What is Fundamental analysis?

Fundamental analysis is basically done for long term and midterm investment which is also called as delivery based investment or trading. The main important aim behind is to study and understand the company in which you are planning to invest your hard earned money and get excellent returns. Generally hard core fundamental analysis is very and is out of the scope of this website, but if you are interested to learn then please contact us and we will provide you appropriate resources to study the same.

How to analyze the fundamentals of the company?

Basically one should be able to judge at least how the company has done in past years, its debit status, its current valuation, its future growth prospects, its earning capacity etc . So that based on these terms he can at least decide whether to invest in this company or not.

What you should look for in a company to invest?

1. About Company

What the company is doing and what are its businesses?
How is the current demand for their products and how the demand will be in future like in next 3 to 5 years and so? (It is difficult to analyze the future demand yourself so you can visit financial websites or contact us)

2. Earnings

This is very important parameter. Broadly look into its last 5 or 10 years earnings whether the company has posted profits or losses. It's all about earnings. The bottom line is investors want to know how much money the company is making and how much it is going to make in the future. To find the earning status ratios used are EPS - Earning per share

3. Current valuation

This is another very important factor which most of the investor forgets while doing their investments. Generally most of the investors invest at higher valuations of shares and when share prices start coming down then they keep worrying, so this should not happen. Before investing one should check the current valuation of the share price and invest only when the share price is at right price and not at over priced share. This is what happened in January 2008. Most of the people invested at very high valuations and later on the share prices started to correct (falling down). To find the current valuation of the stock the ratios used are.

PE ratio - Price to earning ratio Book value PB ratio - Price to book value ratio

Future earnings growth

It is very important to analyze how the company is going to do in future. How will be its returns or its profits etc? Basically most of the investors invest in shares taking into consideration Company's future growth prospects. To find the future growth of the stock the ratios used are

PEG ratio - Price to earning growth ratio Current EPS and Forward EPS Price to sales ratio

4. Debit status

For any company to perform well in the future it is very important to be debt free or less debit because if company is having large debits like borrowings, loans then it becomes difficult for it to plan for any acquisitions, expansion plans take over plans, dividend payout and very important its most of the net profit goes in paying the interest and loans and other debits. So in other words if the company is having fewer debits or no debit then they are having lots of cash in hand and they are free to take any decision in coming future. To find the debit status of the company the ratios used **Debit ratio.**
So to accomplish above parameters fundamental analyst follow certain ratios which are mentioned below.

Earnings

About EPS

The portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serve as an indicator of a company's profitability.

Calculated as = $\frac{\text{Net Income - Dividends on Preferred Stock}}{\text{Average Outstanding Shares}}$

An important aspect of EPS that's often ignored is the capital that is required to generate the earnings (net income) in the calculation. Two companies could generate the same EPS number, but one could do so with less equity (investment) - that company would be more efficient at using its capital to generate income and, all other things being equal would be a "better" company.

What is Common and preferred stock

There are two classes of stock that companies offer: common and preferred. These come with different financial terms and offer different rights in relation to the authority of the company. The following are few important differences between these two types of stock,

Common Stock –

The holders of common stock can reap two main benefits from the issuing company: capital appreciation and dividends. Capital appreciation occurs when a stock's value increases over the amount initially paid for it. The stockholder makes a profit when he or she sells the stock at its current market value after capital appreciation.

Dividends, which are taxable payments, are paid to a company's shareholders from its current earnings. Typically, dividends are paid out to stockholders on a quarterly/annually basis.

Common stock ownership has the additional benefit of enabling its holders to vote on company issues and in the elections of the organization's leadership team. Usually, one share of common stock equates to one vote.

Preferred Stock –

Preferred stock doesn't offer the same potential for profit as common stock, but it's a more stable investment option because it guarantees a regular dividend that isn't directly tied to the market like the price of common stock. This type of stock guarantees dividends, which common stock does not.

The other advantage of preferred stock is that preferred stockholders get priority when it comes to the payment of dividends. In the event of a company's liquidation, preferred stockholders get paid before those who own common stock. In addition, if a company goes bankrupt, preferred stockholders enjoy priority distribution of the company's assets, while holders of common stock don't receive corporate assets unless all preferred stockholders have been compensated (bond investors take priority over both common and preferred stockholders).

Like common stock, preferred stock represents ownership in a company. However, owners of preferred stock do not get voting rights in the business.

