

What's bottom-up analysis?

Allows investors to have a limited portfolio

THIS WEEK WE'LL CONTINUE to unravel how investors can do fundamental analysis to improve their stock-picking skills. In the next two weeks, we'll focus on bottom-up investing, which focuses on individual shares and de-emphasises the importance of macroeconomic variables.

In an article entitled *"A Bottom-up Approach to Small Capitalisation Active Management"*, Dalton, Greiner, Hartman, Maher & Co senior executives Kenneth Greiner and Stephen Bruno say: "Bottom-up managers focus on the individual characteristics of each company and build a portfolio of attractive companies one at a time. The economic sector is a secondary consideration. Bottom-up managers believe that it's the individual characteristics of a company that represent the underlying value and thus are the primary source of the stock's performance in the market."

Bottom-up analysis is simply putting together two components: the "story" of the company and its numbers.

The "story" is the essence of what the company is and its outlook. It's imperative that bottom-up investors research both the company's business plan and its manage-

ment as part of this process. This is largely a qualitative process and one that investors become better at with time as they learn to separate the wheat from the chaff through trial and error.

Pulling the numbers apart is the quantitative part of the bottom-up investment process. Investors will look at the company's financials and may calculate a number of ratios that will provide the tools for them to determine both how well the company operates and how attractive an investment it is. Although it's important that investors understand how these numbers are calculated and what they mean, it's no longer necessary to work them out separately. Today, most of the numbers are readily available – including online at www.securities.co.za – so investors can spend their time more profitably, developing the company story.

If this all seems too complex or time-consuming, Richard Seddon – head of Online Share Trading at the Standard – reminds investors that they can access both economic and selected company research through the Online Share Trading from Standard's website (www.securities.co.za) where a lot of this work has been done for you already.

But he cautions investors to understand the analysis and accept the analyst's view, before executing the recommended trade. Remember, you can read the research reports for extra information without necessarily agreeing with the author's conclusions.

Private investors have the luxury of not having to invest in a broad portfolio of shares or of having to beat the performance of selected benchmarks such as the JSE/FTSE All Share Index, as professional fund managers do. Instead, your portfolio can consist of as many or as few shares as you feel comfortable tracking online. But be warned – portfolios of only one or two shares are likely to be extremely volatile. The more shares you add (called diversification), the less impact sudden movements in one share price will have on the overall portfolio. But this is a two-edged sword because having too many shares in a portfolio runs the risk that it will eventually end up mimicking the performance of the benchmark index. Generally, portfolios of ten to 20 shares are sensible as they are diverse enough to protect investors, but each share represents a big enough part of the portfolio so that its share price movement can make a difference. ▣

Ratios: pricing your investments

Stock-picking made easy

INVESTMENT OFTEN COMES down to choosing a few shares that are likely to be the most attractive investments. Novice investors need to remember that price is not a function of the rand value: in investment terms a R10 share can be more expensive than a R100 share (it's more the amount invested rather than the number of shares). Instead, investors use a number of ratios to determine one share's value relative to that of another. We will look at five common ones: the price:earnings (p:e) ratio, earnings yield, price:book ratio,

price:sales ratio and dividend yield.

Remember that though it's useful to know how to calculate these ratios, they are published in a number of public domains

including the financial press and websites such as Online Share Trading from Standard's website (www.securities.co.za).

The first step is to calculate the basic building block for some of the ratios: earnings per share (eps) and dividends per share (dps) as shown in the table. We need the per share figures to calculate some of the more important pricing ratios.

The p:e ratio is the most commonly used valuation ratio, and we discuss it and the earnings yield in more detail on page 2. In a nutshell, the lower

PRICING YOUR INVESTMENTS	
Earnings per share/ EPS ©	Earnings/ Number of weighted issued shares
Dividend per share/ DPS ©	Dividend/ Number of issued shares
Price: earnings ratio (times)	Share price/ Earnings per share
Earnings yield (%)	Earnings per share/ Share price
Price: book ratio (times)	Share price/ Net asset value
Price: sales ratio (times)	Market capitalisation/ Sales
Dividend yield (%)	Dividend per share/ Share price
All these ratios for all listed companies are available on the Online Share Trading website (www.securities.co.za)	
Source: Graham & Dodd's Security Analysis, Fifth Edition	

1 the p:e ratio, the cheaper the share.

The price:book ratio shows whether the market has factored the company's asset value (on its balance sheet) into its market capitalisation. In general, the lower the price:book ratio, the cheaper the share relative to its peers.

