

PERFORMANCE MEASURES

A company's stock price is guided by its performance. But what are the key performance measures and how to interpret them?

The performance measures are many. Experts on TV breezily talk about earnings per share or sometimes operating profit, but little else. Rarely, will you hear about free cash flow, although, according to academic texts, this is the bedrock of valuation. Analysts pore over financial details of companies, obsessively looking at everything from debt equity ratio to book value to dividend yield. While there are innumerable measures to analyse corporate performance, the market is most interested in profits. This is logical, because without profits, there is not much value in a listed company. But there are other important financial numbers too. Let's look at them:

Operating Profit: This measures the profitability of the core business and is roughly expressed as sales minus all costs except interest, depreciation and taxes. Income from other sources (such as sale of property) is excluded. Derived from operating profit is operating profit margin (OPM), which is OP as a percentage of net sales. OPM measures the strength of the business relative to a period, competitor or industry average. Operating profit is the most important measure of performance and not net profit or PAT.

Profit after Tax (PAT): Also called net profit, PAT captures profit available for distribution and retention. Contrary to widespread belief, this measure is irrelevant in determining the fundamental worth of a company.

Earnings per Share: The most important measure according to the market is earnings per share (EPS). EPS is expressed as net profit (profit after tax) divided by the number of shares. EPS can be distorted by adjustments and other income as reflected in PAT. But a continuously rising EPS is one of the most reliable predictors of future price rise.

Cash Flow: Reported PAT and EPS may not show a clear picture. After all, PAT is an accounting number arrived at, after lots of adjustments. Smart investors prefer to focus on operating cash flow, which is a little complicated in calculation and cannot be described here. A company can show healthy PAT but may have a poor or negative cash flow. PAT will not reveal this internal weakness. Negative cash flow also indicates that there is a fundamental problem with the operations: either the profitability is too low or money is stuck in high inventories and receivables. Companies that do not generate healthy cash flows are bound to run aground. Just as EPS is PAT divided by capital, operating cash flow per share (also known as cash earning per share) is operating cash flow divided by the number of shares. Change in CEPS captures better the true financial condition than changes in EPS.

Profit Margins: While profits are important, equally important is profitability - expressed as a percentage on net sales. Profitability varies from one sector to another and margins are the only way to compare across sectors and within

a sector. Operating profit margin shows how successful a company has been in generating profits from its core operations. Highly profitable companies such as software companies can have an operating margin of 35% and above. Operating profit and OPM are the best measures of efficiency, cost pressures and the core strength of operations. The gross profit margin or gross margin is just another measure of profitability, which takes into account financing costs. Net profit margin is what is left after all costs are included including taxes. It is often distorted by taxes, interest costs and other income and so a mechanical comparison of net margin even among companies within the same sector makes no sense.

Return on Equity: Companies that are generating profits more efficiently than others are obvious favourites. One number that can identify such companies is Return on Net Worth, which is known internationally as ‘return on equity’ (RoE). It is PAT as a percentage on total shareholders’ funds or net worth. ‘Equity’ in this case is net worth and is calculated by adding reserves to equity capital. RoE shows how profitable the business is for shareholders and how efficiently the company is using the shareholders’ funds. RoE is an important driver of long-term value, subject to market moods and fancies. A rising RoE helps investors determine if a company is earning enough money on an incremental basis. Often companies that are unable to raise their RoE prefer to distribute extra dividends.

Return on Capital Employed: RoCE is calculated by dividing profit before tax and interest by capital employed. Capital employed is the total of all equity and preference capital, reserves and all debt. As opposed to RoE, which measures only the return on shareholders’ money, RoCE measures how the entire money invested in business is doing. RoCE is best compared to the cost of borrowing. If the interest on fixed deposits is earning 11% whereas a company is earning just about 13% as RoCE, clearly it is not a great business for shareholders. RoCE is low for companies that are capital-intensive. For companies with insignificant debt, RoE and RoCE are the same. RoCE has little impact on stock prices by the time it is known and is used only in case of valuing companies during a take over.

Return on Assets: This is a measure of how much the assets are producing for the company. RoA is simply net profits divided by total assets and reflects the efficiency in making its assets sweat. As in case of RoE and RoCE, the benchmark for RoA is interest rates or the cost of company’s capital. RoA also exposes whether the company has too much of debt, a fact that

RoE may not be able to capture. RoA, like RoCE may be best used in valuing assets for buying and selling.

Dividends: Regular dividends to shareholders gives them confidence that the company is in sound financial health. When dividends are increased, the message is that the company is prospering. This in turn stimulates greater enthusiasm for the stock. The payout ratio shows the percentage of net earnings being paid as dividends. It can range from zero at companies that pay no dividends to more than 100% when companies are earning lots of cash and cannot re-invest them. Dividends have a significant bearing on long-term returns. The US stocks have earned 9.89% between 1900 and 2000. Of this, 4.5% came from dividends and another 4.5% from dividend growth.

Other Indicators: One key indicator of superior operational strength is how fast the company is turning over its inventories and receivables, which reflects the efficient use of capital. These can be measured by a specific ratio: number of days of average inventory or debtors. The first is arrived at by dividing the cost of goods sold by average inventory while the second is arrived at by dividing sales by average debtors. The average figure comes from adding the opening balance and closing balance of inventory/debtors and dividing it by 2. The lower the number of days for which inventory and debtors are held, the better it is. Even better, if the number shows a falling trend, it means that the company is squeezing more and more out of debtors and stocks. If a company’s collection period is growing longer, it means that it has dumped its products on the market and is unable to recover the money now. These numbers really make sense when compared to other companies in the same sector.

Valuation: All the formulas above relate to the fundamentals of a company. These are all you need to know. But they are relevant in a limited context. Is the investment strategy really determined by these formulas? After all, an ordinary company at cheap valuation is far preferable to a great company at an expensive price. There are a lot of measures that link price to fundamentals. The most popular among these is Price to Earnings (P/E), obtained by dividing market price with EPS. Then there is Price to Sales, Price to Book Value and Price to Dividend. Which are the best measures among these? We will discuss it in another issue.

