cash.

Examples include:

- Hiprop
- Redefine
- Standard Bank, Investec, Nedbank and FNB preference shares

Value shares

Value shares are shares of profitable companies that are selling at a reasonable price compared with their true worth, or value. The trick, of course, is determining what a company is really worth – what investors call its intrinsic value. Some low-priced shares that seem like bargains are low-priced for a reason.

Value shares are often those old-fashioned companies, such as insurance companies and banks, e.g. Standard Bank, that are likely to increase in price in the future, even if not as quickly as other shares. It takes a lot of research to find a

company whose price is a bargain compared to its value. Investors who are attracted to value shares have a number of fundamental tools (e.g. P/E ratios), which are discussed later in the chapter, that they use to find these bargain shares.

Cyclical shares

These are shares in companies whose fortunes are tied closely to the economic cycle. These companies normally show large swings in profitability and are valued accordingly by the market. E.g. Edgars.

Smaller company shares

Smaller companies can be the most exciting part of the market, since there is always the possibility of investing early on in a company that may become a growth share or blue chip of tomorrow. When investing in smaller companies, one needs to pay particularly close attention to the quality of the company's management, and whether or not the company really has a unique selling point or a novel new product. In addition, smaller company shares often need to be given time to mature for their full share price potential to be realised. Though smaller company shares tend to perform better than their larger brethren, in down phases of the market they can sometimes be poor investments.

Examples include:

- Astrapak
- Brait
- Bell
- Comair

Penny shares

Penny shares are those priced at fractions of a Rand, say 20c or less. They may be shares whose price reflects concern about their financial position, or simply companies that have gone out of favour with investors, or where profits are currently

at a low level. Although there are big gains sometimes to be had in penny shares, they require very careful investigation and can be risky.

Examples of penny shares include:

- Siltek
- Moneyweb
- Beige
- Corpcapital
- Spescom

Commodity shares

These are investments in companies whose profits and therefore share price is dependent on the value of a particular commodity, such as gold or oil. Often in extractive industries like mining or oil exploration, or else in primary produce like wheat or other agricultural crops, the prices of commodity shares move at a variance with the rest of the share market and tend to do best in the later stages of a share market cycle when economic activity is strong.

Examples include:

- Anglo American
- BHP BiIlliton
- Sasol

Unit Trusts and Exchange Traded Funds are covered in a later chapter.

4.1.6. Porter's 'five forces' analysis

A useful tool for analysing the outlook for an equities sector is to use the Porter 'five forces' framework. This identifies the five underlying factors determining future profitability, which are:

1) **Rivalry among the existing competitors –** This is competition between companies that already exist in the marketplace. Increased rivalry among the existing players in the market increases competition.
2) **Threat of new entrants –** If there is an increased likelihood of firms entering the industry this will increase competition. Various factors such as high barriers to entry and large economies of scale will decrease the threat of new entrants.
3) **Threat of substitute products –** The greater the threat of substitute products the higher the competition.
4) **Bargaining power of buyers –** If buyers are able to bid down prices or demand higher quality products this increases competition among competitors.
5) **Bargaining power of suppliers –** The fewer the number of suppliers, the greater their bargaining powers and the greater the competition.

In a more advanced course, we discuss in detail how to use the framework in real-life situations.

4.1.7. Delving deeper into understanding industries and share sectors

We have discussed the need to investigate industries and sectors (discussed below) in the process of share valuation and the top-down approach. Let's look a little closer at the questions we need to ask when investigating an industry.

Suppose that you have to bet your entire nest egg on a one-kilometre race. All you need to do is select a winning group. These are your choices:

- A group of thoroughbred race horses
- A group of overweight Elvis impersonators
- A group of lethargic snails

The obvious choice is the thoroughbred racehorses.

Fortunately, this is where the comparison to share investing ends. You don't have to choose the absolute winner because there are lots of winning shares in second

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place, too. The basic point is that you can increase your odds of winning when you choose a winning industry group as part of your strategy. In the race to build wealth, all you need do is to pick decent shares in a decent industry and do so on a long-term basis in a disciplined manner.

As mentioned above, a successful long-term investor looks at the industry just as carefully as he looks at the individual share.

