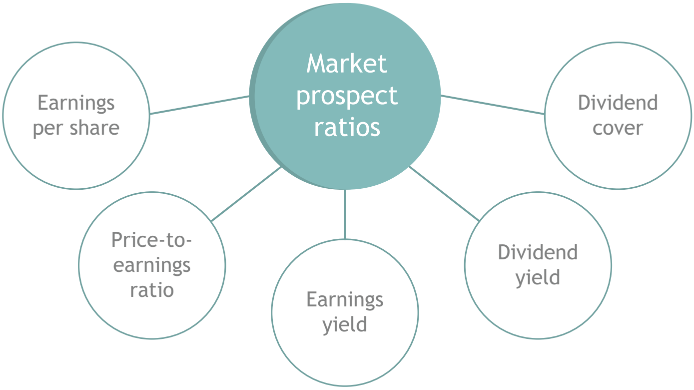
Chapter 5

Market Prospect Ratios

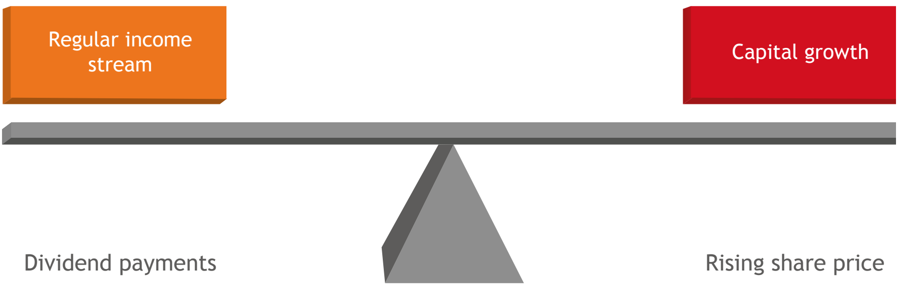
How can I use market prospect ratios to assess the attractiveness of my organisation to potential investors?

Market prospect ratios help potential investors to assess what they might receive from an investment – in terms of future dividends, earnings, or capital gains from a higher share price.

Market prospect ratios allow investors to assess: potential returns, future dividends, earnings, capital gains.



Through analysing recent trends, and by understanding the message the business conveys through these ratios, investors can select businesses that will deliver the returns they are looking for, whether they seek a regular income stream from dividend payments, or capital growth through a rising share price.



Earnings Per Share

Earnings per share (EPS) is a business' net profit or profit after tax, divided by the number of ordinary shares the company has issued.

If X-AMPLE had issued 10m ordinary shares, our calculation would be £4m divided by 10m shares, giving us earnings per share of 40 pence.

Earnings per share = (net profit / number of ordinary shares)

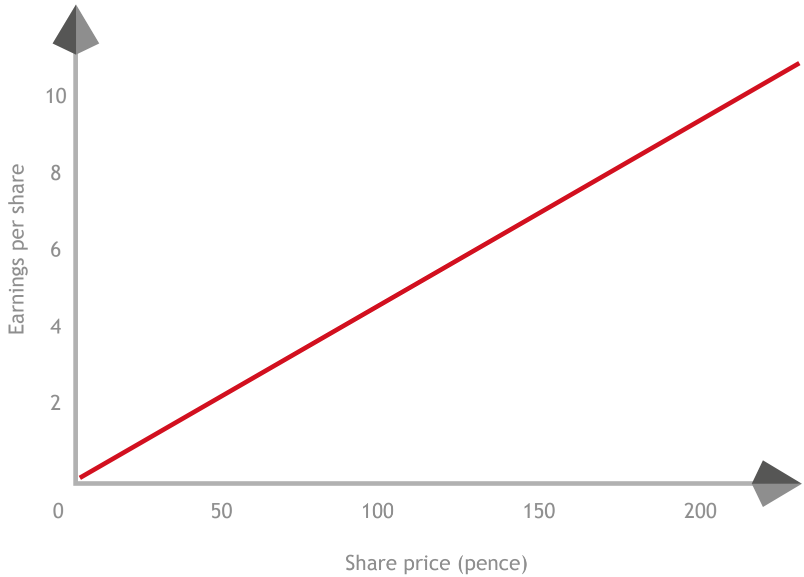
= (4m / 10m) = £0.40

Profit and Loss Account for X-AMPLE Ltd for the Year Ended 30th September 2016		
	£	£
Sales		20 000 000
Cost of sales		(8 00 000)
Gross profit		12 000 000
Less expenses		
Marketing costs	(3 000 000)	
Administration	(2 000 000)	
Depreciation	(500 000)	
		(5 500 000)
Operating profit		6 500 000
Interest		(500 000)
Profit before tax		6 000 000
Corporation tax		(2 000 000)
Net profit after tax		4 000 000
Dividends		(2 500 000)
Retained profit		1 500 000

This means that every share has 40 pence of net profit attributable to it, whether this is paid out as a dividend or kept by the company as retained profit.

