How to be a Stock Market Player

Understanding the Game

Table of Contents

Chapter Name	**Page No.**
Chapter 1: The Definition of Stock *Common Stock Explained*	3
Chapter 2: IPO - Initial Public Offering *The beginning of it all*	7
Chapter 3: How to buy or sell stock- Part I *The Stock Market and the Players*	11
Chapter 4: How to buy or sell stock-Part II *The different types of transactions*	14
Chapter 5: How the Price of Stock is Set *The mystery behind the price of stock*	17
Chapter 6: Researching Stocks *What to look for when buying stock*	20
Chapter 7: Financial Statements *Profit/Loss Statement, Balance Sheet, Cash Flow*	24
Chapter 8: What the Financial Statements Reveal *The Financial Ratios*	29
Chapter 9: Placing a Value on a Company *What is this stock really worth?*	36
Chapter 10: Where to find information on Company *Resources you can use to research a company*	39
Supplement 1: Examples of the Financial Statements	41
Supplement 2: Using a Financial Calculator	42

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The Definition of Stock

Overview

1. Other Names for Stock
2. Why Companies Issue Stock
3. Why People Buy Stock
4. Summary

1. Other Names For Stock

There are a couple of things that you must know before we get into any further discussion. You need to know the financial "lingo". There are different terms that are synonymous with stock. You hear and read these terms all the time, but you have no clue of what these people are talking about. I want you to know a couple of these terms so some financial "hotshot" won't "throw you off".

List of Words Synonymous (Same As) Stock

- Common Stock
- Shares
- Equity or Equity Interest
- Ownership or Ownership Interest
- Stake

These are sentences using these words.

- I have 200 shares in Apple Computer. ***Same as saying, I own 200 shares of Apple Computer Stock.***

- After looking at my statement, I realized that I have a 25% equity position in this company. ***Same as saying, I own 25% of all stock outstanding in this company. So if this company has 1000 shares (common stock) out there I own 250 out of the 1000 shares of stock.***

- "I have a 20% ownership interest in this company and I'll be damned if you close that factory down." ***You've heard this in some of these movies. This sentence is simply saying that I own 20% of all stock outstanding in this company.***

- I have a 50% stake in Microsoft. ***This sentence is saying that I own 50% of all stock outstanding of the Microsoft Company. IF THIS WERE TRUE I WOULD BE RICHER THAN BILL GATES. DID YOU KNOW THAT BILL GATES DOESN'T EVEN OWN 50% OF MICROSOFT SHARES OR COMMON STOCK?***

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I think that you get the point by now. So let's move on to the next subject.

2. Why Companies Issue Stock

If you ever decide that you want to start a company you would have to choose whether you want to be a sole proprietorship, corporation, LLC or limited liability corporation and there are few others, but these are the main business forms. For simplicity sake I will focus in on corporation, because after all stock is issued by corporations.

Nevertheless, when you start a business you have to finance this business. Without any money, your business, no business rather, will ever get off the ground. With that said, how can I finance a business start-up? Well there are a couple of ways you can do it.

Ways to Finance (Raise Money for) a Business

1. You could use your personal savings.
2. You could get a loan from your friends and family.
3. You can get a loan from a bank.
4. You could find an angel investor.
5. You could issue stock.

Think about this for a second. Would you be able to start a soft drink company like Pepsi, Coke, or Dr. Pepper with your personal savings? Would you be able to develop a new car with a loan from your family or friends? JUST SAY NO. Would you be able to secure a loan from the bank for your corner store start-up? Probably, depending on your financial situation. But even with that you would only get $100,000 tops.

When it comes to corporations, we are talking about big ideas that need big time financing. Entrepreneurs usually seek out angel investors or they issue common stock. Our focus however will be common stock. Additionally, entrepreneurs will need to incorporate their business to begin issuing stock.

There are some advantages and disadvantages of entrepreneurs issuing stock.

Advantages of Companies Issuing Stock

1. Their operation/business will be financed. ***They will usually be financed in a big way, so they will not be under-financed or under-funded. This is one of the biggest reasons why businesses issue stocks when they need more money to operate.***
2. The company founders will not be personally liable for any legal claims or misfortunes that take place operating the business. A corporation is a separate entity from its founders. ***Example: Bill Gates is not personally liable, if Microsoft software caused an eye disorder. However, Microsoft, the corporation, will be liable.***

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Disadvantages of Companies Issuing Stock

1. Once you incorporate your business and you are publicly trading or issuing stock, you will have to disclose all financial and business operating statements. This is federal law. (SEC will be discussed in another chapter)
2. You give up full control or ownership interest in the start-up. You no longer own 100% of the company you started.
3. Since you give up full control or ownership interest, you can be fired or terminated from the very company you founded. This is true only if you do not have a majority stake in the company. As long as you maintain the controlling interest in the business then you are fine. Common practice is for entrepreneurs to retain 51% of the stock so they will always maintain control of the company they founded.
4. All major business decisions will have to be approved by shareholders or stockholders no matter how much you think it does or doesn't make sense. This is true only if you do not have a majority stake.

In summary companies issue stock to finance their business operations. When stock is issued, the founders give up ownership interest and full control of the company. The founders can be terminated. Most, if not all, major business decisions will have to be approved by stockholders or shareholders.

3. Why People Buy Stock

Why do you buy anything?

The answer is simply to get something in return. People purchase stock as an investment into a company. When people purchase stock, they are looking to get a return on their investment. This return could be in the form of income via dividends or appreciation of the value of the stock or both.

How Do You Get Returns from Stock

1. Capital Gains (Loss)
2. Dividends

Capital Gains

Let's clear some things up first. A capital gain (profit) or loss is not realized unless the stock is sold. This simply means that until you sell the stock the capital gain or loss is not actual, but rather on paper, hence *paper loss* or *paper gain.* The capital gain or loss is not a real gain or loss until you sell. For instance you bought shares in Apple Inc. for $30 per share and it is now $25 per share, but you hold the shares, you have a $5 paper loss (Price you paid $30 - current value $25 = -$5). If you decide to sell your shares for $25, in that case you actually lose $5.

Capital gain (loss) is the difference between the price you paid for the stock and its current market price or value. If the price you paid for the shares is less than its current value, then it is a capital gain. If the price you paid for the shares is more than its current value, then it is a capital loss.

Dividends

Based on the performance of a company and other factors, a company may declare dividends to all stockholders. This is a payment, usually a very small sum, to stockholders. The amount of the

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payment depends on how many shares you own. The amount is on a per share basis. Let's say Phillip Morris Co. declares a 3 cents dividend to all shareholders and you own only two shares, then your total dividend payment is 6 cents. Newly started companies rarely declare dividends. If you are looking for dividend income, then you should look at established corporations, not start-ups.

There are advantages and disadvantages of purchasing stock.

Advantages of Owning Stock

1. You own a piece (percentage) of a company. Ultimately, stock is an asset just like your house or car. You can use it as collateral on a loan, not that you would want to do something like that.
2. Stock can increase in value, hence capital gains.
3. Stock can give you current income via dividends.
4. Usually yields higher returns than traditional investments such as saving accounts, CD's, etc...

Disadvantages of Owning Stock

1. Stock can decrease in value, hence capital loss.
2. If the corporation goes out of business, your stock in that corporation is worthless. Example: **ENRON**.
3. Unless, you own a significant amount of shares, you don't have much input in the everyday operation of the corporation. You are basically placing your hopes in the management team and the employees of the corporation.
4. Riskier than traditional investments such as saving accounts, CD's, etc...

4. Summary

Stock is synonymous with shares, equity, and ownership. Companies issue stock to raise money for operations. In exchange, companies give up ownership to stockholders. People purchase stock as an investment in corporation in exchange for the opportunity to receive capital gains and dividend income. Stockholders are considered owners of the corporation.

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IPO - Initial Public Offering

Overview

1. What is an IPO?
2. The Process
3. The Myth
4. Summary

1. What is an IPO?

Understanding IPO is critical in understanding stock investing. I have read several investment books, but they seem to always leave this part out. The truth is this is the beginning of it all. Without an IPO, there would not be any stock out there in the market.