Earning Per Share – EPS

EPS plays major role in investment decision.EPS is calculated by taking the net earnings of the company and dividing it by the outstanding shares.

EPS = Net Earnings / Outstanding Shares
(Nowadays you will get this ready made, no need for you to do calculation.)

For example –
If Company A had earnings of RS 1000 crores and 100 shares outstanding, then its EPS becomes 10 (RS 1000 / 100 = 10).

Second example –
If Company B had earnings of RS 1000 crores and 500 shares outstanding, then its EPS becomes 2 (RS 1000 / 500 = 50).

So what is that you have to look in EPS of the company?
Answer - You should look for high EPS stocks and the higher the better is the stock.

Note - You should compare the EPS from one company to another, which are in the same industry/sector and <u>not</u> from one company from Auto sector and another company from IT sector.

Before we move on, you should note that there are three types of EPS numbers:

<u>Trailing EPS</u> - Trailing EPS means last year's EPS which is considered as actual and for ongoing current year.
<u>Current EPS</u> - Current EPS means which is still under projections and going to come on financial year end.
<u>Forward EPS</u> - Forward EPS which is again under projections and going to come on next financial year end

But the EPS alone doesn't tell you the whole story of the company so for this information, we need to look at some more ratios as following. It's not advisable to make your investment decisions based on only single ratio analysis.

EPS is the base for calculating PE ratio.

Importance of Earnings –

Earnings are profits. Quarterly or yearly company's increasing earnings generally makes its stock price move up and in some cases some companies pay out a regular dividend. This is Bullish sign and indicates that the company's is in growth.

When the company declares low earnings then the market may see bearishness in the stock price and hence its share price starts deceasing and corrects further if the company doesn't provide any sufficient justification for low earnings.

Every quarter, companies report its earnings. There are 4 quarters.
Quarter 1 - (April to June and earnings will be declared in July)
Quarter 2 - (July to Sept and earnings will be declared in Oct)
Quarter 3 - (Oct to Dec and earnings will be declared in Jan)
Quarter 4/final - Also called as financial year end - (Jan to Mar and earnings will be declared in April)

Now by this time you would have understood how earnings are important for a stock price to move up or down. But depending only on earnings one should not make investment or trading decision. To make decision more risk free you should look into more tools as mentioned below so that your investment decision becomes more solid and you should get excellent returns in future.

Conclusion - Keep a close watch on quarterly earnings and trade or invest accordingly or manipulate your investing.

Following are the most popular and important tools/ratios to find excellent growth stocks which focuses on earning, growth, and value of the company's.

To make you understand more easily we have explained in very simple steps.

Current Valuations of the shares

Price to Earnings Ratio - PE ratio

PE ratio is again one of the most important ratio on which most of the traders and investors keep watch. Important - The PE ratio tells you whether the stock's price is high or low compared to its forward earnings.

The high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. This generally happen in bull market and share price keeps on increasing. Basically in bull market share prices keep increasing without giving more importance to its current valuation and once market realizes that it is over priced then they start selling. In bear market the low PE stocks having high growth prospects are selected as best investment options.

But, the P/E ratio doesn't tell us the whole story of the company.Generally the P/E ratios are compared of one company to other companies in the same sector/industry and not in other industry before selecting any particular share.

The PE ratio is calculated by taking the share price and dividing it by the companies EPS.

That is PE = Stock Price / EPS
For example A company with a share price of RS 40 and an EPS of 8 would have a PE ratio of 5
(RS 40 / 8 = 5).

Importance - The PE ratio gives you an idea of what the market is willing to pay for the companies earning.

The higher the P/E the more the market is willing to pay for the companies earning. Some investors say that a high P/E ratio means the stock is over priced on the other side it also indicates the market has high hopes for such company's future growth and due to which market is ready to pay high price.
On the other side, a low P/E of high growth stocks may indicate that the market has ignored these stocks which are also known as value stocks. Many investors try finding low P/E ratios stocks of high value growth companies and make investments in such stocks which may prove real diamonds in future

Which P/E ratio to choose?

If you believe that the companies has good long term prospects and good growth then one should not hesitate to invest in high P/E ratio stocks and if you are looking for value stocks which prove real diamonds in future then you can go with low PE stocks provided that companies has good growth and expansions plans.

