

Ratio Analysis

Ratio analysis is one of the fundamental tools used by analysts to provide meaningful relationships between values reported in financial statements. This is because numbers in isolation do little to convey the performance of a company. This article seeks to explain some of the ratios commonly found in WISE's analysis of Companies.

Price/Earnings Ratio

One of the most popular ratios used in fundamental analysis is the price/earnings (p/e) ratio. The price/earnings ratio indicates how much one is willing to pay per dollar of earnings. For example, Neal & Massy's (NML) price/earnings ratio of 11.64 means that you are willing to pay \$11.64 for every dollar earned by the Company. Hence, a relatively high p/e would mean that a share is over valued and vice versa. Recommendations based on p/e earnings are usually done after consideration of the range in which the share usually trades and/or the p/e multiples of other companies within the same sector.

For example, given that NML usually trades up to 17 times earnings, based on its current p/e of 11.64, it would currently be considered a 'BUY'. A sectoral analysis also reveals that the p/e of NML is relatively low in comparison to other shares in that sector. (See Figure 1)

Figure 1

Conglomerate Sector	P/E Ratio *
Ansa McAl (AMCL)	12.51
Barbados Shipping & Trading (BST)	17.50
GraceKennedy Limited (GK)	9.17
Neal & Massy Holdings Limited (NML)	11.64
* The P/E Ratio is calculated at WISE's forecasted EPS	

Another ratio that is also relative to the price of a share is the Market to Book Ratio.

Market to Book

A company's Market to Book ratio relates the price at which a share currently trades to the net asset value of the company. This is because the Book Value of a share estimates the value of a company after all assets are sold and all liabilities are paid off. Hence, the ratio indicates how much higher or lower the company is trading to its actual net asset value per share. A high market to book ratio would indicate that a company is overvalued while a low market to book ratio would indicate that the company is undervalued. A ratio of 5 would be considered high, 3 would be average and less than 2 would be low.

Figure 2

Market to Book Ratio	
NML	2.44
AMCL	2.93
SBTT	3.66
RBL	3.11
TCL	1.32

As shown in Figure 2, according to this computation, TCL would be considered low, while NML, AMCL, SBTT and RBL would be considered average.

Other ratios regularly used in WISE's financial analysis are the Operating Profit Margin and Net Profit Margin Ratios. Both these ratios measure the Operating Profitability of a company.

Operating Profit Margin

The Operating Profit Margin (OPM) relates a company's Operating Profit to Net Sales. Hence, it indicates how successful the company's management has been in generating income from the operations of the business. It gives an idea of the earnings of a company (before interest & taxes) on each dollar of sales.

Figure 3

Operating Profit Margin %					
	2005	2004	2003	2002	2001
NML	9.76	9.85	7.75	7.11	8.69
AMCL	21.25	19.10	19.89	19.14	19.57
SBTT	74.39	73.78	71.56	74.31	71.77
RBL	80.27	72.03	68.35	63.02	69.54
TCL	12.86	22.87	22.84	21.79	21.66

For example, from Figure 3 one can see that the Operating Profit Margin (OPM) for Neal & Massy (NML) steadily increased from 2002 until 2005. Another Conglomerate, Ansa McAl (AMCL) was able to steadily retain a greater amount of its revenue after paying variable costs.

With respect to two Companies from the Banking Sector, both margins generally rose which signifies that they have been able to grow this margin which is of course positive for these Companies.

Trinidad Cement Limited's (TCL) OPM however was slowly growing until 2005. This was due to a small increase in Revenue from 2004 to 2005 in relation to a more rapid increase of costs. Hence Operating Profit was down considerably more than revenue resulting in a significant fall in its OPM.

Net Profit Margin

A company's Net Profit Margin relates Net Profit to Revenue. In other words, it is an indication of what proportion of a company's Revenue was able to find its way to the bottom line. Thus, it signifies how well the business is being run. A historically growing and favourable Net Profit margin is a direct indication of a business' ability to enhance its profits in the future.

Figure 4

Net Profit Margin %					
	2005	2004	2003	2002	2001
NML	7.46	7.56	6.54	6.94	6.92
AMCL	15.28	9.74	12.27	10.83	10.07
SBTT	54.23	53.48	50.98	49.88	48.74
RBL	70.20	58.54	61.40	56.46	60.00
TCL	10.75	13.82	11.87	12.84	10.19

From Figure 4, AMCL and SBTT all generally showed increasing Net Profit Margins over the past five years. This is of course favourable as it exhibits that the Companies were able to grow its bottom line in relation to the top line and therefore retain greater profits. The other three Companies reviewed shows fluctuating margins which could indicate that there has been some difficulty in operating the business.

Return on Assets (ROA)

Return On Assets (ROA) is also a ratio that is frequently used as it indicates the profitability of a company in relation to its total assets. This is important as it demonstrates the efficiency of management in using its assets to generate earnings.

Figure 5

ROA%				
	2005	2004	2003	2002
NML	10.33	10.12	8.47	7.41
AMCL	8.40	7.18	6.45	5.83
SBTT	2.81	2.71	2.61	2.49
RBL	2.90	2.61	2.70	2.49
TCL	5.71	7.86	6.02	6.23

For example, from Figure 5 it is evident that NML, AMCL, SBTT and RBL and produced consistent profits in relation to its total assets. In fact, the profits have been growing in relation to the asset base. TCL's ROA however has not been consistent. In 2005, this Company made investments in order to improve its operations. Hence, this could be a reason for the decline in 2005.

Return On Equity (ROE)

Return On Equity (ROE) measures a stockholder's return on his investment. This ratio indicates the rate at which shareholders are earning interest on their shares. Hence, a good ROE would indicate the company's ability to sustain its profits while being able to reward the shareholders. From Figure 6, one can see that NML, AMCL and RBL has had steadily increasing ROEs which bodes well for these Companies. SBTT however has had a falling ROE while TCL's fluctuated.

Figure 6

ROE%				
	2005	2004	2003	2002
NML	20.71	16.40	16.83	17.34
AMCL	23.84	20.17	18.33	17.97
SBTT	20.72	20.95	22.75	24.68
RBL	20.34	18.45	17.92	16.95
TCL	13.97	18.68	14.70	15.51

All of these ratios bring meaning to Financial Statements and gives analysts a better idea of how Companies are performing. Operating Profitability Ratios indicate how well management is able to run the business as the margin relates to the Revenue the company has earned. The P/E and Market to Book Ratio help analysts relate the market value of a share to a company's Earnings and Net Asset Value respectively. Such ratios are important in determining whether a company is undervalued, fairly valued or overvalued. ROA is useful in determining management's effective use of assets while a company's ROE gives an indication of a stock holder's return on his investment.

It is important to note that a complete analysis of a company would involve the use of several of these ratios in order to gauge its performance. This is because any ratio used in isolation would not give a holistic idea of how well a company is executing its business.