

# Preferred Procedure



## Mini Investment Class by the OKI Tri-State Chapter

*Courtesy Cincinnati Model Investment Club*

*Based on Original Presentation by Gretchen and Jim Hurt*

*Revised 5/1/10 by Sandy and Bob Lowery*

NON-PROFIT  VOLUNTEER BASED  MEMBER DRIVEN



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# SSG Projections

- **After studying side one and section 2 of the SSG, we make projections for the company:**
  - **Projected Growth in Sales for the next five years**
  - **Projected Growth in EPS for the next five years**
- **We have much more confidence in our sales projections than in our EPS projections:**
  - **Sales are very fundamental**
  - **Not many ways management can fudge sales**
  - **EPS is influenced by many factors**

# Rules for Projecting EPS

- **Not greater than historical growth in EPS.**
- **Not greater than projected growth in Sales.**
- **Not greater than 15% (20% for small companies with very high growth rates).**
- **After making EPS growth projection as we teach in the SSG class**
  - **Try the Preferred Procedure**

# Preferred Procedure

- **The Preferred Procedure is another way to make five year projections for EPS.**
- **We pretend we are the CFO of the company five years from now, and fill out the Profit and Loss sheet:**
  - **We accept the five year projections for Sales**
  - **We compute pre-tax profits**
  - **We compute taxes paid and net profit**
  - **We compute number of shares and EPS**

# Example

- **Sales of \$44.525 Billion**
- **Sales growth projected to be 12.0%**
- **Sales (5 year) projected to be \$78.468 Billion**
- **EPS of \$1.74**
- **EPS growth projected to be 12.0%**
- **EPS (5 year) projected to be \$3.07**
- **Analyst's projected 5 year EPS to be \$3.28**

# Company in Five Years (Part 1)

- **Accept projected sales of \$78.468 Billion**
- **Pre-tax Profit Margin has averaged 34.1%, so we expect pre-tax profit to be:**
  - **34.1% times \$78.464 Billion = \$26.756 Billion**
- **Taxes are averaging 23.0%, so we expect to pay taxes of:**
  - **23.0% times \$26.756 Billion = \$6.154 Billion**
- **This leaves \$20.602 Billion for net profit**

# Company in Five Years (Part 2)

- **Projecting \$20.602 Billion for net profit**
- **Project that company will have 7631.5 Million shares in five years.**
- **Thus, we project the company will have an EPS of:**
  - **\$20.602 Billion divided by 7631.5 Million**
- **This is an EPS of \$2.70**
- **Compare this to 12.0% growth EPS of \$3.07**



# Example Preferred Procedure

	<b>Projection</b>	<b>Value</b>
<b>Sales</b>	<b>12.0%</b>	<b>\$78,468</b>
<b>Pre-Tax Profit</b>	<b>34.1%</b>	<b>\$26,758</b>
<b>Taxes</b>	<b>23.0%</b>	<b>\$ 6,154</b>
<b>Pref. Dividends</b>	<b>0</b>	<b>\$ .00</b>
<b>Net Profit</b>		<b>\$20,603</b>
<b>Shares</b>	<b>7,631.5</b>	<b>7,631.5</b>
<b>EPS</b>		<b>\$ 2.70</b>

# Benefits

- **Preferred Procedure uses:**
  - **Sales projections which are usually more accurate than EPS projections**
  - **Projected Pre-Tax Profit Margin (Row 2A)**
  - **Projected Income Tax Rate**
  - **Projected Dividends for Preferred Stock**
  - **Projected Number of Shares Outstanding**
- **Projecting a growth rate for EPS is not explicit about all these projections**

# Conclusion

- **Use Conservative projection for growth rate of both sales and EPS**
- **Use Preferred Procedure, using conservative values for:**
  - **Pre-Tax Profit Margin (Row 2A)**
  - **Income Tax Rate**
  - **Preferred Dividends**
  - **Number of Shares Outstanding**
- **Then use the smaller of the two EPS projections.**

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