At all if you would like to do PE ratio comparison then it has to be done in same sectors/industry stocks and not like one stock from banking sector and other stock from pharmacy sector. So now you would have come to know how to choose stocks based on PE ratio.

What is book value?

Book value is the total value of the company's assets that shareholders would theoretically receive if a company were liquidated (closed). By being compared to the company's market value, the book value can indicate whether a stock is under priced or overpriced.So in other words if the share price is trading below its book value then it is considered as under priced and good for value investing.

Price to Book Ratio - PB ratio Basically PB ratio is mostly utilized by smart investors to find real wealth in shares, so investing in stocks having low PB ratio is to identify potential shares for future growth.

A lower P/B ratio could mean that the stock is undervalued.
Like the PE, the lower the PB, the better the value of the stock for future growth.

Some of the investors become quite wealthy by holding stocks for the long term of such companies whose growth is based on their businesses instead of market and one day when every one notices this stock the value investor's pockets are full of profit.

PB ratio is calculated as
PB ratio = Share Price / Book Value per Share.

Generally, if the ratio comes below 1 then it is considered as value investing. But this doesn't mean that the ratio coming to 1.2 or 1.5 is not value investing. It also depends on its future growth prospects.

Future earnings growth

Projected Earning Growth ratio - PEG ratio

Because the market is usually more concerned about the future than the present, it is always looking for companies projected plans, financial ratios, and other future announcements.

The use of PEG ratio will help you look at future earnings growth of the company.
PEG is a widely used indicator of a stock's potential value.Similar to the P/E ratio, a lower PEG means that the stock is more undervalued.To calculate the PEG the P/E is divided by the projected growth in earnings.

That is PEG = P/E / (projected growth in earnings)

For example -A stock with a P/E of 30 and projected earning growth for next year is 15% then that stock would have a PEG of **2** (30 / 15 = 2).

In above example what does the "**2**" mean?

Lower the PEG ratio the less you pay for each unit in future earning growth. So the conclusion is you can invest in high P/E stocks but the projected earning growth should be high so that companies can provide good returns.

Looking at the opposite situation; a low P/E stock with low or no projected earnings growth is not going to give you good returns in future because its PE is low means investors are not ready to pay high and its PEG is also low because companies do not have any good future growth or expansion plans so investment in such stocks could prove less or no returns.

A few important things to remember about PEG:

It is about year-to-year earnings growth.It relies on projections, which may not always be accurate. It's forward earning estimation which market analyst or company calculates.

Following two ratios are again the projection or estimation done by either market analyst or by company resources.

Current EPS - Current EPS means which is still under projections and going to come on financial year end.
Forward EPS - Forward EPS which is again under projections and going to come on next financial year end.

Debit status of the Company
Debit Ratio

This is one the very important ratio as this tells you how much company relies on debit to finance its assets.The higher the ratio the more risk for company to manage going forward. So look for company's having low debit ratio.
Generally it is considered that debit ratio less then 1is good investment option. But even some investor considers higher debit ratio provided the company is having good growth prospects.

If company has fewer debits then company can make more profit instead paying for its debits like interests rates, loans etc.

Dividend Yield

If you are a value investor or looking for dividend income then you should look for Dividend Yield figure of the stock.This measurement tells you what percentage return a companies pays out to shareholders in the form of dividends. Older, well-established companies tend to payout a higher percentage then do younger companies and their dividend history can be more consistent.

You calculate the Dividend Yield by taking the annual dividend per share and divide by the stock's price. That is Dividend Yield = annual dividend per share / stock's price per share
For example If a company's annual dividend is RS 1.50 and the stock trades at RS 25, the Dividend Yield is 6%. (RS 1.50 / RS 25 = 0.06).

Important Note - Any single tool or ratio should not be used to make your investment or trading decision nor will they provide you any buy or sell recommendation. All tools should be used to find growth and value stocks.
After making use of above all tools you will get excellent stocks which will give you excellent returns in mid term to long term.You will find all these ratios in any financial website or you can contact us.

Company's announcements Always keep a close watch on stocks you are interested to buy or you already bought for any mergers, take over, acquisitions, stake sells, new product launch etc. This would make the major impact on company. This is important point.

Final and last - very important Check out company's PAT (profit after tax) of every quarterly if you are short term to midterm trader and if you are long term investor then check out its yearly PAT. The company should have posted consistent growth.