Hold on to basics as markets sway

Here are four important financial ratios that will help you keep a steady eye on companies

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These days it's common to find stock prices moving sharply up or down for a few days and then reversing the trend just as quickly. Volatility makes it cumbersome for you to link stock prices to a company's fundamental ability to grow and deliver profits. Also, in volatile markets, benchmark indices don't necessarily reflect the price movement in individual stocks. At the moment, we are close to the peak as far as Nifty and Sensex are concerned. Yet, stock prices of many companies aren't at their all-time highs. It's confusing to figure out details such as whether you should buy or sell now given that benchmark indices are at such highs; are valuations overdone or is that only restricted to the index. It's better we step back from these sort of technical concepts and consider what really makes a stock desirable. There are a few things that investors can't and shouldn't ignore whatever be the market cycle. These are a company's ability to stay ahead of competitors, grow profits consistently over a long period of time and, as a result, deliver an above average return on capital. Raamdeo Agrawal, joint managing director, Motilal Oswal Financial Services Ltd, terms this kind of profit as "uncommon profit" and says that the more uncommon the profits, the more uncommon will be the returns. Here are four important financial ratios that will help you keep a steady eye on companies and build a list of quality stocks despite the market cycle.

RETURN ON CAPITAL EMPLOYED: HOW IS YOUR MONEY DOING

Mathematically, return on capital employed (RoCE) is calculated as the ratio of net profit to the total capital deployed in the business (debt + equity). What this ratio tells us is how much a company can earn per unit of capital used in the business. Or, in other words, it shows whether or not the capital employed in the business is being used in an effective and profitable manner. Says Motilal Oswal's Agrawal: "RoCE and return on equity (RoE) are like an interest rate. For example, when you give money to a bank, you get a return; similarly, giving equity capital to an enterprise is done with the intention of a return and that's what the two ratios show—what your money is earning." However, you can't consider RoCE in isolation and need to look at two more aspects related to this ratio. You have to see the trend of the ratio in context to the life cycle of a company. All companies have a life cycle: its incorporation, the growth phase, maturity and then sell-out or rebirth with new products and services. In the initial years, the ratio could be low as the company is only setting up. Says Dhananjay Sinha, head-research and strategist, Emkay Global Financial Services Ltd: "For a new company, the balance sheet is just shaping up and the financial ratios based on it may not be relevant. For these ratios to be sensible the balance sheet has to be mature with some leverage already there."

PROFIT GROWTH: IN GOOD TIMES AND IN BAD

Ultimately a company has to deliver profits. To calculate this, look at how net profit has grown over a defined time period and put that in perspective by looking at the compounded annual growth rather than the absolute growth (some years can be better than the others). But profit can't be looked at in isolation. You have to look at the operating profit margin, which shows what the company earns for every unit of sale done; the fatter the margin, the better it is. Then see the historical trend of profit growth over, say, the past 5-8 years. During a slowdown, you need to consider whether the change in trend was in line with the overall economic environment, and whether the company stayed ahead of competitors in terms of RoCE. Emkay's Sinha says, "It's important to see how the company has behaved across cycles. The longer the period, the better it is as more cycles get captured."Also, filter through the annual profit figure to see if any one-time or exceptional items are included that could bump up the figure extraordinarily. Lastly, make sure that the profit margin or the ratio of profits-to-sales is growing or is at least consistent. A declining margin despite growing profits could indicate tough times. Vikas Gupta, executive vice-president, investments and traded markets, ArthVeda Fund Management Pvt. Ltd, says, "It's important to check whether a company has managed to maintain a consistent profit margin. And this has to be tested in times of economic downturn as well."

RETURNS HIGHER THAN COST OF CAPITAL: BEYOND NORMAL

In its Annual Wealth Creation Study for 2013, Motilal Oswal Financial Services spoke about a concept called "uncommon profits". The firm defined it as returns earned by a company above its cost of capital. It is generally believed that over long periods, returns generated by a stock will more or less converge with the long-term cost of capital. In terms of the stock market, the profit growth or potential of growth is reflected in the change in stock prices. The report says that for some companies, the profit can remain higher than the RoCE for many years, and that these are the most desirable stocks to pick. To spot such companies, it advises that the investor should look out for uncommon profit in the difference between RoCE and weighted average cost of capital. This may be further modified to return on equity less cost of equity in case of returns for equity shareholders. This may not be an easy concept to grasp but a company that generates uncommon profit for prolonged periods of time is one that can create value in the long run. This value then gets reflected in its increasing stock price. Motilal Oswal's Agrawal says, “It can take time for the stock to react but as long as you know that the company is delivering profits, the stock will react.” Competitive forces will drive down return on capital to cost of capital over time. You have to monitor this metric from time to time. The companies that manage to maintain above ordinary profits are the ones to look out for.

GEARING: WHEN DEBT IS TOO MUCH OR TOO LITTLE

This refers to the amount of debt on a company’s balance sheet. Various ratios such as debt-to-equity, interest coverage and total debt-to-total assets indicate how much leverage a company has and whether it is being used optimally. According to ArthVeda Fund Management’s Gupta, “The most important filter today is the level of debt a company carries; high debt can lead to high cost and be a burden on the balance sheet.” Having too much debt not only bogs down the balance sheet but also adds substantially to the cost thereby putting pressure on net profit. This pressure can get aggravated in an economic downturn. Also, if the debt is too little, it may mean that the company is not utilizing leverage effectively to increase its operational reach and efficiency and is thus, restricting growth.

WHAT SHOULD YOU DO?

Financial ratios are reflective of the qualitative aspects of a company. Some of these, like quality of management, external pressures in the form of regulation and competition, allocation of capital, etc., are what lead to profit generation or the lack of it. Hence, you have to keep a track of these aspects as well and look at the financial ratios within a relevant framework.