IPO is the abbreviation of **I**nitial **P**ublic **O**ffering. An initial public offering is the first time a company introduces their stock to potential stock investors. An initial public offering is the first chance that stock investors get to purchase ownership (stock) in that company.

An IPO is like:

- The Ford Company introducing the "New 2008 Thunderbird". This is the first time that this car is being offered.
- Microsoft introducing "Windows Vista 2009". The first time this software is offered to the public.

2. The Process

In the first chapter we discussed start-up businesses. We discussed that businesses need to be financed for operations. We also discussed that when a business decides to issue stock to raise money they must incorporate. The IPO is the process by which this money is raised. Before we continue, I want to add that ***all businesses are private or privately held until they are incorporated as a corporation. When a private company decides to incorporate they are becoming public or "going public", hence, Initial Public Offering. You will hear reporters on the news announcing that a company is "going public". This is what they are talking about. After the IPO you will hear that the company is publicly traded. This means that you can purchase their stock.*** Okay, now back to the process of an IPO.

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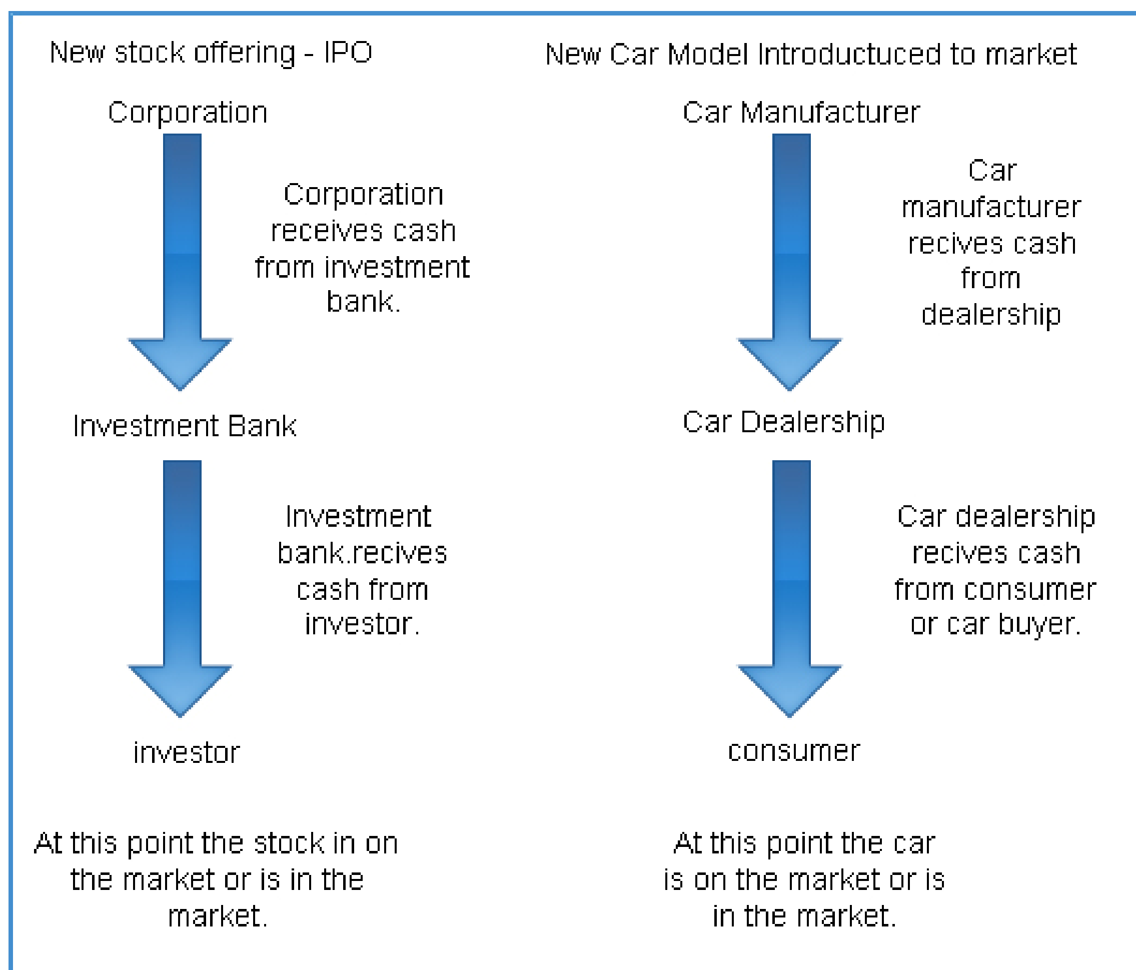
The process includes:

1. A privately held company wants to expand and need finance. They decide that stock is one way that they can raise the money.
2. They determine the amount needed to raise, which will determine how many shares to issue.
3. They hire an investment bank to buy and sell shares to the public.
4. They sell shares to investment bank.
5. The proceeds (funds) from sale of shares to the investment bank are used by the company or corporation to finance operations.
6. The investment bank sells shares to general public.

This is generally the process of how shares flow from the issuing corporation to the general public, although it may vary.

Earlier, I stated that an IPO is like a new model car being introduced to the public. Look below to see the similarities of IPO and new model car being introduced to the market.



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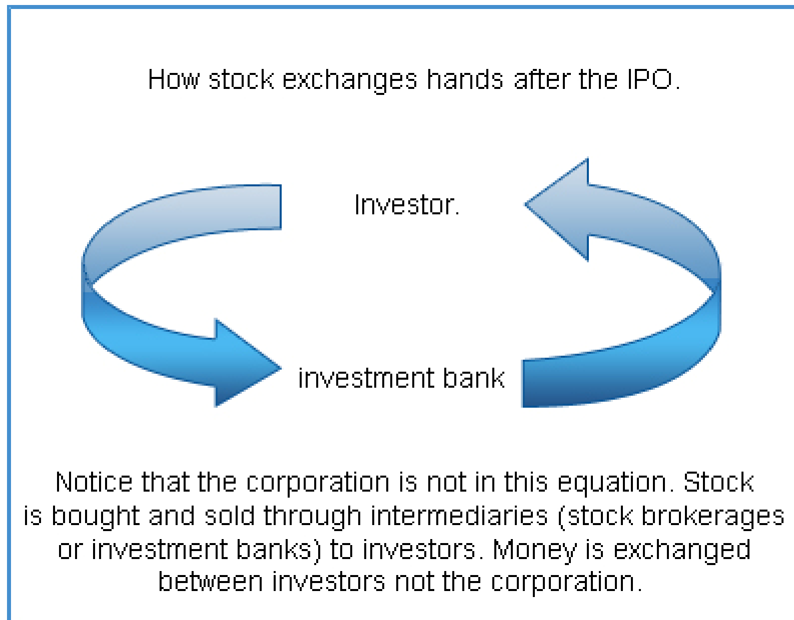
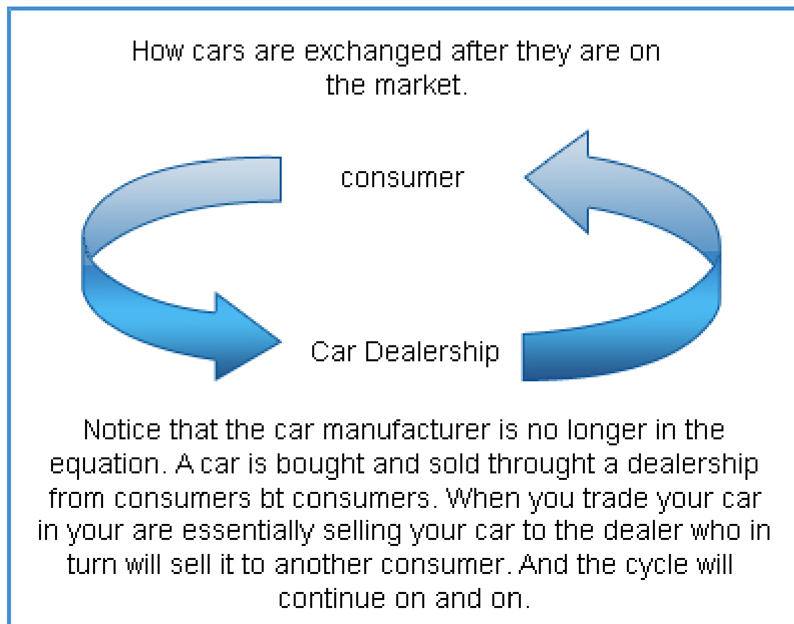
Look at how cars and stock change hands after the IPO.





