

# Six figures that can help you decide whether to buy a share

Now's not the time for investing on a whim. That's why we're publishing these six key ratios that offer an insight into a company's potential.

## 1 Dividend yield

The dividend yield relates the annual dividend income per share paid out by a company to its market share price and reflects how much income an investor receives for each pound invested.

**Dividend yield =**

$$\frac{\text{Net dividend income per share}}{\text{Market share price}}$$

If a company declares a net dividend of 2.5p per share and its share price is 100p, then the dividend yield will be  $2.5/100 = 2.5\%$ .

**Note:** A dividend yield should not be considered in isolation. A comparatively low dividend yield could indicate a high share price that reflects a company's positive growth prospects or it could mean that the company cannot afford to pay a decent dividend. A comparatively high dividend yield may provide a dividend that lessens the financial impact of any fall in share price but it may also raise concerns about a company's future prospects (see the previous article).

## 2 Dividend cover

Dividend cover relates a company's earnings (net profit after tax) to the net dividend paid to shareholders and reflects the number of times a company's profit covers the ordinary dividend.

**Dividend cover =**

$$\frac{\text{Net earnings per share}}{\text{Net dividend per share}}$$

If a company has earnings per share of 5p and it pays out a dividend of 2.5p, the dividend cover will be  $5 / 2.5 = 2$ .

**Note:** Generally a ratio of 2 or higher is considered safe; anything below 1.5 is risky. At 1, a company's profits are only just covering the dividend. Under 1, the company is paying the dividend from retained earnings which is not normally a sustainable situation.

## 3 Price/earnings ratio (P/E ratio or PER)

The P/E ratio (also known as the 'multiple') relates the market share price to earnings per share (EPS) and reflects the price investors are prepared to pay for each pound of earnings of a company.

**P/E ratio =**

$$\frac{\text{Market share price}}{\text{Earnings per share (net profit after tax/ no. of shares)}}$$

For example, for a company with a share price of 100p and EPS of 5p, the P/E ratio is 20.

**Note:** A high P/E indicates that the market expects the company's future earnings to grow higher than a company with a lower P/E. However, the P/E should not be considered in isolation but rather used as a tool to compare a company with others within the same industry or to compare a company's current performance with its historical performance.

## 4 Price/earnings to growth ratio (PEG ratio)

The PEG ratio relates a company's P/E ratio to its estimated future growth rate in earnings per share of the company. It is seen as a better investment tool than the P/E ratio because it considers future growth in addition to historical performance.

**PEG ratio =**

$$\frac{\text{P/E ratio}}{\text{Estimated future growth (expressed as a percentage)}}$$

If a company with a P/E ratio of 20 is forecast a future growth rate of 15%, then the PEG will be  $20 / 15 = 1.33$ .

**Note:** The lower the PEG, the less you pay for estimated future earnings; shares with a PEG of 1 or lower are considered

good value. However, a PEG ratio is only as reliable as a broker's forecast; it therefore makes sense to consider multiple or consensus forecasts.

## 5 Gearing ratio

Gearing relates to the level of a company's borrowed money to its equity capital and reflects how encumbered a company is with debt. It is usually expressed as a percentage.

**Gearing ratio =**

$$\frac{\text{Interest bearing bonds and preference share capital}}{\text{Equity capital}}$$

If a company borrows £120 million against equity capital of £200 million it will have a gearing of 60%.

**Note:** 'Prudent' gearing ratios vary between industries. Generally, anything over 100% is considered risky or 'highly geared'.

## 6 Price-to-book ratio (P/B ratio)

The P/B ratio relates the market share price to the net asset book value per share and can be a useful tool for finding undervalued companies.

**P/B ratio =**

$$\frac{\text{Market share price}}{\text{Net asset book value per share}}$$

If a company has a book value (value of assets – value of liabilities) of £100 million and 200 million shares, then each share represents 50p of book value. If the share price is 100p then the P/B ratio is  $100 / 50 = 2$ .

**Note:** Generally, if a P/B ratio is less than 1 the shares are good value; at over 2 they may be over-priced. However, the usefulness of this ratio is dependent on the valuation of the assets being both accurate and current.

Some of these ratios can be found on a company's summary page at [www.share.com](http://www.share.com).