Fundamental Analysis of Shares

Abstract

Fundamental analysis talks about company valuations on the basis of Profit and Loss Account and Balance Sheet of the Company. Several Ratios are quick indicators of financial position of the company. Ratios are broadly classified into Solvency Ratios, Liquidity Ratios, Turnover Ratios and Profitability Ratios. Fundamental analysis is used for long term i.e. for 1 year or more. Tools used in fundamental analysis are Price to Book Value ratio (P/BV Ratio), Price Earnings Ratio (PE Ratio), Compounded Average Growth Rate (CAGR), Return on Equity (ROE), Return on Capital Employed (ROCE), Earning per Share (EPS), Price Earning Growth Ratio (PEG Ratio), Dividend Yield Ratio, Debt-Equity Ratio and Working Capital Cycle etc. On the basis of these ratios one can identify the strength and weakness in the share value of the company. Finding out Intrinsic Value, and Enterprise Value are some other methods used to identify the true value of a share. In this paper I will discuss about these ratios and try to find out the methods, techniques and level of indicator used by the analyst to take buying and selling decisions.

Ravinder Kumar Bhatia
Assistant Professor,
Deptt. of Commrece,
Govt. Degree College,
Haripur Nihastha, Raebareli, India

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Introduction

There are various companies listed in stock exchange. This includes Government Companies as well as Private Sector Companies. When a Public Limited Company is required funds it can issue shares to the public. When a person buy shares from initial public offer it is known as primary market and if any person bought shares from stock exchange through brokers, it is known as secondary market. There are various stock exchanges in India. But stocks are bought and sold mainly through BSE and NSE. It contains various indices for each sector such as bank index, auto index & pharma index as well as separate indices for large cap, mid cap and small cap stocks. SENSEX is the indices of Bombay Stock Exchange and NIFTY are the indices of National Stock Exchange. There are 30 stocks listed in SENSEX and 50 stocks listed in NIFTY. These two indices mainly indicate the upward and downward movement in the market in India. Most of large companies of India are listed in these two exchanges. Such as HDFC, ITC, Reliance, SBI, Bajaj Finance, L&T etc. Upward and downward movement in share price may be due to internal factor such as sales, growth; liquidity etc or it may be due to external factors such as government policies, political environment, subsidies, taxation, FII and FDI inflows and outflows. Controlling external factors are out of the reach of the company. So, fundamental analysis of the company is based on the financial position of the company i.e. Profit and Loss Account and Balance Sheet of the company. Several ratios help in quick analysis of these companies statements.

Objectives of the Study

1. To know about fundamental analysis of the company
2. To know about tools used in fundamental analysis of the company
3. To find out parameters on which one can buy and sold stocks

Review of Literature

Fundamental analysis is based on the analysis of Balance Sheet and Profit and Loss account. Several ratios are used to analyze the financial position of the company. Book value per share is calculated by dividing the owner's equity or net asset value (total assets- intangible assets – liabilities) by the number of shares. Market price per share is the price of share prevailing in the market. Market value per share may be more or less from book value per share. Market price of share increase or decrease due to macro trends of the economy or economic policies of the government. It is also affected by company own decisions, its growth prospects and liquidity. Price to book value ratio is an important measure to identify the number of times at which share is quoted in the market (i.e. market value) as compare to its book value. Formula for P/B value ratio is

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market price per share divided by the book value per share. Price Earnings ratio is another measure to identify the number of times at which share is quoted in compare to its earnings. Formula for P/E Ratio is market price per share divided by earning per share. In other words we can say market price per share will increase when its P/E valuations increases or its earnings per share increases (Market Price = PE x EPS). Earnings of the company are the interest of shareholders in the company. Company can retain the whole profits or it can distribute some profits as dividend. Dividend is the part of profit distributed by the company to shareholders for having faith and interest in the company. Shareholders can't force to company to pay dividends. Usually shareholders prefer companies which are paying high dividends. Dividend yield ratio shows the amount of dividend that a company pays to its investors in comparison to market price of its share or stock. Dividend yield ratio is calculated by dividing the annual dividend paid per share by the market price per share. Earnings per share is the earning available to equity share holder after making all adjustment of all expenditure, interest, taxes and dividends. Earnings per share are calculated by dividing the earnings of the company with the number of shares. Debt-Equity ratio compares the debt capital of the company with the equity capital. Company whose debt is high, a large portion of its earnings can be used to repay loan and interest cost. Return on capital employed is calculated by dividing the company profits before interest and tax from the capital employed in the business. Capital employed is the sum total of shareholders equity and long term debts of the business. Return on equity is calculated by dividing net profit (after interest and tax) from the equity share capital of the company. Compounded average growth rate (CAGR) measures compounded growth of profits, return on equity and sales in last 3,5 and 10 years. It tells the investor, whether the company is consistently growing or not. Whether the EPS of last 3 or 5 years are constant and it is growing with certain percentage. Price earnings growth ratio (PEG) is calculated by dividing the (PE) price earnings ratio with the CAGR in earning per share. Deliverable quantity to total quantity ratio is another measure to identify the strength and weakness in the company stock. All the above ratios give some indications about company financial position and indication of growth or downfall in the company.