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3. The Myth

People think that companies receive money from stock after the IPO. This is absolutely false. The only time companies get money from stock after the IPO is when they issue another stock offering or secondary offering. *Refer to the example above. Notice that the corporation is not involved in the exchange of cash after the IPO.*

Let's explain this:

A company issue 5000 shares to raise $1 million during the IPO. At this point there are only 5000 shares out in the public. After a couple of years they decide they want to expand more so they issue another 5000 shares to raise another $1 million. At this point they have raised $2 million from two separate stock offerings and have only 10,000 shares outstanding (in the stock market).

4. Summary

IPO is the first time a private company introduces their stock to potential investors. It is the first chance that the public can purchase ownership within this company. Once a private company issues stock, it is no longer a private company, it is public. Companies use an investment bank to get shares to the public. Companies do not receive any money from their stock after the IPO.

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How to Buy and Sell Stock-Part I

Overview

1. The Market
2. Brokers
3. Direct Investment Plans
4. Summary

1. The Market

Firstly, anything that is bought and sold has a market. This market is made up of buyers and sellers. In our case this market is referred to as the stock market. Buying and selling of stock is referred to as *stock trading or trading*. Additionally, buyers and sellers need a place to buy and sell. In our case this place is referred to as a Stock Exchange. There are several stock exchanges around the United States and abroad, however, the one that you should be most familiar with is the **N**ew **Y**ork **S**tock **E**xchange or **NYSE**. If you are not familiar with the NYSE, it is the largest stock exchange in the world. With that said; you and I cannot just go to the NYSE and buy and sell stock, unless, of course, we are dealers representing a stockbroker.

2. Brokers

Just like a real estate agent is the intermediary between the buyer and the seller of a home, a stockbroker is the intermediary between the buyer and seller of stock. Like a real estate agent, a stock broker usually charges a commission for completing the transaction. If you want to invest in stocks you will most likely need to hire a broker. You can also apply for a direct investment plan, which we will discuss in the next section.

Stockbrokers come in a couple of forms. There are full service brokers, discount brokers, and online brokers. The difference between these three types of brokers deals mainly with the level of interaction with the investor.

Full Service Brokers

Full service brokers may provide you with financial advising, financial planning, investment advice and company research in addition to facilitating your purchase or sell of stock. Of course all of this comes with a cost. If you are interested in these types of brokers here are a few to look at:

1. Charles Schwab
2. Merrill Lynch
3. Morgan Stanley
4. Citi Smith Barney
5. UBS

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Full service brokers usually charge higher commission fees per trade (purchase or sell of stock).

Discount Brokers

Discount brokers merely facilitate the transaction or trade. You the investor call in the trade that you need to make and they execute it. With the internet explosion you should be able to go to the brokers' web site and initiate a trade. Discount brokers will usually provide you with little investment advice. Here are a couple discount brokers out there:

1. TD Waterhouse
2. Fidelity Brokerage Services

Discount broker charge lower commission fees per trade than the full service broker of course.

Online Brokers (Internet brokers)

With the advent of the internet and the world-wide web, internet brokers have burst upon the stock brokerage scene. They have forced many full service brokerages, who usually deal with clients on an intimate level, to open up internet brokerage segments as a part of their businesses. In spite of all that, internet brokers provide investors a way to initiate and execute trades online electronically. All at the lowest commission fees per trade. Here is a list of online brokerages:

1. Ameritrade
2. Scottrade
3. E Trade
4. Sharebuilder

Deciding on which type of broker you use depends on you. Most brokers require a minimum balance to open an account. Some brokers may require you to maintain a certain balance, it depends on the brokerage. I know from personal experience that Sharebuilder does not require a minimum balance to start an account.

3. Direct Investment Plans

Well, I don't want to deal with a broker and their commissions. You can do this too. Some of your larger and more established corporations have direct investment plans. Direct investment plans are simply buying shares of a particular corporation directly from the corporation. In essence eliminating the middle man, the broker, and their commissions. However, through my research you may still encounter some fees. These huge companies hire transfer agents to manage their direct investment plans.

Most companies who have direct investment plans require a minimum investment or a minimum ongoing investment (automatic investment plan).

To find out which companies have direct investment plans visit the website of companies that you are interested in investing in and go to the investor relations section.

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4. Summary

The stock market involves buyers and sellers of stock represented by stockbrokers, who facilitate these transactions in a stock exchange, such as the NYSE. Stockbrokers differ in the level of interaction with the investor. There are three types of brokers full service, discount, and online or internet brokers. You can also purchase stock through a direct investment plan.

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How to Buy or Sell Stock-Part II

Overview

1. Odd Lots versus Round Lots
2. Real Time Orders versus Regular Orders
3. Types of Real Time Orders
4. Summary

1. Odd Lots versus Round Lots

When purchasing stock you can buy in either a round lot or an odd lot. **A round lot is simply 100 shares of stock or multiples of 100 shares of stock**. An example of a round lot would be a purchase of 300 shares of stock. An odd lot is the exact opposite of a round lot**. An odd lot consists of less than 100 shares of stock**. An example of this would be a purchase of 25 shares of stock. Unless you are a wealthy individual, odd lots will probably make up the bulk of your stock transactions. In addition to round and odd lots, there are **mixed lot transactions which consist of both round and odd lots**. An example of a mixed lot would be a purchase of 125 shares of stock (100 share = round lot, 25 shares = odd lot).

2. Real Time Orders versus Regular Orders

Note: An order is synonymous with trade; hence a real time order is like saying a real time trade or real time stock trade.

Regular Orders

A regular order is an order to buy or sell stock at the price available at the time the order is filled. For instance you can put in an order for 2 shares of Starbucks stock however **the order isn't expedited immediately by your broker**. As a result the market price for that stock may be higher or lower when the order is finally filled by your broker.

Special note: Usually if you are involved with an automatic investment plan or direct investment plans you will encounter this type of order.

Real Time Orders

A real time order is an order to buy or sell stock immediately at the price available. Real time orders are filled immediately within minutes, if not seconds, from when the order was placed. As a result, the market price for that stock will change minimally, if at all, once the order is filled. This is primarily a method used by day traders or stock traders, who monitor stock prices throughout the day.

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The Differences in Commission

Usually the commission for making real time trades is much higher than placing regular trade. In addition to that, there is a couple of ways to trade in real time which we will discuss in the next section.

3. Types of Real Time Orders

If you want to control the amount you spend or limit the amount you lose on a stock, there are a couple of options out there. Of course, these special benefits come with a price in the form of higher commission fees.

Limit Orders

A limit order is an order to buy at or below a specified price or to sell at or above a specified price. This way you control what you will pay for a stock and what you will sell your stock for. Investors use this strategy to limit their losses and prevent over paying for a stock.

Examples

- You place a limit buy order to buy 75 shares of Microsoft at $20; the stock is currently trading at $21 per share. Once the price falls to $20 or below per share your broker will execute the order. Once the price exceeds $20 per share the broker will stop the order.
- You place a limit sell order to sell 20 shares of Starbucks at $22; the stock is currently trading at $21.50 per share. Once the price rises to $22 or above your broker will expedite the order. If the price falls below $22 the broker will stop the order.

Keep in mind that these market prices may never be reached; hence you may never buy or sell stock at that particular price. These orders will not be activated until they reach your specified price points.

With that said, you can place a limit order in one of these forms:

1. A **fill or kill order**, which simply means that if the limit order cannot be filled immediately, it is canceled.
2. A **day order** means that if the limit order is not executed by the end of the day, it is canceled.
3. A **good-till-canceled order** means the limit order is in effect unless executed, canceled, or renewed.