The important questions to ask yourself when you're choosing an industry are:

- Is the industry growing? – The saying " the trend is your friend" applies when choosing an industry in which to invest, as long as the trend is an upward one. If you look at three different shares that are equal in every significant way but you find that share A is in an industry growing 15% per year while the other two industries have either little growth or are shrinking, which share would you choose?
- Are the industry's products or services in demand? – Look at the products and services that an industry provides. Do they look like things that society will continue to want? Are products and services on the horizon that could replace them? Does the industry face a danger of going out of fashion?
- What does the industry's growth rely on? - Does the industry rely on an established megatrend, or on factors that are losing relevance?
- Is this industry dependent on another industry? When one industry suffers, you may find it helpful to understand which industries will subsequently suffer.
- Who are the leading companies in the industry? - Once you have chosen the industry, you can choose from two basic companies, namely established leaders, which is a safe way to go or innovators, which have more potential.
- Is the industry a target of government action? – Intervention by politicians and bureaucrats can have an impact on an industry's economic situation.

Which category does the industry fall into? – Most industries normally fall into two categories, namely cyclical and defensive. This translates into what society wants and what it needs. Society buys what it needs in both good and bad times. It buys what it wants when times are good and holds off when times are bad. Cyclical industries are those whose fortunes rise and fall with the economy's rise and fall.

Defensive industries are those that produce goods and services that are needed no matter what's happening in the economy.

4.2. Fundamental analysis: Individual company analysis

4.2.1. The bottom-up approach

Now that you know where the economy/market is situated and where you think it is going, comes the hard decision – which shares should you buy? Although every part of the investment decision-making process is important, this part is crucial because it is your share-selection that will ultimately determine your performance relative to the rest of the market.

A very common question is, 'How many different shares should I have in my portfolio?' The answer is, 'As many as you like' – provided you are capable of keeping track of all your shares online.

Extensive research shows that if you own only one or two shares, your portfolio is likely to experience an extreme level of volatility (up and down movement) relative to the rest of the market. The volatility declines steadily, however, as the number of shares you hold increases. But be careful – if you spread your investments too widely, the performance of your portfolio will begin to mimic that of the index, which you should be hoping to outperform.

If you do just want to pick cycles using a top-down approach, you should restrict your investment to entering and exiting exchange traded funds (ETFs) that are index-weighted – that is, they have the same composition as, for example, the Alsi 40 and Satrix 40. As a portfolio that mimics the index would be unwieldy and very time-consuming to manage, the Satrix 40 is a very useful way of achieving diversity and ensuring that at least part of your portfolio performs in line with the market.

As a private investor, however, you will not be measuring your performance against a benchmark or have to weight your portfolio in the same manner as a fund

manager. Therefore, you can select or ignore a sector as you wish, depending on your view of its future performance.

Analysing individual companies

If you do decide to directly invest all or some of your funds into shares, you will also need to analyse the specific shares in which you are thinking of investing. The bottom-up approach of share analysis begins with the narrow focus of the individual merits of a particular company and then expands to look at the sector, the market and the economy.

The analysis of an individual company has 2 components:

- the ‘story’ – for example, what the company does and what its outlook is;
- the ‘numbers’ – for example, the financials of the company, statement of financial position and ratio analysis.

Unfortunately, the statement of financial position and ratio analysis is probably the most daunting part of fundamental analysis for non-professional investors, with a large number of numerical techniques appearing to be used. However, you can make it less painful by adopting a methodical approach and always remembering that behind all the numbers is a real business run by real people producing real goods and services – this is the part we call ‘the story’.

As it is unlikely that you will need to do the number crunching for every company, your time will be more profitably spent developing the company story. The mechanical statement of financial position and ratio analyses, both historical and forecast, can be obtained from data available online.

While doing the work on the historical numbers will confer you no advantage – it is already ‘priced in’ to the market – it is very important that you understand how the numbers are arrived at and what they actually mean.

In this course we introduce you to some of the very important numbers and ratios that you should be able to calculate and understand.

4.2.2. Company fundamentals

When you hear the word fundamentals in the world of share investing, that refers to the company's financial condition and related data. When investors do fundamental analysis, they look at the company's fundamentals – its balance sheet, income statement, cash flow, and other operational data, along with external factors as discussed above. Essentially the fundamentals should indicate to you that the company is in a strong financial condition.

