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Financial Ratios Demystified to Help Make Better Investment Decisions

ET EXPLAINER

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Mumbai: Over the past few years, participation of retail investors in the stock market has increased significantly. At a time when the equity market is facing higher volatility, it makes sense to learn about various financial ratios that can help in making investment decisions. Here's a brief introduction to some of the important ratios arranged in five broad categories.

Liquidity Ratios These ratios indicate whether a company has enough money to pay short-term obligations. One such ratio is the current ratio, which measures the extent of current assets including cash and equivalents, inventory and accounts receivable in proportion to the current liabilities such as accounts payable. It is calculated as current assets divided by current liabilities. The other ratio is quick ratio, or acid test, which considers only the liquid assets of the company and excludes inventory and prepaid expenses in the numerator and hence it is considered as a stricter measure of liquidity.

Leverage Ratios They focus on the capital structure of a company, which is typically composed of some combination of debt and equity. The debt ratio, which is calculated as total debt divided by total assets, puts a company's borrowings in perspective with its assets. A higher ratio means that the company is heavily leveraged.

Another ratio is debt-to-equity (D/E) ratio, which measures the extent of total debt with respect to equity. Different sectors will have different capital intensity. For instance, manufacturing companies often carry higher debt in their books compared with the services sector companies. This ratio is important for investors because debt obligations have a higher priority if the company goes bankrupt. For debt intensive sectors, another ratio of importance is the interest coverage, which captures a company's ability to service debt. It is derived by the division of earnings before interest and tax (EBIT) by interest expenses. Higher the ratio, the better it is.

Efficiency Ratios These ratios calculate how effectively a company is using its capital to generate revenue. Asset turnover ratio, which is calculated as net sales divided by average total assets, measures how much of the revenue is produced by each unit of assets. While a higher number is desirable, the type of business determines the extent of an optimum ratio.

Receivables turnover ratio, which is calculated by dividing credit sales with accounts receivable, indicates the collection efficiency of a business. A higher ratio reflects efficient credit management. An inverse of the ratio when multiplied by the number of days in a given period gives the number of days sales were outstanding. A lower number is desirable.

Profitability Ratios These ratios show the ability to generate profit. Operating margin, which is obtained by dividing operating income with net sales, reflects profitability of the business. Return on assets (RoA), calculated as net income divided by total assets, shows the ability of a business to generate profit per unit of assets. RoA is a handy tool while evaluating companies with a heavy asset base such as banking and financial institutions. Return on equity (ROE), calculated as net income divided by total equity, measures how effectively the company makes use of the shareholders' money.

Market Value Ratios These ratios help in ascertaining the value of a company. Price-earnings (P/E) multiple is calculated as share price divided by earnings per share (EPS). It shows how much an investor would pay per unit of net profit. In the case of a loss making company, P/E ratio will not be useful. In such cases, investors may consider price-book (P/B) multiple, calculated as share price divided by book value per share. P/B is also relevant for banking and finance companies, utilities and companies with a higher asset base. P/E and P/B values are often high for businesses with better prospects.

There are situations where a company's share price may not have increased during a period, but that does not mean it is a bad investment if it pays dividends. Dividend yield, calculated as dividend per share divided by share price, indicates how much a company pays out in dividends compared with its share price. Although high dividend yields are attractive, investors need to understand that every rupee paid as dividend is a rupee that is not reinvested in the business. Usually, mature businesses tend to pay higher dividends.

These ratios should not be considered in isolation. It is necessary to take a holistic approach while applying them. For instance, an attractive price to book ratio does not necessarily make a company a good investment choice. Investors need to pay attention to various other parameters such as profitability and efficiency.