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Stop-Loss Orders

A **stop-loss order** is an order to sell a stock when the market price reaches or drops below a specified level. This minimizes your loss on your investment in a stock.

Example

- You have stock in ExxonMobil; the stock is currently trading at $95 per share. You place a stop loss order with your broker to sell if the price drops below $90 per share. Once it hits $89 per share your order is activated and you sell at the best price available to avoid a big loss, hence *stop-loss.*

Special Note: All of these orders happen in real time once activated or your specific market price is reached.

4. Summary

Stock is bought and sold in round lots, odd lots, or mixed lots. You can place orders to buy and sell stock in real time or by regular order, which is associated with automatic investment plan or direct investment plan. If you want to control what you spend and lose on stock you can place special real time orders called limit orders and stop-loss orders.

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How the Price of Stock is Set

Overview

1. The Stock Market Revisited
2. Supply and Demand
3. Factors that Affect Supply and Demand
4. Summary

1. The Stock Market Revisited

In chapter 3 we discussed how stock is bought and sold. What we did not discuss was how the price is set for stock. In any market or store there are prices for each product being bought or sold. In addition to that, the buyers and sellers of these products have a say in the price. In short, the price is set by the sellers' willingness to sell and at what price (supply); and the buyers' willingness to buy and at what price (demand). Eventually, the price that the seller is willing to sell at will equal the price that the buyer is willing to buy at, this price is called the market price. The market price is constantly fluctuating due to supply and demand.

2. Supply and Demand

Supply and demand is real in terms of stock prices. Stock sellers represent the **supply** and stock buyers represent the **demand**. If there are a lot of sellers out there and little buyers, then the price of stock will go down. On the contrary if there are a lot of buyers out there and a few sellers, then the price of stock will rise.

Let's break this down with a couple of examples.

Example #1: Too many sellers little to no buyers.

When Enron Corporation was exposed for their fraudulent business practices, holders of their stock tried to sell off their shares. However, there were no buyers out there, thus the price of Enron stock plummeted.

Example #2: Too many buyers little to no sellers.

Apple Computer shares were once trading at $14 per share. However, with the recent success of Apple's Ipod and other hot products the share price has skyrocketed to over $100 per share. This rise in price is due to the high demand of this stock.

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3. The Factors that Affect Supply and Demand

Many factors determine whether you want to sell or buy a certain stock. Ultimately, these factors determine the underlying market value of a particular stock.

The factors that affect supply and demand of certain stock include:

- **Financial Performance** which includes sales revenue, earnings, debt load, return on assets, return on equity. *You may have heard on the news about a particular company announcing or releasing its earnings for the quarter or the year-end. This announcement may affect their stock price.* We will discuss financial performance in-depth in a later chapter.
- **Management** which could be a direct correlation to the financial performance of the company. Mismanagement could include fraudulent or unethical business practices. As of late, many CEO's and corporate executives have been prosecuted for misuse of company funds among other things.
- **Industry Performance** is a reflection of the industry as a whole. Eventually, with the development of new technology, some industries become obsolete. Ultimately there are no longer enough sales to support the business. The market for this product has disappeared. *With the evolution of the DVD, the VHS is practically obsolete. Ever heard of the eight track or tape cassette? What about the typewriter?*
- **Social Awareness** involves the effect that a business has on society as a whole. Some products that companies make affect a person's health or well-being. In addition to that, the manufacturing process may have an effect on the environment. Some companies use child labor and underpay employees. Because of these social issues a company can suffer in relation to sales and ultimately the stock price will be affected. *Wal-mart is one of the largest companies in the world, yet they struggle to maintain their goodwill. Wal-mart has been under scrutiny for underpaying employees among other things.*
- **Legal Issues** which involve lawsuits, settlements, and bad press. First of all, lawyers involve lots of money. Money which could be used to improve the business and so on. If a company is not a mega-corporation such as Wal-Mart, Exxon, Phillip Morris, a lawsuit can destroy it. As a result, legal problems can adversely affect the financial performance of a company thus affecting its stock price.
- **Government Regulations** involves laws passed by the government which can affect a corporation. It can also involve a government, whether local, state, or federal, exercising its authority to hinder businesses operations. There have been instances when local governments have exercised eminent domain to disallow a corporation from building in their community. *In 1911 the United States Supreme Court ruled that Standard Oil Co., founded by John D. Rockefeller, was a monopoly and thereby ordered to break the company up into several independent units.* ***Note: Exxon, Mobil, Chevron, Penzoil, BP, Conoco were originally a part of the Standard Oil Co. HUGE!!!!*** *A law called the Sherman Antitrust Act was later passed to prevent the upstart of another Standard Oil. As a result, a business monopoly over an industry is illegal.*
- **The Media** plays a major role in how a company is perceived. Firstly, you probably would not be aware of any of the factors listed above if it were not for the media. The media includes television, newspapers, magazines, radio and the internet. The media outlets that specialize in business reporting are great resources for information about a particular company. However, the reports, with exception to the facts, can be somewhat opinionated or biased. There is usually an analyst that is giving their view on a particular company. To go even further the analyst may give you a "winner" or "loser" or simply a stock to keep an eye on. If this analyst personally does not like this company or the people involved with this company he could say this company is a "loser" when the company is actually performing well. By the same token, an analyst can give a favorable rating when the company is

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horrible. Bottom-line, don't listen to everything you hear, do your own research.

All of these are major factors that could affect your decision to buy or sell a stock. Ultimately, it depends on you whether to sell, buy, or hold.

4. Summary

In conclusion, the price of stock is dependent on the sellers' willingness to sell and at what price; and the buyers' willingness to buy and at what price. Eventually, the seller's price and buyer's price equal out, this price is the market price. Sellers represent the supply and buyers represent the demand. Too many sellers and few buyers equal low market price. Too many buyers and few sellers equal high market price. Supply and demand for a stock are affected by several factors which include financial performance, management, industry performance, social awareness, government regulations, and the media.

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Researching a Stock as a Business

Overview

1. Introduction
2. Financial Condition
3. The Industry as a Whole
4. Market Condition
5. The Business Model
6. Summary

1. Introduction

Just like a bank investigates or researches you before they give you a loan (an investment in you) of any kind, you must investigate any business before you invest in it. Researching a particular business or stocks helps you gauge the risk of this investment. Essentially, researching allows you to understand what you are getting into. As a result, you are able to make a sound and educated investment decision. There are several things you should look at before investing in any company. Most of these things are covered in Chapter 5 in the section subtitled "Factors that Affect Supply and Demand", however we will take a more in-depth look in this chapter.

2. Financial Condition

The financial condition of a company can tell us a lot. Just like the pH of your blood could tell a doctor a lot about your health, the financial condition of a company can tell us lot about the well being of that company. The financial condition of a company includes the Profit/Loss statement otherwise known as the income statement and the balance sheet.

Profit/Loss Statement

The profit/loss statement highlights companies' sales (revenues) less expenses. A company's sales less its expenses is equal to its profit or loss.

Example: A company generates $300 million sales revenue and has expenses totaling $250 million.

$300 million (sales) - *$250 million (expenses)* = *$50 million (profit).*

Example: A company generates $300 million in sales revenue and has expenses totaling $320 million.

$300 million (sales) - *$320 million (expenses)* = *-$20 million (loss)*

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Generally, if the company is generating a profit, all is well. If the company is generating a loss most of the time it is not good. However, if the company is a start-up or a new technology investors expect a loss as a matter of fact companies may project that they will have a loss in certain years. It's when, after ten years, the start-up can't deliver a profit when investors should become concerned.

Balance Sheet

This report highlights companies' assets and liabilities (debt). Sound familiar? A bank has concerns if you have more debt than cash or assets. You should be concerned if a company has more debt than cash or assets, as well. Basically, what a balance sheet tells us is when trouble arises such as a lawsuit, bad sales year, a weather catastrophe, or any unforeseen circumstance that could adversely affect business operations, the company can survive with its cash reserves or assets. Remember that a company that can longer operate is worthless. If a company cannot operate they can no longer generate sales.

In the next chapter we will look in detail at the financial statements.

