

Management and Return on Equity



Mini Investment Class by the OKI Tri-State Chapter

*Courtesy Cincinnati Model Investment Club and Money Tree Investment Club
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OKI Tri-State Chapter

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Return on Equity

- Return on equity measures how well management uses the assets of the company to create sales.
- Earnings come from the sales.
- The Asset Turnover Rate allows us to see how well management is using the assets to create sales.

Asset Turnover Rate

- Asset Turnover Rate is the amount of sales created by each dollar of assets (sales divided by assets).
- A decline in Asset Turnover Rate probably means management is investing in non-productive assets.

ROE Declines

2 EVALUATING MANAGEMENT

Company **Teleflex Inc** (TFX)

08/20/03

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	LAST 5 YEAR AVG.	TREND	
												UP	DOWN
A % Pre-tax Profit on Sales (Net Before Taxes + Sales)	7.8	7.8	8.1	9.3	9.3	8.7	8.9	9.0	8.4	8.3	8.7		EVEN
B % Earned on Equity (E/S + Book Value)	12.4	13.2	13.6	14.0	14.9	15.1	15.6	15.7	14.3	12.6	14.7		DOWN

In this example Pre-Tax Profit stayed even, but Return on Equity took a big drop. This is a good indication that the problem was not in the net profit margin.

Asset Turnover Rate Declines

	2001	2002
Total Assets	\$1,635,020	\$1,813,384
Sales	\$1,905,004	\$2,076,229
Asset Turnover Rate	1.17	1.14

The change does not appear to be large but if you think of it in the following way you will see it is a significant change. For every dollar of assets, the company generated 3 cents less in sales in 2002.

Asset Turnover Rate

	2001	2002	% Change
Sales	\$1,905,004	\$2,076,229	9%
Total Assets	\$1,635,020	\$1,813,384	11%
Cash	\$46,900	\$44,494	-5.10%
Accounts Receivable	\$363,674	\$401,888	10.50%
Inventories	\$308,775	\$365,535	18.40%
Goodwill	\$223,911	\$257,999	15.20%

Sales grew 9% and Assets grew 11%. Which of the above items created the problem with Asset Turnover Rate?

Questions to Research

Cash- We expect management to use the cash on hand to grow the assets such as building a new plant or or making an acquisition. These items would show up on the balance sheet. Management should pay cost of goods sold, overhead, taxes, and dividends out of revenues from sales.

Did management spend the cash on hand on productive assets?

Questions to Research

Accounts Receivable - If customers are not paying their bills in a timely manner, why not? Is management stuffing the pipeline? This allows the company to book a sale which makes the revenues look good.

If Accounts Receivable were increasing we would want to know why.

Inventories - If inventories are building up, is obsolescence going to be a problem? Why aren't the products selling? Money tied up in inventory is money that often could be put to better use.

Why are Inventories increasing?

Questions to Research

Goodwill - the excess value of an asset beyond its book value. When companies make an acquisition of another company there will often be a large increase in goodwill on the balance sheet.

Goodwill no longer has to be depreciated as long as the goodwill is an accurate reflection of the true value of the asset. But if the goodwill is not a true reflection of the value, it must be written off of profits.

Does this additional goodwill reflect the true value of the acquisition or will it have to be written off at some future time?

Questions to Research

- Questions about items on the balance sheet are often much harder to answer.
- Three additional places that may provide additional information to help you determine how serious the problems are:
 - Cash Flow Statement
 - Footnotes in the Annual Report
 - Call Investor Relations

Why bother with Asset Turnover Rate?

- Large increases in inventory, accounts receivable and goodwill are non-productive assets.
- A decrease in cash on hand could be an early warning sign of serious cash flow problems developing in a company.

When There Are Balance Sheet Concerns

- Find as much information as you can about the problem(s). Call Investor Relations!
- Decide how long you are going to give the company to fix the problem(s).
- Closely monitor the situation every quarter.
- If things do not improve, consider selling.



2 EVALUATING MANAGEMENT

Company _____

	19__	19__	19__	19__	19__	19__	19__	19__	19__	19__	19__	19__	LAST 5 YEAR AVG.	TREND		
														UP	DOWN	
A % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)																
B % Earned on Equity (E.S. ÷ Book Value)																

3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

Year	PRESENT PRICE		C Earnings Per Share	HIGH THIS YEAR		LOW THIS YEAR		
	A	B		D	E	F	G	H
	PRICE HIGH	PRICE LOW		Price Earnings Ratio HIGH A ÷ C	Price Earnings Ratio LOW B ÷ C	Dividend Per Share	% Payout F ÷ C X 100	% High Yield F ÷ B X 100
1								
2								
3								
4								
5								
6 TOTAL								
7 AVERAGE								
8 AVERAGE PRICE-EARNINGS RATIO								
9 AVERAGE PRICE-EARNINGS RATIO								

4 EVALUATING RISK and REWARD over the next 5 years

Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell. The upside-downside ratio is the key to evaluating risk and reward.

A HIGH PRICE — NEXT 5 YEARS
 High Price (A) _____ X Low Earnings (C) = _____ (421)
 Low Price (B) _____ X High Earnings (D) = _____ (422)

B AVERAGE YIELD OVER NEXT 5 YEARS
 Avg. Earnings Per Share (C) _____ X Avg. % Payout (G) _____ = _____ % (423)
 Present Price (B) _____

C ZONING
 High Forecast Price (A) _____ to _____ (424)
 Lower 1/3 = _____ to _____ (Buy)
 Middle 1/3 = _____ to _____ (Maybe)
 Upper 1/3 = _____ to _____ (Sell)
 Present Market Price of _____ is in the _____ Range (425)

D UP-SIDE DOWN-SIDE RATIO (Potential Gain vs. Risk of Loss)
 High Price (A) _____ Minus Present Price _____ = _____ (426)
 Present Price _____ Minus Low Price (B) _____ = _____ To 1

E PRICE TARGET (Note: This shows the potential market price appreciation over the next five years in simple interest terms.)
 High Price (A) _____ = (_____) X 100 = (_____) - 100 = _____ % Appreciation (427)
 Present Market Price _____

5 5-YEAR POTENTIAL

This combines price appreciation with dividend yield to get an estimate of total return. It provides a standard for comparing income and growth stocks.

A Present Full Year's Dividend \$ _____ Note: Results are expressed as a simple rate, use the table below to convert to a compound rate.
 Present Price of Stock \$ _____ X 100 = _____ Present Yield or % Returned on Purchase Price (428)

B AVERAGE YIELD OVER NEXT 5 YEARS
 Avg. Earnings Per Share Next 5 Years _____ X Avg. % Payout (G) _____ = _____ % (429)
 Present Price \$ _____

C ESTIMATED AVERAGE ANNUAL RETURN OVER NEXT FIVE YEARS
 5 Year Appreciation Potential (426) _____ = _____ % (430)
 Average Yield (429) _____ = _____ %
 Average Total Annual Return Over the Next 5 Years (430) _____ = _____ %

Simple Rate	2	4	6	8	10	12	14	16	18	20	22	24	26	28	30	32	34	36	38	40
Compound Rate	2	4	6	8	10	12	14	16	18	20	22	24	26	28	30	32	34	36	38	40

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