If a company is trading at a discount to its net asset value (or shareholders' funds), it may be cheap as the company's asset value – apart from any future earnings – is not fully reflected in the share price. If it continues to trade at a substantial discount, it may be attractive to corporate raiders who will break up the company to “unlock”

this asset value. This framework is usually applied to “old economy” entities such as manufacturing entities or utilities. The caveat is that the balance sheet should reflect the current market value of the company's asset base and doesn't overstate it. Investors will need to make their own judgement in this regard.

The price:book ratio is also commonly used in comparing banks, but with one crucial difference. In this case, the book value refers to the net debtors book (loans) value reflected in the balance sheet.

The price:sales ratio is the market capitalisation divided by annual sales. It's most

commonly used to compare companies in the same sector, such as retail. The rule of thumb is that lower price:sales ratios are more attractive.

The dividend yield is the dividend divided by the share price. Investors need to remember that dividends are tax-free when they stack up the relative attractions of buying a share for income or depositing the cash in a money market account. For example a 6% return in a money market fund is quite different to a 6% dividend yield due to tax. A 6% money market rate is equal to 3,6% after tax, compared with the full 6% earned from a dividend. ▣

The currency of stock markets

Making share prices comparable

THE PRICE:EARNINGS RATIO (or p:e) ratio can be described as the currency of stock markets as it makes share prices comparable. Actual rand prices don't tell investors whether a share is cheap or expensive relative to its peers (For example, a R100 share can be cheaper than a R10 one in these terms). It also shows how many years of earnings it will take an investor to recoup the money he has invested in a stock.

The ratio is calculated by dividing the share price (p) by the company's earnings (e). It tells you how many rand an investor is paying for each rand in earnings.

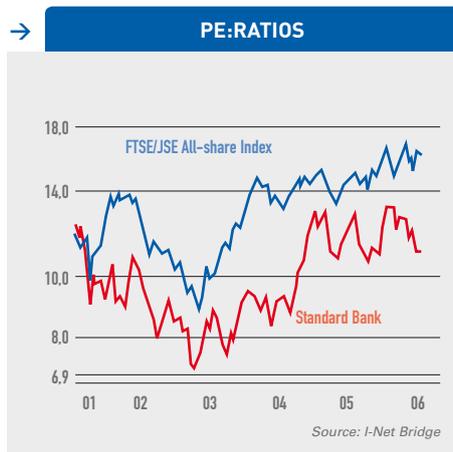
Generally, a lower p:e means that the share is cheaper. But remember that low p:e ratios alone do not imply a bargain. It's a good sign, if a low p:e ratio is supported by other positive indicators such as a strong industry, improving profitability and good sales.

You can look up the historic p:e ratios for all listed companies, as well as the forward p:e's for about 120 of the biggest companies on Standard Bank's Online Share Trading website.

Here are some tips to help you evaluate p:e ratios.

- Always compare a company's p:e ratio with that of its industry. Investigate why a company's p:e ratio is far above or below that of its industry.
- Compare the p:e of an individual company with that of the market as a whole and with the p:e ratio for the major indices.
- Measure up the company's current p:e

ratio with its past history. A current p:e below the historical average may be a buy signal if the company's growth outlook remains sound.



Investors should look at two different types of p:e ratios: the trailing p:e and the forward p:e. The trailing p:e is the most commonly quoted as it's calculated from historical data. The forward p:e is calculated from analysts' earnings forecasts. Although it should be preferable because it looks to the future, it may or may not be accurate depending on the actual earnings performance.

The p:e ratio is the inverse of the earnings yield. The earnings yield (or earnings divided by the share price) represents the return shareholders notionally earn when they invest in a company at a specific share price. Investors can compare the earnings

yield to other investment alternatives, such as interest rates on bank deposits.

However, p:e ratios have one crucial failing – they are relative, not absolute, measures. On its own, a p:e ratio cannot tell you if a share is cheap or expensive, it needs to be compared to a peer group.

The PEG ratio (or price:earnings to growth ratio) addresses this issue.

To calculate the PEG ratio, divide the p:e by the company's projected growth rate (which you can find in the consensus of analyst forecasts available on the Online Share Trading website www.securities.co.za). For example, a company will have a PEG ratio of 1,5 if its p:e is 15 times and the market expects it to grow at an average 10% over the next few years.