3. The Industry as a Whole

It is very important to look at the industry that a company is in involved in. This defines the companies' primary business. Industries are further broken down into sectors.

For instance the retail industry is broken down into several sectors that include:

- Grocery Retail (Krogers)
- Drugstore Retail (Walgreens, CVS, Rite Aid)
- Specialty Retail (Home Depot, Leowes)
- Clothing Retail (The Gap, Banana Republic)
- General Mass Merchandise Retail (Wal-Mart, Target, K-mart)
- Department Store Retailer (Macy's)

There may be more sectors within the retail industry but you understand what I'm getting at.

If you find a company that you are interested in investing in, you need to find out what industry and sector this company is involved in. Once you find out the industry you will be able to determine several things about this company.

What you will find out about a company just by knowing the industry it is in?

- **Market Share** - You will know if this company is one of the leaders in its industry and/or sector. You can say that an industry is a market or a market is an industry. You can also see if the market is saturated, which means that there are a whole bunch of players in the market. Simply put a lot of competitors in one industry. **Market Share** is the percentage of sales in regards to everybody involved in the industry. ***For instance let's say that the soft drink beverage market or industry, which includes Coke, Pepsi, Dr. Pepper, generate $500 billion sales annually as a whole. Of that, $500 million, Coke generates $250 billion while Pepsi along with Dr. Pepper generate $125 million each. You would be able to say that Coke has a 50% market share, while Pepsi and Dr. Pepper each have a 25% market share. You would also be able to conclude that***

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Coke is the market leader.

- **Industry Trends -** Industry trends tells us how the business is changing. ***For instance, there was a time when the media industry was dominated by the newspaper, TV, and magazine. The emergence of the internet as a media force has changed the outlook of the entire media industry.***
- **Industry Practices or Norms-** Earlier in this chapter we discussed profit/loss statement and balance sheet. In some industries, such as retail, 3% profit margin is good.

Note: Profit Margin is equal to profit as a percentage of sales. We will discuss further in a later chapter.

In other industries a 3% profit margin is horrible. You will know if a company is performing above or below industry standards based on your knowledge of industry practices or norms.

As you see, knowing about the industry that a company is in can tell you a lot about its current situation and position in the industry.

4. Market Conditions

The market condition refers to the overall environment in which it affects the customer's demand and ability to buy hence the sales of a company is affected. The environment involves social changes, economic changes, weather irregularities, disease, and government intervention. You should mainly be concerned with the market conditions in its current state.

Examples of the Market Condition due to changes in the overall environment:

1. *After the attack on the World Trade Center, the airline industry took a devastating blow to sales. However, the defense and security industries had increases in sales.*
2. *With the aftermath of Hurricane Katrina the hotel industry especially in the neighboring cities had an increase in sales. Oil and Gas companies had spikes in sales due to evacuation efforts.*
3. *Since state governments heavily tax cigarettes, cigarette companies may have issues with sales.*
4. *Since people realize that tobacco smoke causes cancer, this may trigger people to stop smoking, which will hurt cigarette sales.*
5. *Since people have less discretionary income due to an economic downturn, leisure industries will suffer.*

The current market condition is important, however, many investors try to predict the future. If you can predict the future, more power to you. Nevertheless, knowing the market conditions and how it affects a company is good to know.

5. The Business Model

The business model is simply a blueprint of how the business operates and how it makes its money. A business model can tell you if the business is ran efficiently or if it is being mismanaged. The business model can tell you how many ways that a company makes its money. It also lays out the company's business strategy. Within each industry there are standard business models. However, each company within that industry has customized this standard model to their specifications. The difference in the business model is what gives a company its edge against the competition. A company is always looking for ways to operate more efficiently.

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With that said, business models will always be changing.

Most important is how the company makes its money. If after viewing the business model you cannot clearly see what is going on, as far as what is the product or service, you should not invest in that company. If the company has only one source of revenue, you should do more research.

A business model will tell you what lines of business the company is involved in. In this day and age most companies have multiple lines of business, thus several sources of revenue. Lines of business are simply the industries, markets, or sectors that a company is involved in.

- ***For instance Pepsico's primary business is soft drink beverages; however its other businesses include Frito Lay, which is part of the snack foods industry.***
- ***Microsoft's primary business is software, however it is also involved in the video game console business, the Xbox.***

6. Summary

Most importantly, before making any investment decision in anything you must do your research. When investing in stock you should look at the financial condition of the company, the industry, market condition, and the business model. If you understand these factors, then you can make an educated investment decision.

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The Financial Statements

Overview

1. Financial Condition Revisited
2. The Balance Sheet
3. The Profit/Loss Statement or Income Statement
4. Cash Flow Statement
5. Summary

1. Financial Condition Revisited

In chapter 6 we discussed how the financial condition of a company is important in researching stock as a business. The financial condition of a company is assessed by evaluating the three basic financial statements. The three basic financial statements are:

1. The Balance Sheet
2. The Profit/Loss Statement
3. Cash Flow Statement

In this chapter, we will break down the components of each financial statement.

To provide you with a better understanding of the financial statements, I have included links to "real-life" financial statements of some actual companies.

2. The Balance Sheet

The **balance sheet** is a statement of the company's assets, liabilities, and stockholders' (Owners) equity.

The balance sheet can tell us about a company's liquidity, solvency, and, thus, its financial flexibility. **Liquidity** is a measure of how quickly assets can be converted to cash. **Solvency** is a measure of the ability to pay its debts as they become due. After determining a company's liquidity and solvency, you can gauge its financial flexibility. In short, **financial flexibility** is the ability of a company to react if unexpected or unforeseen circumstances were to occur that affect the business adversely.

Company Assets

An **asset** is any resource or entity in which a company owns or controls, that can potentially provide future economic benefits. You can also say that an asset as anything that the company uses to generate cash flow.

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Example of a Company Assets include:

1. **Cash**, which can be used by a company to invest in a project that will generate sales for the company.
2. **A Company Plant or Factory**, which is used to manufacture products to be sold to generate sales revenue. Additionally, a plant or factory can be sold which will generate cash to the company.
3. **Brand-name -** It is sometimes difficult for a company to place a value on their brands, but brands and brand-names are powerful in the marketplace. I know several people that don't buy certain products because it is not a particular brand. As a result, you can say that brand-names and brands generate sales for a company, hence it is an asset.
4. **Investments -** Some companies put money into short-term or long-term investments such as bonds and even stock. Investments can potentially provide a company with future benefits.
5. **Patents** - With some companies, especially drug companies, patents are very important in doing business. A patent is an exclusive right to a process, design, or invention for a limited period of time.

You can also divide company assets into certain categories. Assets are can be defined as:

- **Current Assets** - Includes cash assets and assets that are expected to be converted to cash, sold, or consumed within one year. Current Assets can include cash, short-term investments, inventory, accounts receivables, and prepaid expenses.
- **Fixed Assets** - Includes assets that are not expected to be converted into cash within one year. Fixed Assets can include properties, plants (factories), and equipment.
- **Intangible Assets** - Assets that lacks a physical presence, you cannot touch something that is intangible. Intangible assets include copyrights, patents, brand-names, trade names, trademarks, and secret processes. These assets are used to generate cash flow.

Company Liabilities

A company **liability** is any legal debt or obligation that arises during the course of business operations. Liabilities are settled through the transfer of assets including cash, investments, property and so on. Liabilities can even been settled by the transfer of goods and services, this is considered as business trading.

Examples of Company Liabilities include:

1. **Bank Loans** - You already know what this is. It must be paid back.
2. **Accounts Payable -** Could be a line of credit extended by a vendor.
3. **Salaries Payable** - The accrued salaries owed to employees.
4. **Taxes payable** - What is owed to Uncle Sam and his friends at the IRS.
5. **Unearned Revenue** - Gifts is a great example of this. At a retail store a customer purchases a gift in the amount of $50. The store receives $50 in cash but did not give up any asset, product, and inventory. The customers give the gift card to a friend. As a result, the store **owes** (liability) the friend $50 worth of merchandise. Until the gift card is used, this $50 value will remain a liability until settled.

