Investors' Chronicle

Investing explained

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Investing in shares

When you buy a share, you become a part-owner of a company. You share in the company's successes and failures and technically get a say in how it is run

Not all companies are open to ownership by anyone. Companies choose to sell parts of themselves to the public if they want to raise money or their profile. When a company goes public, they sell a handful of shares onto the stock market in what is called an initial public offering (IPO).

Once a company's shares are listed, they are traded constantly. Stock markets operate much as any other market does: buyers pay their money in exchange for shares, sellers offer their shares to other buyers, traders help facilitate the transactions.

Price is based on supply and demand. In theory, if a company is performing well, demand for its shares will be high and the price will rise. If a company is performing badly, demand for its shares will fall and current owners might want to sell their shares. When more people want to sell shares than buy, the price falls.

Investors can buy the shares of companies that are listed on public stock markets either directly or indirectly via funds (more on that in another guide). Direct investment may be a better option for investors with a large pot of savings which can be split across multiple companies – you don't want all your fortunes tied to the success of just one company. Indirect investment is a cheap and easy way of allowing you to spread your money across multiple companies and industries.

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How do companies make you money?

Your returns will either be made by capital growth or by dividend payments. Capital growth refers to the increasing value of your investment. For example, if you bought a company share at 10p and the company performs well, demand for its shares might increase, raising the value of your share to 15p. If you then sell that share at 15p, you will have made a 50 per cent return.

The second way companies can add to your wealth is in the payment of dividends. This is when highly profitable companies pay extra cash they have generated back to their shareholders, usually twice a year. In the UK, dividends usually account for a lot of the total investor return: in 2019, the FTSE All-Share generated capital growth of 13 per cent and a total return of 19 per cent when dividend income was added.

Determine your investing style

There's no one correct way to invest, but approaches can broadly be broken down into four styles:

- **Growth** – look for companies with high or potentially high earnings growth rates.
- **Quality** – look for durable companies that are growing with strong balance sheets.
- **Value** – look for companies with low valuation ratios underappreciated by the market. Often in 'turnaround' stories.
- **Momentum** - follow recent stock price trends

These styles shouldn't be interpreted too rigidly, as all investors share a common goal of trying to make money – and circumstances change. But the valuation metrics you choose to consider may change depending on the type of company you are investing in.

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Determine a company's value

There are two main ways of determining company value.

I) Market Capitalisation

The value of a company is often thought of in terms of its share price and market capitalisation (the aggregate market value of shares in issue). However, this only represents part of the picture and can be misleading for companies with high borrowings, high lease liabilities and pension deficits.

So we also have...

II) Enterprise Value (EV)

EV represents the market cap plus other claims on the company's assets and earnings which rank above the claims of shareholders. The most significant of such claims usually relates to a company's lenders – ie its net debt. Other major considerations are lease obligations and pension deficits.

In its most basic form: EV = market cap + debt – cash

Top Tip: Enterprise value is extremely difficult to calculate accurately because debt moves around during the course of a year and the figures investors get from the balance sheet only represent a period-end snapshot (usually period ends are chosen to present the most flattering possible picture of debt). Other potential components of the EV valuation require a company or investor to make assumptions to estimate the true size of the liability.

Decide if you think the price is right

To understand company valuation, it must be compared with the company's underlying financial performance. Here are three things to value a company against.

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I. Comparisons with profits

The most commonly used measures of profits for valuing shares are:

- **Earnings per share (EPS)** – profits per share after interest costs, minority interests and tax are taken.
- **Earnings before interest and tax (Ebit)** – as well as payment for debt, interest payments include some of the costs associated with pensions and leases.
- **Earnings before interest, tax, depreciation and amortisation (Ebitda)** – profits before interest payments, and also depreciation and amortisation expenses (which are charges used to offset the benefits of assets used in a period with their historic cost)

Because Ebit and Ebitda are measures of profit before interest payments and before the deduction of minority interests (the proportion of a subsidiary's profit that belongs to a minority owner of the subsidiary) valuation comparisons need to be made with EV. But because EPS is profits per share after interest and minorities (and also tax), it needs to be compared with share price.

