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8 Key Financial Ratios

#1 – Price-Earnings (PE)

PE ratio is the most common financial ratio to investors.
This simply tells you how much earnings are you paying for at the current price. The lower the PE, the better.

PE is not a fixed number, it is ever-changing.

Firstly, price can change. No one can predict how high the stock prices can go and although the PE can be high in your opinion, it can continue to go higher beyond your imagination.

The other factor that causes PE to change is the significant rise and fall in earnings. A company can be making a lot of money for the past 10 years but because of competition, they may lose market share and suffer a decline in earnings.

Hence, PE ratio is at best a view of the company and its stock’s historical performance. It does not tell you the future. You would need to assess the quality aspect of the company – Can it sustain it’s earnings? Will the earnings grow?

#2 – Price / Free Cash Flow(FCF)

FCF is calculated based on the values from the cash flow statement, which shows the movement of money in and out of the company. **FCF is defined as, Cash Flow from Operations – Capital Expenditures.**

If the number is positive, it tells us that the company is taking in more money than it is spending. And it often indicates a rise in earnings. PE and P/FCF should tell the same story.

You can use either or use both to detect any anomaly/divergence.

#3 – Price Earnings Growth Rate (PEG)

PEG ratio, which is simply **PE / Annual Earnings Per Share (EPS) Growth Rate.**

EPS is simply earnings divided by the number of shares. But we need to look at the growth of earnings. So we have to average out the growth in EPS for the past few years.

For example, if the company has been growing at a rate of 10% per year, and its PE is 10, the PEG would be 1.

In general, a PEG ratio of less than 1 is deemed as undervalued.

However, it is important to understand that we are ASSUMING the company would continue to grow at this rate. No one can forecast earnings accurately.

Warren Buffett is smart in this area because he buys into companies with a competitive advantage. This way, he can be more certain that the earnings will continue to grow, or at least remain the same.

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#4 – Price-to-Book (PB) or Price-to-Net Asset Value

PB ratio is the second most common ratio. Some people call it price to net asset value (NAV) instead.

Net asset is the difference between the value of the TANGIBLE assets the company possessed and the liability the company assumed (intangible assets like goodwill which should be excluded).

Let's revisit the house example. Your house is worth $1m dollars and you owe the bank $500k, so the net asset value of the house is $500k. Hence, the higher the net asset value, the better.

If the stock's PB ratio is less than 1, it means that you are paying less than the net asset of the company – think along the lines that you can buy a house below market value.

#5 – Debt-to-Asset or Debt-to-Equity

Debt-to-Asset (D/A) is Total Liabilities / Total Assets
Debt-to-Equity (D/E) is defined as Total Liabilities / Net Asset Value

Both are measures of the debt level of a company.

Remember to use the same metric to make comparisons. Do not compare a stock's D/A with another stock's D/E!

You should not be happy to see D/A and D/E rising. Leveraged performance is impressive during good times. But during bad times, companies run the risk of bankruptcy.

#6 – Current Ratio or Quick Ratio

Long term debts usually take up the majority of the total liabilities. Although the company may have a manageable long-term debt level, it may not have sufficient liquidity to meet short term debts. This is important as cash in the short term is the lifeline of a business.

One way to assess this is to look at the Current Ratio or Quick Ratio.

Current Ratio = Current Assets / Current Liabilities.
'Current' in accounting means less than 1 year. Current assets are examples like cash and fixed deposits. Current liabilities are loans that are due within one year.

Quick Ratio = Current Assets – Inventory / Current Liabilities
Quick Ratio is slightly more stringent than Current ratio. And it is more apt for companies that sell products where inventory can take up a large part of their assets. It does not make a difference to the company selling a service.

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#7 – Payout Ratio

A company can do two things to their earnings:
1. distribute dividends to shareholders and/or
2. retain earnings for company's usage.

Payout ratio measures the percentage of earnings given out as dividends.

You will understand how much the company is keeping the earnings and you should ask the management what do they intend to do with the money.
- Are they expanding the business geographically or production capacity?
- Are they acquiring other businesses?
- Or are they just keeping the money without having knowing what to do with it?

There is nothing wrong for the company to retain earnings if the management is going to make good use of the money. Otherwise, they should give out a higher percentage of dividends to shareholders.

This is a good ratio to question the management and judge if they really care about the shareholders.

#8 – Management Ownership Percentage

Not a financial ratio per se but it is important to look at. It is unlikely for the CEO or Chairman of a large corporation to own more than 50%. Hence, this is more applicable to small companies.

But, I like to buy into small and profitable companies where their CEO/Chairman is a majority shareholder. This helps me to ensure that his interests are aligned with the shareholders.

It is natural for humans to be selfish to a certain extent and if you have a CEO/Chairman with more stake in the company, you are certain he will look after you (and himself).