There are several reasons to buy shares in companies that are in a healthy financial condition including:

- Greater survivability during bad times: Companies that have good earnings and sales and low debt are in stronger shape than companies that don't (duh!). When flash-in-the-pan growth shares hit bad times, they wither and die.
- Takeover money to build strength: A strong financial position gives a company the ability to make purchases that can further the company's strength. This can be something as simple as equipment or as complex as the acquisition of another company.
- Marketing opportunities to ensure continued success.

The management of a company

The management of a company is crucial to success. How would you know whether management is running the company properly? The best way is to check the numbers. You will see that if the company's management is running the business well, the ultimate result is a rising share price.

Return on equity

Although you can measure how well management is doing in several ways, you can take a quick snapshot of a management team's competence by checking the company's return on equity (ROE). ROE is very useful to see whether the company is using its equity (or net assets) efficiently and profitably. The ROE is best

expressed in the following table illustrating the balance sheet of hypothetical company Modsquad Inc.

Table 1:

	Balance Sheet	Balance Sheet
Modsquad, Inc	December 1, 2003	December 1, 2004
Total assets (TA)	R55,000	R65,000
Total liabilities (TL)	-R20,000	-R25,000
Equity (TA less TL	R35,000	R40,000

The idea is to look at the company's equity and relate it to its earnings.

Table 2:

	Income Statement	Income Statement
Modsquad, Inc	Year 2003	Year 2004
Sales	R82,000	R90,000
Expenses	-R75,000	-R78,000
Net earnings	R7,000	R12,000

In the first table, you can see that Modsquad, Inc., increased the equity from R35,000 to R40,000 in one year. The second table shows that its earnings went from R7,000 to R12,000. The ROE for the year 2003 is 20% (R7,000 in earnings divided by R35,000 in equity), which is a solid number. The following year, the ROE was 30% (R12,000/R40,000). For ROE, the higher the number, the better. Any number higher than 10-15% is good, and Modsquad, Inc's management is sprouting some great numbers.

Equity and earnings growth

Two additional barometers of success are a company's growth of equity and growth in earnings. In the first table, Modsquad, Inc's equity grew by R5,000 (from R35,000 to R40,000), or 14%, which is very good. Also, look at the growth in earnings (in the second table). The earnings grew from R7,000 to R12,000, or a percentage increase of 71% (R12,000 less R7,000 is R5,000 and R5,000/R7,000 = 71%), which is excellent –management is doing good things here.

What you must bear in mind when analysing and valuing a company is that a company's financial situation does change and that a diligent investor continues to look at the numbers for as long as the share is in their portfolio.

So let's begin at the beginning with some basic accounting revision and an analysis of turnover, growth and return on equity.

4.2.3. Understanding basic accounting

As share investors, you need to pick up some rudimentary knowledge of accounting to round out your share-picking prowess and to be sure that you're getting good value for your investment. Accounting is the language of business. If you don't understand basic accounting, then you'll have difficulty being a successful investor. Investing without knowledge is like travelling without a map. However, if you can run a household budget, using accounting analysis to evaluate shares will be easier than you think.

So, before we begin looking at ratios and some of the key numbers, let us have a quick revision of basic accounting concepts.

The balance sheet

A company's balance sheet gives you a financial snapshot of what the company looks like in terms of the following equation:

Assets – liabilities = net worth

By looking at a company's balance sheet, you can address the following questions:

- What does the company own (assets)? The company can own assets, which can be financial, tangible, and/or intangible. Assets can be anything that has value or that can be converted to or sold for cash. Financial assets can be cash, investments, or accounts receivable. Assets can be tangible things such as share, equipment, and/or buildings. They can also be intangible such as licenses, trademarks, or copyrights.
- What does the company owe (liabilities)? Liabilities are anything of value that the company must ultimately pay to someone else. Liabilities can be invoices (accounts payable) or short-term or long-term debt.
- What is the company's net equity (net worth)? After you subtract the liabilities from the assets, the remainder is called either net worth, net equity; or net shareholders' equity.