Liabilities can be furthered divided into two classifications. These classifications are called:

- **Current Liabilities** - Legal debts or obligations that must be settled within one year. Current

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liabilities could include salaries payable, unearned revenue, taxes payable and so on.

- **Long-term liabilities** - Legal debts or obligations that are *not* settled within one year. Long-term liabilities could include bond repayments, lease obligations, and bank repayments (notes payable).

Stockholders' (Owners) Equity

Stockholders' equity is a measure of the equity stake that an investor has in a company. Stockholders equity is calculated simply by subtracting the total assets minus total liabilities.

Total Assets - total liabilities = stockholders'(owners)equity

Stockholders equity is also considered as the book value or net worth of a company.

- ***So let's say that Microsoft has $3 million in total assets and $2 million in total liabilities, then the stockholders equity in Microsoft would be $1 million ($3 million - $2 million = $1 million).***
- ***Let's say that GE has $40 million in total assets and $160 million in total liabilities, then the stockholders equity would be -$120 million ($40 million - $160 million = -$120 million). NOT GOOD***

3. The Profit/Loss Statement or Income Statement

The **income statement** is a financial statement that measures a company's financial performance over a specific accounting period usually quarterly and/or annually. The income statement is only based on revenues and expenses, as referenced in the last chapter.

The income statement can really reveal how a company is being managed. ***Think about this for a second. You have a friend who makes $10,000 a month but is always broke and doesn't have any cash reserves in the bank. Something is very wrong with this picture. Your friend is, obviously, not managing their finances properly. They need to cut back on something because they are clearly overspending (expenses).*** A company that has more expenses than sales has some issues unless it is a start-up. ***When medical students get out of medical school we expect for them to have debt and more expenses than what they make,* they are just getting started*.*** You should use this same logic when looking at very new companies.

Nevertheless, the income statement or profit/loss statement is broken down into two components revenues and expenses.

Sales Revenues

Revenues are simply the sales that the company made either by production or delivery of goods, rendering services or by other activities that define their business operations. Additionally, revenues increase the company's assets. Sales increase cash and/or accounts receivables. **Revenue** is synonymous with **income** and the two terms are used interchangeably. So remember that revenue is the same thing as income.

Revenues can be divided into operating revenue and non-operating revenue.

- **Operating revenue (income)** is sales generated through normal operations or everyday

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business.

- **Non-operating revenue (income)** can be money or assets acquired through a sell of a business, income from outside investments, and so on. It is not uncommon for a company to have stock in other companies. SunTrust Bank for example owned a sizeable stake in the Coca Cola Corporation; however, their primary business is banking. *Non-operating income could also be classified as other income. It is simply all revenue received not associated with normal business activity.*

Expenses

Expenses are simply the costs that a company incurs during production and delivery of goods, rendering services or by other activities that define their business operations. Expenses, unlike revenue, decrease assets and increase liabilities. Expenses decrease cash and increase accounts payable.

Expenses can be classified as:

- **Cost of Goods Sold-** All cost incurred to manufacture the products that are sold or if the company is a wholesaler or retailer, then the cost of goods sold is the amount that the company paid for the merchandise to resell.
- **Selling Expenses** - All cost associated with getting the product sold to the end user. This includes all forms of advertisement, sales associates, and so on.
- **Administrative Expenses** - All cost associated with administration of the company. This includes payroll clerks, supplies, insurance, rent or lease, and so on.

Usually companies will consolidate these expenses into one amount and classify it as SGA expenses. SGA stands for **Selling, General, and Administrative Expenses**.

In addition to this, expenses can be classified as operating expenses or non-operating expenses.

- **Operating Expenses** are cost incurred through everyday business operations.
- **Non-Operating Expenses** could be costs incurred to sell a business or investment. For instance, if SunTrust wanted to sell their ownership interest in Coke to another party, then brokerage fees and attorney fees would arise. *Non-operating expenses could be classified as other expenses. It is simply all expenses not associated with normal business activity.*

Lastly, the IRS usually gets in on all the action. This would of course be classified as Income Tax. The company has little control over the IRS's cut, so you should not be overly concerned of income tax expenses during your research.

After calculating:

Revenues minus Cost of Goods Sold equals Gross Profit;

Gross Profit minus Selling, General & Administrative Expense equals Operating Profit (loss) or Net Profit (loss)

You should be able to see what's going on with the company. It is ideal for the company to make some kind of profit. If there is a loss, then additional research should be done.

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Special Note: Cost of Goods Sold may be calculated differently depending on the business model, but it is usually all resources used whether it is labor hours (payroll) or materials used to produce a company's product or perform a service.

4. The Cash Flow Statement

This financial statement gives us a detailed view of all cash received and disbursed within a financial period. The **Cash Flow Statement** breaks down how cash was made and how it was used. **The key is this financial statement only deals with only CASH.**

Example: You purchase a car for $10,000 and paid $10,000 cash. You will see a decrease in your bank account of $10,000. However, if you finance the $10,000 and put no cash down, then you will see no change in your bank account or no change in your cash balance.

The Cash Flow Statement shows:

1. The cash effects of operations during a period.
2. The cash effects of investing transactions.
3. The cash effects of financing activities.
4. The net increase or decrease in cash during a period.

The cash flow statement is divided into three main sections:

1. Cash Flows from operating activities.
2. Cash flows from investing activities.
3. Cash flows from financing activities.

Cash Flows from operating activities deals with income (revenue) or expenses associated with everyday operations which primarily include sales and selling, general, administrative expense.

Cash flows from investing activities involve cash received or used to enhance operations or minimize operations. This can include the purchase of a plant or factory or sale of plant or factory. It can involve the purchase of another company.

Cash flows from financing activities involve cash flows provided by or used in financing or funding operations. This can include issuing stock for cash or taking out a bank loan for cash.

The cash effects from operating, investing, and financing activities will equal a net decrease or increase in cash.

5. Summary

The financial condition of a company can be assessed by looking at the three major financial statements. The balance sheets provides investors with an idea of how financially flexible a company is based on its assets, liabilities, and equity. The Profit/Loss or Income Statement tells investors if a company is turning a profit or loss. The Cash Flow Statement tells the investor where the cash going to and where it is coming from. Together these statements can give us a wealth of information about a company's health and well-being.

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What the Financial Statements Reveal?

Overview

7. Introduction to the Financial Ratios
8. Liquidity Ratios
9. Activity Ratios
10. Profitability Ratios
11. Coverage Ratios
12. Summary

1. Introduction to the Financial Ratios

The figures from the three major financial statements can be used for detailed analysis of a company. Investors will be able to gauge a company's profitability, liquidity, and debt coverage through figures from the financial statements. Ultimately, most figures from each financial statement are related. Through specific financial ratios you can identify trends in these relationships.

I assume that you understand basic math, however, a ratio is a mathematical expression that looks like this:

$\frac{1}{2}$ or you could say that this is 1 over 2 or 1 divided into 2 or 1 to 2;

You could also say that this expression is equal to .50 or 50% or 50 percent or one half.

Understand that most of these ratios will be given to you. For the most part you will not have to perform these calculations. However, it is critical to understand how to interpret these ratios. In addition to that, understand that the ratio of a particular company should be compared to the industry average. Knowing the industry average will allow you to better understand the company's situation.

2. Liquidity Ratios

Liquidity ratios measure the company's ability to meet short-term obligations or current debt. The two main ratios involved are called the current ratio and quick ratio. The current ratio measures short-term debt paying ability while the quick ratio measures **immediate** short-term debt paying ability.

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Current Ratio

Current Ratio equals Current Assets over Current Liabilities or

$$\frac{\text{current assets}}{\text{current liabilities}}$$

Both current assets and current liabilities can be derived from the balance sheet.

Example: You are researching a company and you notice that they have $1 million in current assets and $2 million in current liabilities.

$$\frac{\$1\text{ million}}{\$2\text{ million}} = .50$$

This essentially means that you have 50 cents for every $1 of current debt. If the company was to cash out all current assets they would still have $1 million in current debt. This does not include long-term debt.

