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# Evaluating Companies with Financial Metrics   Seminar #6

## glossary of terms

*Source: www.investopedia.com*

### BASIC RATIOS/CALCULATIONS

**Liquidity** – The ability of an asset to be converted quickly into cash.

**Solvency** – The ability of a company to pay its long term expenses and remain in business.

**Earnings per Share (EPS)** - Performance indicator that expresses company's net income in relation to the number of ordinary shares issued. EPS = net income/weighted avg # of shares outstanding during the year. (From income statement)

**Free Cash Flow (FCF)** - Calculated as net cash provided by operating activities minus capital expenditures and dividends. It indicates a company's level of financial flexibility. FCF = EBIT - income tax + depreciation - capital expenditures +/- changes in working capital (From statement of cash flows)

> EBIT: Operating Profit from Income Statement
> Depreciation & Amortization: from Balance Sheet
> Capital Expenditures: from Statement of Cash Flows (Cash Flows from Investing Activities)
> Changes in Working Capital: Statement of Cash Flows (Cash Flows from Operating Activities)

**FCF/Net Income** - A measuring of the quality of earnings relative to the FCF that a company can generate

**Year-on-Year (YoY) FCF Growth** - Measures the rate at which a company's FCF grows each year; positive FCF is good as it indicates the company can generate cash from its activities to finance its operations

**Price/Earnings Ratio (P/E Ratio)** - Measures the multiple of earnings per share at which the stock is traded. Gives investors the multiple they are paying for the Company's earning power. This is calculated by dividing the price of a stock by its earning per share. P/E ratio = stock price / earnings per share.

**Discounted Cash Flow (DCF)** - A valuation method that estimates the attractiveness of an investment opportunity by predicting future free cash flow projections and discounting them (using weighted average cost of capital) to determine the present value of those future cash flows. All future line items on the financial statements are projected forward several years

**Weighted Average Cost of Capital (WACC)** - A valuation technique that averages the costs of financing (debt or equity) of a company's assets and can evaluate how much interest a company has to pay for each dollar it finances with equity, debt, etc.

**Comparable Analysis** – A valuation techniques that compares a company's current stock value relative to that of its peers. It is important to note that this valuation technique will yield the lowest valuation because it does not add a premium onto the value of the company, like that would be added during a transaction.

**Working Capital** - Company's short-term disposable capital used to finance the day-to-day operations. It is calculated as current assets minus current liabilities. (From balance sheet)

**Current Ratio:** Current Assets ÷ Current Liabilities (From balance sheet)

**Quick Ratio ("Acid Test Ratio"):** Current Assets minus inventory (called "Quick Assets) ÷ Current Liabilities (From balance sheet)

**Debt to Equity Ratio:** Total Liabilities ÷ Shareholders' Equity (From balance sheet)

**Gross Margin** - Reveals how much a company earns taking into consideration the costs that it incurs for producing its products and/or services. Gross margin = (gross profit/net sales) x 100. (From income statement)

**Return on investment (ROI)** - Net Profit ÷ Net Worth. Profitability ratio, best looked at occasionally, because it tends to magnify short-term shifts in thinly capitalized companies.

**Market Capitalization** - The total market value of all outstanding shares. Calculated by multiplying the number of shares by the current market price.

**Price/Book Ratio (P/B Ratio)** – Market Capitalization ÷ (Total Assets – Intangible Assets and Liabilities). Compares a stock's market value (price at which the market values the stock) to its book value (price at which the balance sheet values the stock).

**Price/Sales Ratio** – Share Price ÷ Revenue Per Share in the last year. Measures a stock's value based on its past performance.

**Liquidity ratios** provide information about a firm's ability to meet its short-term financial obligations. They are of particular interest to those extending short-term credit to the firm. Two frequently-used liquidity ratios are the *current ratio* (or *working capital ratio*) and the *quick ratio*.

**Asset Turnover Ratios** indicate of how efficiently the firm utilizes its assets. They sometimes are referred to as efficiency ratios, asset utilization ratios, or asset management ratios. Two commonly used asset turnover ratios are *receivables turnover* and *inventory turnover*.

**Financial Leverage Ratios** provide an indication of the long-term solvency of the firm. Unlike liquidity ratios that are concerned with short-term assets and liabilities, financial leverage ratios measure the extent to which the firm is using long term debt.

**Profitability Ratios** offer several different measures of the success of the firm at generating profits.

**Dividend Policy Ratios** provide insight into the dividend policy of the firm and the prospects for future growth. Two commonly used ratios are the dividend yield and payout ratio.