Once you understand the basics, you need to compare the company's balance sheet at a recent point in time to a past time. You should do this comparative analysis with all the key items on the balance sheet. You do this to see the company's progress. Is it growing its assets and/or shrinking its debt? Most importantly, is the company's net worth growing? Is it growing by at least 10-15% from a year ago? All too often, investors stop doing their homework after they make an initial investment. You should continue to look at the company's numbers on a regular basis so that you can be ahead of the curve. If the company starts to have problems, you can get out before the rest of the market starts getting out, which will cause the share price to fall.

To judge the financial strength of a company, ask yourself the following questions:

- Are the company's assets greater in value than they were six months ago, a year ago, or two years ago? Compare current asset size to the most recent two years to make sure that the company is growing in size and financial strength.
- How do the individual items compare with prior periods? Some particular assets that you should take note of are cash, share, and accounts receivable.

- Are liabilities such as accounts payable and debt about the same or lower or higher compared to prior periods? Are they growing at a similar, faster, or slower rate than the company's assets? Remember that debt that rises faster and higher than items on the other side of the balance sheet is a warning sign of pending financial problems.
- Is the company's net worth or equity greater than the previous year? And is that year greater than the year before? In a healthy company, the net worth should be constantly rising. As a general rule, net worth should be at least 10-15% higher than the previous year.

The income statement

Where do you look if you want to find out what a company's profit is? Check out the company's income statement. It reports in detail a simple accounting equation that you probably already know:

Sales – expenses = net profit (or net earnings or net income)

Looking at the income statement, an investor can try to answer the following questions:

- What sales did the company make? Companies sell products and services that generate revenue.
- What expenses did the company occur? In generating sales, companies pay expenses such as salaries, rates, advertising, administration, and so on.
- What is the net income? Also called earnings, or net profit, net income is the bottom line. After paying for all expenses, what profit did the company make?

The information you glean should give you a strong idea about the company's current financial strength and whether or not it's successfully increasing sales, holding down expenses and ultimately maintaining profitability. We discuss this in more detail below.

Sales (Turnover)

Sales refers to the money that a company receives as customers buy its goods and/or services. It is a simple item on the income statement and a useful number to look at. Analysing a company by looking at its sales is called top line analysis.

As an investor you should take into account the following points about sales:

- Sales should be increasing. A healthy, growing company has growing sales. They should grow at least 10-15% from the prior year, and you should look at the most recent three years.
- Core sales (sales of those products or services that the company specialises in) should be increasing. Frequently, the sales figure has a lot of stuff lumped into it. Maybe the company sells software, but the core sales number may also include other things, such as the sale of a building or other unusual item. Take a close look. Isolate the company's primary offerings and ask whether these sales are growing at a reasonable rate (such as 10-15%)
- Are there odd items or odd ways of calculating sales?

If you want to get a good clue whether a company is artificially boosting sales, check the company's accounts receivable (an asset in the balance sheet). Accounts receivable is the money owed to a company for goods that customers have purchased on credit. If you find out that sales went up by R10 million (great!) but accounts receivable went up by R20 million (uh-oh), then something is just not right.

Expenses

What a company spends has a direct relationship on its profitability. If spending isn't controlled or held at a sustainable level, it could spell trouble for a company.

When you look at a company's expense items, consider the following:

- Compare expense items of the prior period. Are expenses higher, lower, or about the same from the prior period? If there is a significant difference, you should see the commensurate benefits elsewhere. In other words, if overall

expenses are 10% higher compared to the prior period, are sales at least 10% more during the same period?

- Are some expenses too high? Look at the individual expense items. Are they significantly higher than the year before? If so, why?
- Have any unusual items been expenses? Sometimes an unusual expense isn't necessarily a negative. Expenses may be higher than usual if a company writes off uncollectible accounts receivable as bad debt expense. Doing so inflates the total expenses and subsequently results in lower earnings. Pay attention to non-recurring charges that show up on the income statement and determine whether they make sense.

Profit

Profit is for a company what oxygen is to you and me. That's neither good nor bad; it just is. Without profit, a company can't survive, much less thrive. Without profit, it can't provide jobs, pay taxes, and invest in new products, equipment, or innovation. Without profit, the company eventually goes bankrupt, and the value of its share evaporates.

Earnings or profit is the single most important item on the income statement. It's also the one that receives the most attention in the financial media. When a company makes a profit, it's usually reported as earnings per share (EPS). We discuss EPS (earnings per share) in great detail later on.