Quick Ratio

In regards to the Quick ratio, you are dealing with strictly cash or extremely liquid assets like stock. As we covered in the earlier chapters liquid assets are assets that can be turned into cash quickly. In essence, the quick ratio can give you a more accurate read on a company's ability to repay current debt. Whereas, with the current ratio you have all current assets, which include cash, securities, and **accounts receivable.** Accounts receivables, however, cannot be converted to cash immediately. Quick ratio is cash, securities, and receivables divided by current liabilities.

$$\frac{\text{cash securities and receivables}}{\text{current liabilities}}$$

Example: A company has a total of $2.5 million in cash, securities, and receivables and has $1 million in current liabilities.

$$\frac{\$2.5\text{ million}}{\$1\text{ million}} = 2.5$$

This means that you have $2.50 in cash, essentially, for every $1 of current debt. If the company was to shut down operations and pay all currents debts, they would have $1.5 million in cash left. This is a great situation.

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3. Activity Ratios

Activity ratios measure how well the company is using assets in regards to sales. The three major activity ratios include accounts receivable turnover, inventory turnover, and total asset turnover.

Accounts Receivable Turnover

Accounts receivable turnover is equal to Annual Sales over Accounts Receivables.

$$\frac{\text{annual sales}}{\text{account recivables}}$$

Higher the turnover figures, the better.

Example: A company has sales of $50 million and has $20 million in accounts receivables.

$$\frac{\$50 \text{ million}}{\$20 \text{ million}} = 2.5$$

This means that this company is turning its receivables 2 ½ times a year. This figure also means that the company is generating $2.50 in sales for each dollar invested in receivables.

Inventory Turnover

Inventory turnover is equal to Annual Sales over Inventory.

$$\frac{\text{annual sales}}{\text{inventory}}$$

The higher the inventory turnover figure, the better. Inventory turnover would be of great importance when researching a retail company. This figure will let you know if management is aware of what their customers are looking for.

Example: A company generated $24 million in sales and has $2 million in inventory.

$$\frac{\$24 \text{ million}}{\$2 \text{ million}} = 12$$

This means that this company is turning its inventory 12 times a year. If you look at this figure little more deeply you will see that this company holding inventory for a little over a month, about 30 days (365 days per year/12 = 30.44). The higher the inventory turnover the less time that an item is in the warehouse, which means less cash tied up in that item.

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Total Asset Turnover

Total asset turnover is equal to annual sales over total assets.

$$\frac{\text{annual sales}}{\text{total assets}}$$

The higher the total asset turnover figure, the better. This figure measures how well assets are being used to generate sales.

Example: A company generated $2 million in sales and has $1 million in total assets.

$$\frac{\$2\text{ million}}{\$1\text{ million}} = 2$$

This means that for every dollar invested in assets $2 in sales are being generated. That's pretty good.

4. Profitability Ratios

The profitability ratio measures a company's profit in relation to its sales, assets, and equity. The most common profitability ratios include net profit margin, return on assets, and return on equity.

Net Profit Margin

Net profit margin is net income over annual sales.

$$\frac{\text{net income or net profit}}{\text{annual sales}}$$

Net profit margin measures profit as a percentage of sales (revenue). Clearly, it is favorable to have higher profit margin.

Example: A company has a net income of $2 million from $5.5 million of sales.

$$\frac{\$2\text{ million}}{\$5.5\text{ million}} = 36 \quad \text{or} \quad 36\%$$

This means that for every dollar in revenue .36 cents in profit is generated.

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Return on Assets

Return on Assets is net income divided by total assets.

$$\frac{\text{net income}}{\text{total assets}}$$

ROA measures the profit as a percentage of assets. It tells us how well a company is using its assets to generate a profit. The higher this number the better.

Example: A company generated a net profit of $2 million and their total assets amount to $50 million.

$$\frac{\$2\text{ million}}{\$50\text{ million}} = .04 \quad \text{or} \quad 4\%$$

This means that this company is making a profit of 4 cents for every dollar invested in total assets.

Return on Equity or Return on Investment

Return of Equity or Return on Investment is net income divided by stockholders equity.

$$\frac{\text{net income}}{\text{stockholders equity}}$$

ROE or ROI is a measure of profits as a percentage of shareholder equity. It tells us how much a company makes for every dollar of stockholder's equity. ROI is what every investor is looking at. It is ideal that a company's ROI is increasing year after year.

Example: A company generated a net profit of $4.5 million and the total stockholder's equity is $46 million.

$$\frac{\$4.5\text{ million}}{\$46\text{ million}} = .097 \quad \text{or} \quad 9.7\%$$

This mean that for every dollar invested the company made a profit of almost 10 cents (.097 cents).

5. Coverage Ratios

The coverage ratios are financial ratios that measure the amount of debt financing being used to support operations and the ability of a company to service its debt. There are two major ratios used in this category debt-to-equity ratio and time interest earned.

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Debt-to-Equity Ratio

Debt-to-equity ratio is Total Debt or Total Liabilities divided by stockholder's equity.

$$\frac{\text{total dept}}{\text{stockholders equity}}$$

Debt-to-equity ratio measures the amount of financing provided by lenders (debt) and shareholders (equity). As we discussed in an earlier chapter, companies can raise money by issuing stock or by securing a loan from a bank. It is not unusual for companies to use a combination of debt and equity financing. Nevertheless, debt-to-equity will tell us the percentage of debt financing in relation to equity financing.

Example: A company has $400 million in total debt and the stockholder's equity is at $100 million.

$$\frac{\$400\text{ million}}{\$100\text{ million}} = 4 \quad \text{or} \quad 400\%$$

This means that this company has $4 worth of debt for every $1 of equity.

Times Interest Earned

Times Interest Earned is equal to earnings before interest and taxes divided by interest expense.

$$\frac{\text{income before interest and taxes}}{\text{interest expence}}$$

Times Interest Earned measures the ability of a company to pay interest payments due. It is important for a company to have more than enough funds to cover its interest expenses.

Example: A company made $40 million in profit before interest and taxes and it had interest expense amounting to $2.3 million.

$$\frac{\$40\text{ million}}{\$2.3\text{ million}} = 7.39$$

This means that this company has $17.39 for every $1 of interest expense.

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6. Summary

Using financial ratios can help you quickly identify negative or positive trends within a company. Financial ratios are divided into four major categories which highlight a company's liquidity, activity, profitability, and coverage. It is important to note that all of these ratios will be given to you when you start doing your research on companies. For the most part you will not have to perform any exotic calculations. However, you will need to know what ratios are normal within the particular industry that your prospective company is involved in.

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Placing a Value on a Company

Overview

1. How the Price of stock is set - Revisited
2. Predictability of Performance of a Company
3. Earnings Per Share - EPS
4. P/E Ratio
5. Putting it all Together
6. Your Desired Rate of Return
7. Summary

1. How the Price of Stock is Set - Revisited

As I stated in an earlier chapter, the market value of a company (stock) is based on the sellers willingness to sell and at what price; and a buyers willingness to buy and at what price. In this chapter we are focusing on you as the buyer. Your willingness to buy and at what price is based on your research of a particular company. At this point you will know whether a company is good, average, or below average. Now we need to get a number….Think about this….We know that a Mercedes Benz car has all of these luxury features that you love…Great…How much does this car cost? See how this can mess up your willingness to buy…..Same thing applies to a company that you see has all the makings of a great operation. The company boasts features like minimal debt, record profits, and is a leader in its industry. All of this is great, but now your question is what the price of the stock is?

2. Predictability of Performance of a Company

You ever wonder why loan officers at a bank want your last three paycheck stubs or your income tax returns for the past two years before they give you a loan. Well, they want to be able to project how much income you will generate based on your past performance. If you have been in and out of work for the past two years, then a bank will not be able to accurately predict your future earning, because you are inconsistent. Therefore, you are a financial risk.

With that said, you need to be able to reasonably predict a company's future performance based on its past performance. You can do this with relative ease if a company has been in business for 5 years or more. However, if the business is a start-up, you cannot reasonably predict its future performance, which makes it a financial risk.

When evaluating the performance of a company, you are looking for trends. Are the company's sales steadily increasing year after year? Or are sales on the decline? Are they showing steady improvement in profit year after year? Are sales up and down, no consistency?