So we have:
EV/Ebit
EV/Ebitda
P/EPS, known as a P/E ratio.

II. Comparisons with the source profits (Sales or NAV)

In most industries the source of a company's profits are its sales, but in some industries, such as property and finance, it is its assets. Valuing against a company's source of potential profits is very useful if profits are currently low or non-existent but are expected to be much bigger at some point in the future (recovery plays or early-stage growth plays). Sales can be compared against either EV or share price. In the case of assets, share price is compared with NAV per share (also referred to as book value or shareholder equity). So we have:

EV/Sales
P/Sales (alternatively referred to as price to sales ratio or PSR)
P/NAV (alternatively referred to as price to book or P/BV or P/B)

III. Comparisons with cash flows

Reported cash flow is more tangible and harder to manipulate than profits. However, cash flow statements are far from tamper-proof and cash flows can be very volatile, especially for companies that periodically have high investment needs (ie building a new factory). Acquisitions can also make cash flow much harder to interpret. Popular cash measures include operating cash flow (the amount of cash generated before investment, interest and tax) and free cash flow (the amount of cash generated after all necessary spending in the year). Two popular ratios are:
P/free cash flow (FCF) per share
EV/Operating cash flow

NB All valuation ratios can be expressed as yields by flipping the equation on its head and multiplying by 100.

Justifying a higher or lower valuation

Company value and valuation don't mean a lot out of context. When deciding whether a company's shares are worth buying and whether the price is right, valuation should be looked at in the context of the company's operations and the wider market. Here are five ways of rationalising a company's valuation.

1. Balance sheet risk

Weak balance sheets put shareholder value at greater risk should trading deteriorate. It follows that companies with weak balance sheets (high liabilities, especially debt) should have lower valuations to compensate for this risk.

2. Cyclical risk

Companies with profits that are highly sensitive to their industry's business cycle have high cyclical risk and should have lower valuations to compensate for this. Cyclical companies are typically owned by value investors.

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3. Operational risk

Companies with high fixed cost bases will have profits that are very sensitive to changes in sales (using industry jargon this is referred to as high operating gearing) and should have lower valuations to compensate for this risk.

4. Quality

A company should command a higher valuation if it is able to produce (a) a high return on money it invests in its business, (b) a high level of profit on the sales it makes, and (c) turn a high proportion of profit into cash. The consistency with which a company can do these things is also key. There are a number of useful ways to measure different aspect of quality:

(a) Return on money invested

Return on invested capital or ROIC compares profit after tax with money invested in the business. Return on capital employed or ROCE compares Ebit with money invested in the business (in its most basic form capital employed is total assets less current liabilities except short-term debt).

(b) Return on sales

Various measures of profit can be expressed as a proportion of sales, which is known as a company's margin. The most used measures are operating margin (operating profit as a percentage of sales), Ebit margin (often the same or very similar to operating margin) and gross margin (particularly useful as a measure of a company's pricing power).

(c) Turning profits into cash

Cash conversion can be measured in several different ways. The most popular measures are operating cash flow (ie before tax and interest) as a percentage of Ebitda (as a crude rule of thumb >80% is good), operating cash as a percentage of operating profit (>100% is good), and post-tax profit to free cash flow (FCF) (>80% is good). FCF is cash left over after accounting for all necessary cash expenses for the year and it therefore represents money a company is free to spend on things like dividends, acquisitions and debt reduction.

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5. Growth

The higher a company's growth rate, the higher the valuation should be to reflect the prospect of higher profits in the future. Useful ways to measure growth (both for sales and EPS) include:

Historical growth based on the compound average growth rate (CAGR)
Forecast growth (although future earnings are notoriously difficult to predict)
Forecast revisions (upgrades and downgrades)

A price/earnings growth (PEG) ratio can be used to assess what investors are being asked to pay for a share based on a multiple of its current earnings relative to growth in earnings. PEG = P/E ratio / EPS growth rate (a crude rule of thumb is that a PEG of less than 1 is attractive).

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