A higher earnings per share often leads to a rise in the share price, because it represents greater value for equity investors.

EPS measures how much net profit is attributable to each share.



A higher EPS leads to a rise in the share price.

Price-to-earnings ratio

The price-to-earnings ratio or P/E ratio equals a business' share price divided by its earnings per share.

If X-AMPLE had a share price of 320 pence, then our calculation would be 320 divided by 40, giving us a price-to-earnings ratio of 8.

Price-Earnings Ratio = Share Price / Earnings Per Share

320 / 40 = 8

This means that the market value of every share is 8 times the net profit attributable to that share this year. Investors are willing to pay £8 for every £1 of net profit X-AMPLE makes.

A high price-to-earnings ratio - compared with similar businesses in the same industry - indicates that investors are willing to pay more for the profits the business makes this year, because they are confident that profits will rise in the future.

A low price-to-earnings ratio indicates that investors are not confident about the company's future earnings.

P/E Ratio measures how much investors are willing to pay for every pound of net profit the business makes.

A high P/E ratio shows when investors are confident profits will rise.

A low P/E ratio shows investors are not confident in future earnings.

Earnings yield

The earnings yield is simply the price-to-earnings ratio expressed in a different way. Both compare the share price with the earnings per share, but while the P/E ratio demonstrates how many more times a share is worth than the profit per share, the earnings yield looks at what percentage of the share's value is earned as profit.

Earnings yield measures what percentage of the share's value is earned as net profit.

The earnings yield equals a business' earnings per share divided by its share price, then multiplied by one hundred to give a percentage.

In X-AMPLE's case, this is 40 pence, divided by 320 pence, multiplied by one hundred, giving an earnings yield of 12.5%.

$$\text{Earnings Yield} = \left(\text{Earnings Per Share} \,/\, \text{Share Price} \right) \times 100$$

= (40 / 320) x 100 = 12.5%

This means that for every pound an investor's shares are worth, X-AMPLE generates a net profit of 12.5 pence for the shareholder.

A low earnings yield indicates that investors are confident the business will do well in the future and are consequently willing to accept lower returns today.

A high earnings yield shows a lack of investor confidence in future performance.

Low earnings yield –
investors are confident about future performance.

High earnings yield –
a lack of investor confidence in future profits.

Dividend yield

Dividend yield measures how much dividend a shareholder receives for every pound's worth of shares.

The dividend yield equals a business' dividend per share, divided by its share price, and then multiplied by one hundred to give a percentage.

If X-AMPLE paid a dividend of 25 pence, our calculation would be 25 pence, divided by 320 pence, giving us a dividend yield of 7.8%.

$$\text{Dividend Yield} = \left(\text{Dividend Per Share} \,/\, \text{Share Price}\right) \times 100$$

= (25 / 320) x 100 = 7.8%

This means that for every pound their shares are worth, a shareholder receives a dividend payment of 7.8 pence.

Some businesses choose to pay a high dividend to attract investors seeking a regular income. These are known as income stocks.

Other businesses pay low or no dividends, and prefer to invest their money for future growth. These growth stocks will attract investors seeking capital growth.

Income stocks – pay a high dividend to attract investors seeking a regular income.

Growth stocks – pay low or no dividends and attract investors seeking capital appreciation.

Dividend cover

Dividend cover measures how many times over the business could afford to pay its dividend.

The dividend cover equals a business' earnings per share, divided by its dividend per share.

In X-AMPLE's case, this is 40 pence, divided by 25 pence, giving a dividend cover of 1.6.

$$\text{Dividend Cover} = \left(\text{Earnings Per Share} \,/\, \text{Dividend Per Share} \right)$$

$$= 40 / 25 = 1.6$$

This means that X-AMPLE could afford to pay its dividend 1.6 times over.

A low dividend cover indicates that the business might struggle to pay a similar dividend in the future; or that it is having to pay a large dividend to maintain its share price.

A high dividend cover indicates that the business is keeping a large amount of its earnings as retained profit, perhaps for future investment.

Low dividend cover – the business might struggle to pay a similar dividend in the future.

High dividend cover – the business is keeping a large amount of its earnings as retained profit.

"Market prospect ratios allow investors to assess potential returns, future dividends, earnings, and capital gains"