A good tip is that you must not simply look at current earnings as an isolated figure. Always compare current earnings to earnings in past periods (usually a year). In other words, compare apples with apples.

A strong company should show consistent growth from a period before, and you should check the period before that, too, so that you can determine whether earnings are consistently rising over time. Earnings growth is an important barometer of the company's potential growth and bodes well for the share price.

When you look at earnings, here are some things to consider:

- Total earnings: This is the most watched item. Total earnings should grow year to year by at least 10-15%.
- Operational earnings: Break down the total earnings and look at a key subset – that portion of earnings derived from the company's core activity. Is the company continuing to make money from its primary goods and services?
- Non-recurring items: Are earnings higher or lower than usual or than expected and why? Frequently, the difference results from items such as the sale of an asset or a large depreciation write-off.

Okay, so now you are familiar with the sort of accounting knowledge needed and the types of questions to ask, and what to look out for when analysing a company's fundamentals.

4.2.4. Recognising value when you see it

If you pick a share based on the value of the company that is issuing the share, you're a value investor – an investor who looks at a company's value and judges whether he can purchase the share at a good price. (Is the share price a fair representation of the company's value?) Value investors analyse a company's fundamentals (earnings, assets, and so on) and buy the share if the price is low relative to these factors.

When you look at determining the value of a company, as stated above the most important items to consider are:

- The balance sheet to figure out the company's net worth
- The income statement to figure out the company's profitability
- Ratios that let you analyse just how well (or not so well) the company is doing

A value investor doesn't buy a company's share because it's cheap; he/she buys it because it is undervalued (the company is worth more than the price its share reflects – its market value is less than its book value).

The heart of a company's value, besides its net worth, is its ability to generate profit.

Companies have values the same way many things have value, such as eggs. And there is such a thing as a fair price to buy them at, too. Eggs, for example, have value. You can eat them and have a tasty treat while getting nutrition as well. But would you buy an egg for R1,000 (and, no, you're not a starving millionaire on a desert island?) No, of course not. But what if you could buy an egg for 5 cents? At that point it has value and a good price. This kind of deal is a value investor's dream.

Market value

When you hear someone quoting a share at R47 per share, the price reflects the share's market value. The total market valuation of a company's share is referred to as the market capitalisation as discussed early on in this course.

The problem with market valuation is that it is not always a good indicator of a good investment. In recent years, plenty of companies have had astronomical market values, yet they proved to be terrible companies and subsequently terrible investments. Often investors and analysts misunderstand the difference between the fleeting market value of the share and the true value of the underlying company.

Book value

Book value looks at a company from a balance sheet perspective (assets minus liabilities equals net worth or shareholder's equity). It's a way of judging a company by its net worth to see whether the share's market value is reasonable compared to the company's intrinsic value. The closer the share's market value is to the book value, the safer the investment. Remember that you never base a share investing decision on just one criterion such as book value.

Earnings and sales value

A company's intrinsic value is directly tied to its ability to make money. In that case, many analysts like to value shares from the perspective of the company's income statement. A common barometer of value, which we learn about next, expressed in a

ratio, is the price to earnings ratio. The price is a reference to the company's market value (as reflected in its share price). Earnings are referenced to the company's ability to make money.

4.3. Determining the value of a company

4.3.1. Introduction

Choosing the right shares to invest in can seem like a combination of art, luck, timing, and science. It may seem like there is no rhyme or reason to it. When you talk to the so-called experts, you get all sorts of opinions, which frequently are contradictory. You may hear about someone's "successful system" or see a book titled *Make a fortune in the Share Market.* Then you read the horror stories of people who lost a fortune on share investing. Does any approach work with some consistency? What's an investor to do?

The most tried-and-true method for picking a good share starts with picking a good company. This is why you will need to know how to determine the value of the company. Don't rely on luck to help you choose good shares: good old-fashioned homework, research, and common sense are your best diagnostic tools. What constitutes a good company? And just what is a good price? (It is important here to determine the way in which an individual determines the value of a company as opposed to the market i.e. demand and supply, which we discuss later on in more detail)

4.3.2. Earnings per share

Earnings per share is simply the earnings or profit a company achieves per share.

In other words, if a company has earnings of R1,000,000 and 100,000 shares, the earnings per share would be R10.

The earnings per share is an extremely important ratio because it indicates how profitable a company has been.

