J D Women's College

Course Name- MBA (PG)
Finance specialization
(3rd semester)

Subject- Security Analysis and Portfolio Management
Topic- Financial Analysis (part2)

Faculty Name – Anjali
Faculty member
Department of Management Study

Financial Analysis

Lecture note-2

FORECASTING EARNINGS OF COMPANY

The earnings have a direct and powerful effect upon dividends and share prices of a company. So the importance of forecasting earnings cannot be overstated. These ratios are generally known as 'Return on Investment Ratios'. These ratio help in evaluating whether the business is earning adequate return on the capital invested or not. With the help of the following ratios the performance of the business can be measured. The earning forecasting ratios are:

• **Return on Total Assets:** Changes in reported earnings can result from changes in methods of accounting, changes in the operations of the business and/or in financing of business, that is, changes in productivity or in resource base. This ratio represents the overall efficiency of capital invested in business. This ratio can also be called as gross capital employed ratio. The total assets here are combination of fixed assets and current assets. The Return on Total Assets is calculated as follows:

Return on Assets = Net Income (EBIT)/Total Assets

In general, the greater the return on assets, the higher the market value of the firm, other things being equal. Return on assets is the product of the turnover of assets and the margin of profits:

Return on Assets = Sales/Assets * Earnings before interest and Tax/Assets

• **Return on Equity:** This ratio is calculated to evaluate the profitability of the business from the point of view of the ordinary shareholders.

Return on Equity = Net Profit/Net Worth

• **Earnings and Role of Financing**

Borrowing of money at a fixed cost and the use of these funds to earn return on assets is known as employing leverage. If one can earn more on borrowed money than you have to pay for it, the leverage is to firm's advantage. However, leverage should be used within reasonable limits because excessive use of debt relative to equity increases borrowing costs and also the cost of equity fund s. The volatility of share holders returns increases with the expansion of the degree of financial leverage. The greater volatility of earnings owing to increased leverage can, at certain levels of debt financing, cause the market to pay less per rupee of earnings. Further with the use of more debts it may become progressively difficult to maintain (orimprove) the rate of return on assets. One of the best ways of measuring the proportions of debt and equity financing is:

a) Debt to asset ratio = Total Debt/Total Assets

b) Debt to equity ratio = Total Debt/Net Worth

c) Long term debt to equity = Long Term Debt/Net Worth

• **Valuation Ratios: Earnings and Dividend Level**

a) Book value per share: This ratio indicates the share of equity shareholders after the company has paid all its liabilities, creditors, debenture holder and preference shareholders. It is calculated as follows:

Book value per share = Paid up Equity share capital + Reserves & Surplus/Total number of equity shares outstanding

b) Earnings per share (EPS): This ratio measures the earnings per share available to ordinary shareholders. Equity shareholders have the right to all profits left after payment of taxes and preference dividend. This ratio is calculated by dividing the profits available for equity shareholders by the number of equity shares issued.

EPS = Equity Earnings or EAT/Number of equity shares outstanding

This ratio is quite significant. EPS affects the market value of shares. It is an indicator of the dividend paying capacity of the firm. By comparing the EPS with other firms, management can know whether ordinary share capital is being utilized effectively or not.

c) Dividend per Share (DPS): All the profits after tax and preference dividend available for equity shareholders are not distributed among them as dividend. Rather, a part of it is related in business. The balance of profits is distributed among equity shareholders. To calculate dividend per share, the profits distributed as dividend among equity shareholders is divided by number of equity shares.

DPS = Profits distributed to Equity shareholders/Number of Equity shares

d) Dividend Payout Ratio (D/P ratio): This ratio establishes the relationship between the earnings available for ordinary shareholders and the dividend paid to them. In other words, it explains what percentage of profit after tax and preference dividend has been paid to equity shareholders as dividend. It can be calculated as under:

D/P ratio = Equity Dividends/Equity Earnings

e) Dividend and Earnings Yield: These ratios are used to evaluate the profitability from the stand point of ordinary shareholders. Earning per share (EPS) and Dividend per Share (DPS) are calculated on the basis of book value of share but yield is always calculated on the basis of market value of shares. This ratio is called as Earnings Price ratio.

Dividend Yield = Dividend per share/Market value per share

Earnings Yield = Earnings per share/Market value per share

f) Price to Earnings Ratio: This ratio is calculated by dividing the market price of a share by earnings per share.

P/E ratio = Market Price of the share/EPS