A PEG ratio in excess of 1 implies that the share is expensive as its p:e is pricing in growth above the actual expected growth rate. Although there are always exceptions, investors tend to look for PEGs lower than 1.

→ **APPLYING THE P:E RATIO**

HOW would you react on being told that a business that makes R2 000 profit is for sale for R1m? If you're sane, the odds are you would turn down that offer as the R1m price is too expensive (a p:e ratio of 500 times) for its earnings. It would be more reasonable to pay (say) R12 000 (a p:e of 6 times) for the company.

2 However, the PEG is very sensitive to forecasts – so always evaluate the consensus forecast.

Remember that there may be a reason if

a share looks cheap, so do your homework before committing your hard-earned cash. Ask questions such as what the underlying growth trend is, whether management is hon-

est and if its finances are sound. Don't use the p:e on its own, use it in conjunction with other ratios or technical analysis to confirm your decision. ▣

Evaluating a company's operational performance

INVESTORS SHOULD TAKE the time to reassure themselves that the company in which they're about to invest is either operating well or improving on a less than optimal past performance. There are a myriad of different ratios to choose from, we have suggested just a few basic ones that can be used. Remember that many of these ratios are available to you. The Online Share Trading website from Standard (www.securities.co.za) has these ratios for every single listed company.

To evaluate the overall performance of a company, focus on three key areas: the operational performance, its creditworthiness and shareholder value creation.

Operational performance

In very simple terms, the operational performance is whether the company is profitable and its growth in earnings consistent. As the actual bottom-line can be influenced by factors outside management's control (such as changes in interest and tax rates or profits or losses on sales of assets), investors should evaluate how much money the company makes from its core business. First, look to see if sales and operating profit are increasing over time and that costs are under control. Then check if the underlying profitability is improving or deteriorating by calculating

the gross and operating margins. Falling margins can be a red flag, so investors should always investigate the underlying reasons for these changes.

Creditworthiness

To evaluate a company's creditworthiness, look at two areas: its cash flow management and its borrowings.

Good cash flow management is vital as a company can be profitable on paper and still go bust if its growth is not properly managed. The quickest way to check whether a company is technically solvent is to calculate the current ratio. A current ratio of less than

one means that the company's current liabilities exceed its current assets: it may not be able to continue as a going concern without raising new capital from either its shareholders or lenders. The quick ratio is a more conservative form of the current ratio as it strips out inventory that cannot be instantly converted to cash.

Investors should also watch a company's working capital management by calculating debtors, creditors and inventory days. If the creditors days fall, it may signal that a company's suppliers are uncomfortable with a company's financial position. Similarly, rapid growth in debtors days may indicate that a company is not collecting its debtors book and may have to write off bad debts in future.

Bank debt is another important area, but investors need to be aware that it's positive for a company to use some debt (gearing) to grow its business, as long as it is controlled. One rule is to check the interest cover. Interest cover of less than one is negative: it shows that a company cannot service its interest payments from its operating profit.

Shareholder value creation

As discussed last week, investors can see if a company is creating value if its return on equity (ROE) exceeds its cost of capital. ▣

EVALUATING A COMPANY'S OPERATIONS	
<i>Operational statistics</i>	
Gross margin (%)	Gross profit/ revenue
Operating margin (%)	Operating profit/ revenue
CF0: Earnings (times)	Cash flow from operations/ Earnings
<i>Credit Evaluation</i>	
Debt: equity (:1)	Debt/ Shareholders' funds
Interest cover (times)	Operating profit/ Interest paid
Short-term debt: total debt (:1)	Short term debt/ Total debt
Debtors' turnover (times)	Credit sales/ Average debtors
Debtors' days	365/ Debtors' turnover
Creditors' turnover (times)	Sales/ Average creditors
Creditors' days	365/ Creditors' turnover
Inventory turnover (times)	Cost of goods sold/ Average inventory
Inventory days	365/ Inventory turnover
Current ratio (times)	Current assets/ Current liabilities
Quick ratio (times)	(Current assets - inventory)/ Current liabilities
<i>Value creation</i>	
Return on equity	Earnings/ shareholders' funds
Please note that all these ratios are available on www.securities.co.za	
<small>Source: Graham & Dodd's Security Analysis, Fifth Edition</small>	

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What do bottom-up investors focus

on more – the individual share or the macroeconomy?

2. What does a low p:e generally mean?

3. What two aspects should be looked at to evaluate a company's creditworthiness? ▣