Research Design

Companies listed in BSE, NSE and other indices have been taken in order to conduct this study. Both large cap and mid cap stock are taken in this study. Companies giving profits and are consistent in giving profits to investors has been taken in this study. Various ratios such as Return Ratios, P/BV, PE, PEG, EPS, CAGR in EPS, ROC and ROE have been used to identify the strength of the company. Low beta and less volatile stocks have been chosen in this study. Capital procurement is the primary motive in selection of stocks.

Findings

There are number of companies which erode investor wealth. There are also some companies which doubles investor wealth in every three years. Following are the 1, 3, 5 and 10 years returns of such companies. I have taken some large caps and some mid caps in the example.

S.No.	Name of Company		Returns in %			
	As on 28/02/2019	CMP	1Year	3Years	5Years	10Years
1	HDFC Bank	2302.80	8.64	79.62	168.18	674.99
2	Kotak Mahindra Bank	1334.50	17.87	92.24	184.32	741.77
3	Bajaj Finance	3025.00	13.73	220.33	1286.89	17073.72
4	Titan	1141.85	25.92	176.89	211.18	1689.15
5	Havells	772.50	-8.34	59.13	142.27	2135.45
6	Relaxo Footwear	770.75	18.00	126.33	344.27	10840.98
7	VIP Industries	483.35	-28.86	197.72	297.76	1177.05

S.No.	Name of Company As on 28/02/2019	B.V.	P/BV	PE	PEG	ROC	ROE	CAGR in EPS (4 Years)
1	HDFC Bank	562.02	4.01	27.63	1.34	7.69	16.96	18.96
2	Kotak Mahindra Bank	302.00	4.96	40.30	1.69	7.92	13.22	17.77
3	Bajaj Finance	299.48	11.10	46.10	1.15	13.02	21.98	25.04
4	Titan	68.17	16.12	68.39	4.95	26.42	25.22	16.02
5	Havells	67.7	9.68	51.77	4.37	28.55	19.86	22.67
6	Relaxo Footwear	44.54	9.83	60.62	2.08	29.63	23.51	14.47
7	VIP Industries	38.68	10.14	40.73	1.83	36.26	25.29	31.18

Note :

1. Dividend distributed is additional to the above returns.
2. Increase in Number of shares due to Split and Bonus is adjusted in stock price.
3. CAGR in EPS is calculated taking 2015 EPS as base year.

Conclusion

These are some of the companies which give good returns in short term as well as long term. So one can study about these companies and identify the returns given by these companies. A person can also take share market as a financial career. National stock exchange organized various short term as well as long term course in stock market study. NSE also conducts certification courses in stock market. So, as per fundamental analysis study and return ratios, I found some companies doubling investor wealth in every three years. 5 year returns are near to 200 % to 300 %. When we saw 10 year returns of these companies, returns are nearly 10 times. Stocks are taken from Banking, NBFC and Consumption sector. CAGR in EPS is more than 15 percent in most of these companies. In spite of consist downfall of share market from last two years; returns of these companies are consistent and less volatile. By finding out intrinsic value of shares one can consider margin of safety in stocks in taking buying decisions.

Suggestions for Indicators

1. A Price earnings growth (PEG) ratio of 0.10 indicates a company PE of 6 when CAGR in EPS is 60. So PEG less than one are good indicator of investment.
2. A Price Earnings ratio of 10 is good for investment when market or sector PE is 30
3. Return On Capital Employed (ROCE) and Return on Equity (ROE) is preferable when it is more than 20 percent
4. Price to Book Value (P/BV) is preferable when it is near to one. This means that market price is near to book value
5. Low working capital days compare to its pears indicates company strength and less blockage of working capital in the market.
6. Positive net cash flows and free cash flows indicates the financial strength and cash rich position of the company
7. Low Debt-Equity ratio indicates that company is less depend on external borrowers and uses its earnings and reserves for its growth.
8. Compounded Average Growth Rate (CAGR) more than 20 percent in EPS, Sales Growth and Net Profits is preferable for investment.

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