It is used to measure the performance of a company as well as the value of a company.

It is also a key input into the price earnings ratio, which we discuss below.

The **growth** of a company's earnings per share is an important indicator of how well the company is doing. When making a decision about what share to buy, a company that has experienced growth in its earnings per share each year is a company you are more likely to invest in than one that has never achieved growth.

The earnings per share of all companies is shown on the Standard Bank website (www.securities.co.za). It is important you look at this carefully before making a decision as to which shares to purchase.

We have discussed above the importance of the earnings of a company. We look now at the mechanics of computing the basic earnings per share of a company.

Earnings per share is simply the earnings or profit you make on each share you own in a company.

In order to calculate earnings per share we need the following:

- Net income (last line of income statement)
- Number of shares outstanding

How to calculate earnings per share (EPS)

The formula to calculate EPS is as follows:

EPS = Net income/shares

The calculation of the earnings figure

Earnings in the definition of earnings per share is the earnings attributable to the ordinary shares holders. As a result, preference dividends are first deducted from net income and then the profit left after this is earnings.

Illustrative Example

A company reflects the following information on its Income Statement:

Net income before taxation	R10,000,000
Taxation	R2,900,000
Ordinary dividends	R500,000

The company has 5,000,000 issued shares.

Compute the company's earnings per share:

Earnings = net income after taxation and preference dividends
= 10,000,000 – 2,900,000
= 7,100,000

Earnings per share = 7,100,000/5,000,000 = R1,42

We use the EPS figure to determine the P/E ratio and it is used extensively to compare one share with another to determine value.

4.3.3. The P/E ratio

A ratio is a helpful numerical tool that you can use to find out the relationship between two or more figures found in the company's financial data. A ratio can add meaning to a number or put it in perspective. Ratios sound complicated, but they're easier to understand than you think.

Say that you're considering a share investment and the company you're looking at has earnings of R1 million this year. You may think that's a nice profit, but in order for this amount to be meaningful, you have to compare it to something. What if you find out that the other companies in the industry (of similar size and scope) had earnings of R500 million? Would that change your thinking? Or what if you found out the same company had earnings of R75 million in the prior period? Would that change your mind?

The key ratio to be aware of is the Price to earnings ratio (P/E).

P/E ratio

The P/E ratio is the reciprocal or inverse of Earnings per share (EPS).

The price to earnings (P/E) ratio is very important in analysing a potential share investment because it's one of the most widely regarded barometers of a company's value, and it's usually reported along with the company's share price in the financial page listing. The major significance of the P/E ratio is that it establishes a direct relationship between the bottom line of a company's operations – the earnings – and the share price.

The P in P/E stands for the share's current price. The E is for earnings per share. The P/E ratio is also referred to as the "earnings multiple" or just "multiple."

The P/E ratio is calculated by dividing the price of the share by the earnings per share. If the price of a single share of share is R10 and the earnings (on a per-share basis) is R1, then the P/E ratio is 10. If the share price goes to R35 per share and the earnings are unchanged, then the P/E is 35. Basically, the higher the P/E, the more you pay for the company's earnings.

Why would you buy shares in one company with a relatively high P/E ratio instead of investing in another company with a lower P/E ratio? Keep in mind that investors buy shares based on expectations. They may bid up the price of the share (subsequently raising the share's P/E ratio) because they feel that the company will have increased

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earnings in the near future. Perhaps they feel that the company has great potential (a pending new invention or lucrative business deal) that will eventually make the company more profitable. This in turn would have a beneficial impact on the company's share price. The danger with a high P/E is that if the company does not achieve the hopeful results, the share price could fall.

You should look at two types of P/E to get a balanced picture of the company's value.

- Trailing P/E: This is the most frequently quoted P/E because it deals with existing data. The trailing P/E uses the most recent 12 months of earnings in its calculation.
- Forward P/E: This is based on projections or expectations of earnings in the coming 12-month period. Although this may seem preferable because it does look into the near future, it's still considered an estimate that may or may not prove to be accurate.

Both trailing and forward P/E are available on the Standard Bank website for most shares.

The following example illustrates the importance of the P/E ratio. Say that you want to buy a business and I'm selling a business. If you come to me and say, "What do you have to offer?' I might say, "Have I got a deal for you! I operate a retail business that sells spatulas. The business nets a cool R2,000 profit per year." You reluctantly say, "uh, okay, what's the asking price for the business?' I reply, "You can have it for only R1 million! What do you say?"

If you're sane, odds are that you would politely turn down that offer. Even though the business is profitable (a cool R2,000 a year), you would be crazy to pay a million bucks for it. In other words, the business is way overvalued (too expensive for what you are getting in return for your investment Rands). The millions Rands would generate a better rate of return elsewhere and probably with less risk. As for the business, the P/E ratio of 500 (R1,000,000 divided by R2,000 = 500) is outrageous. This is definitely a case of an overvalued company – and a lousy investment.

What if the business were offered R12,000? Would that price make more sense? Yes. The P/E ratio would be a more reasonable 6 (R12,000 divided by R2,000). In other words, the business would pay for itself in about 6 years (versus 500 years in the prior example).

Looking at the P/E ratio offers a shortcut for investors asking the question, “is this share overvalued?’ As a general rule, the lower the P/E, the safer (or more conservative) the share is. The reverse is more noteworthy: The higher the P/E, the greater the risk.

Just remember that when a P/E is referred to as high or low, you have to ask the question, “ Compared to what?” A P/E of 30 is considered very high for a large bank but quite reasonable for a small cap, high-technology firm. Keep in mind that phrases such as “large cap” and “small cap” are just a reference to the company’s market value or size. Remember “cap” is short for capitalisation.

The following basic points can help you evaluate P/E ratios:

- Compare a company’s P/E ratio with its industry. Bank shares normally have a P/E that hovers in the 9-14 range. Therefore, if you’re considering a bank worth a P/E of 45, then something is wrong with the bank.
- Compare a company’s P/E with the general market. If you’re looking at a small cap share on the JSE that has a P/E of 100 but the average P/E for established companies on the JSE is 15, find out why. You should also compare the share’s P/E ratio with the P/E ratio for major indexes.
- Compare a company’s current P/E with recent periods (such as this year versus last year). If it currently has a P/E ratio of 20 and it previously has a P/E ratio of 30, it is showing that either the share price has declined or that earnings have risen. In this case, there is less risk that the share could fall. That bodes well for the share.
- Low P/E ratios are not necessarily a sign of a bargain, but if you are looking at a share for many other reasons that seem positive (solid sales, strong industry, and so on) and it also has a low P/E, that’s a good sign.

- High P/E ratios are not necessarily bad, but they do mean that you should investigate further. If a company is weak and the industry is shaky, heed the high P/E as a warning sign. Frequently, a high P/E means that investors have bid up a share price, anticipating future income. The problem is that if the anticipated income does not materialise, the share price could fall.
- Note that for a share that does not have a high P/E ratio. In other words, it may have a price (the P), but it doesn't have earnings (the E). No earnings simply means no P/E.

Drawbacks of the P/E ratio

The possible drawbacks are as follows:

- EPS (earnings per share) can be negative and the P/E does not make economic sense with a negative denominator
- The ongoing or recurring components of earnings are what are important when determining intrinsic value - Earnings often contain volatile transient components, which makes it difficult for the analyst
- EPS can be distorted by management as a result of their discretion regarding accounting principles. Distortions can affect the comparability of P/Es across companies.
- Some of the many broad economic factors that may impact on a company include the rate of economic growth, the rate of inflation, the rate of employment growth, the level of interest rates, the exchange rate and the various arms of government economic policy.

4.4. Summary

In this unit we learnt in detail about how to value shares and what to look out for when buying shares. We learnt the important point that to determine the value of shares in a particular company, we must pay close attention to its operating environment as well as the operating strategy and performance of the company. We learnt that taking a top-down approach to analysing a company's prospects involves looking first at the broad macroeconomic, social and political environment. We then focus the analysis to consider the more industry specific or even regional influences

on a company's earnings. We learnt that the bottom-up approach of share analysis begins with the narrow focus of the individual merits of a particular company and then expands to look at the sector, the market and the economy. We also learnt that earnings or profit is the single most important item on the statement. When a company makes a profit, it's usually reported as earnings per share (EPS). Finally we learnt that the P/E ratio is the reciprocal or inverse of Earnings per share (EPS).

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