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After you identify these trends then you need to be able to quantify the increases or decreases. *Example: I identified a trend; Starbucks has a steady increase in net profit over the last 5 years. I then find out what the percent increases are between each year and come up with an average increase of 5%. Now, I can reasonably predict that the net profit for next year will be a 5% increase, at least.*

Note: You should be interested in companies that have consistently increased sales or profit. You should be weary of companies that have consistently decreased in sales or profit. Something is not right.

3. Earnings Per Share - EPS

Earning per share is equal to net income minus preferred dividends divided by all shares outstanding. This simply gives you the net profit earned by each share. EPS is key component in stock price valuation.

Earnings per share also give you an accurate view of how much you have earned for each individual share that you own. For instance Starbuck Inc. had earned $3.00 per share and you own five shares. You essentially have earned $15.00 ($3.00 EPS x 5 shares) total for all shares that you own.

A company's EPS is usually given to you on the income statement. You should not have to do any complex calculations to get EPS.

Remember that EPS has a direct relationship to net profit. So if profit is increasing, then EPS is increasing.

4. P/E Ratio

Price-to-Earnings Ratio is equal to the market value of a stock over its earnings per share. ***Note: EPS times P/E Ratio is equal to market value of a stock***

Earlier we stated that Starbucks Inc was earning $3.00 per share. In addition to that, it is trading at $36.00 per share (market value). From this information we can conclude that the P/E ratio is 12.

Like EPS, the P/E ratio is essential in predicting the future value of a stock. The P/E ratio, like EPS, is usually given to you, however, to predict future value of a stock you need to find the historical P/E ratios. From the historical P/E ratios, you will be able to derive a 5-year or 10-year average. This average may also be given to you. This average will allow you to reasonably predict future market value of a stock.

5. Putting it all Together

You have identified a solid company that has been increasing sales and profits consistently. You realize that the company has a strong balance sheet, not much debt. You have performed the applicable financial ratios. In addition to that, you find that the EPS has been increasing by average of 10% each year for the last ten years. Last year's EPS was $1.00 per share. So you can reasonably predict, based on past performance, that this years EPS will be $1.10(1.00 x 1.10). Furthermore, you can reasonably project that in five years the EPS will be about $1.61.

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Year	EPS
1	$1.10 (1.00 x 1.10)
2	$1.21 (1.10 x 1.10)
3	$1.33 (1.21 x 1.10)
4	$1.46 (1.33 x 1.10)
5	$1.61 (1.46 x 1.10)

In addition to this you determine that the average P/E ratio is 26. From this information you can reasonably project that in year 5 this stock will be worth $41.00 per share (1.61 x 26). If the stock is currently trading at price lower than $41.00, then this is a good buy. However if the stock is trading at a price higher than $41.00, this may not be such a good buy.

6. Your Desired Rate of Return

The price you pay for something determines your rate of return. This is why we negotiate prices for everything. Remember that the lower the price that you pay for something, then the higher your rate of return. How much you want to earn is entirely up to you. If you desire a 10% rate of return on your investment, then you will have to find investments that will potentially yield a 10% return. From the earlier example, you predict that the market price of this stock will be $41.00 in year 5. The market price is currently $25.00 per share. If you were to buy at $25 per share, you will potentially have a capital gain of $16 per share ($41.00 - $25.00) after four years. This is an annual rate of return of about 13%. Try to get that type of return at your bank.

From your desired rate of return, you can place your own value on a company based on your research. Let's say that you want to earn at least 10% annually on all of your investments. From the earlier example you are only willing to pay only $28.00 for that stock that has a potential future value of $41.00 in four years.

If the stock is trading higher than what you are willing to pay, then do not buy. If it is trading lower than what you are willing to pay, then you might want to "back the truck up".

Notice that the price you are willing to pay is based on your research along with your desired rate of return.

7. Summary

In order to place a value on a company, you need to determine if the performance is reasonably predictable. Secondly, find out the EPS for the last five to ten years. Determine the percent of increase for EPS each year and take the average. From this you can predict future earnings per share. Thirdly, find the average P/E ratio for the company. Based on average P/E ratio along with the projected earnings per share, you can reasonably gauge the future market value of a company. Finally, determine the rate of return that you want on your investment. From your desired rate of return and research you will be able to set a price that you and only you are willing to pay for a particular stock.

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Where to Find Information on a Company

Overview

1. Company Website
2. Information Websites
3. Wall Street Journal
4. Value Line Investment Survey
5. Summary

1. Company Website

If you need to find information on a company and its stock, look no further than the company website. If you do not know the website address then simply type the company's name into a search engine.

Once you are at the company's main site look for a link that reads **investor relations.** Click on investor relations link and it will lead you to the financial statements and so forth. Some companies may have an independent site dedicated to investor relations, so do not get alarmed when you don't see an "investor relations" link on the company's main site.

At the company site you will have access to:

- Annual Report – This usually highlights the company's past accomplishments, history, management team, business strategy, financial statements.
- Current stock price (usually in real time)
- 10-K Report – A report submitted to the SEC (Securities Exchange Commission) on an annual basis. This report is much more detailed than the annual report and usually includes company history, organizational structure, business operations, business holdings, financial statements, subsidiaries, etc.
- 10-Q Report – A report submitted to the SEC on a quarterly basis. This contains pretty much the same information that is in the 10K.
- 8-K Report – A report of any unscheduled events or company changes that could affect shareholders.

The company site may also have information on how to start a Direct Investment Plan.

In addition to that, the company site will give you the **ticker symbol** for the company. A **ticker symbol** is an arrangement of letters representing a company that is publicly traded on the stock market. Every company has a unique ticker symbol, which is used to facilitate trades in the stock market.

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Examples of Ticker Symbols

- *The ticker symbol for Starbucks is SBUX.*
- *The ticker symbol for Walgreens is WAG.*
- *The ticker symbol for Wal-mart is WMT.*

2. Information Websites

There are several websites that you can find information on certain companies. Some of the top search engines have sections dedicated to financial markets. Just look for any link that reads **money** or **finance**. Here are some information websites that you can use for your research of a company:

- http://finance.yahoo.com/
- http://moneycentral.msn.com/home.asp
- www.hoovers.com
- http://www.cnbc.com/

In addition to particular financial information these sites will contain the latest news on your company of interest.

3. Wall Street Journal

The Wall Street Journal is the most popular newspaper for investors, by far. It contains the latest news on all companies private or public. This is a great resource to find companies to invest in. In addition to the latest news, the Wall Street publishes all the latest stock prices of stocks that you may be interested in or you already own.

4. Value Line Investment Survey

This is a great resource; however, most people may not be able to purchase the Value Line at $700 a pop. Nevertheless, if you make a stop at your local library they should have a copy on hand. This reference breaks down companies by industry. In addition to that, the Value Line gives you the EPS history, industry rank, financial ratios and more. If you don't want to be number crunching all day, then check out this resource at your local library. There is also a version available online, but of course it will cost you.

5. Summary

There are several ways to find information on a particular company. Firstly, you can visit to the company website. In addition to that, you can look at financial information sites. Thirdly, you can read the Wall Street Journal to get current market price and the latest news on companies. Finally, you can find critical information in the Value Line Investment Survey.

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Supplement

Examples of the Financial Statements

I have selected two companies to explore. **Notice how the format of the financial statements differs from company to company.**

Income Statements

- Altria Group (Formerly Phillip Morris)
- Wrigley

Balance Sheet

- Altria Group (Formerly Phillip Morris)
- Wrigley

Statement of Cash-flows

- Altria Group (Formerly Phillip Morris)
- Wrigley

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Supplement

Using a Financial Calculator

The financial calculator is the lifeblood of investment professionals. Did you think they were punching out these figures by hand? With an financial calculator you can find out several things:

- How much was the annual rate of return?
- What is the present value based on future value, interest, and periods?
- What is the future value based on present value, interest, and periods?

There are several financial calculators out there. However, the one that I have been using since my college days is the BA II by Texas Instruments. It is about $20 to $30 depending on where you look. This calculator will come in very handy when it comes to making the calculations that I made in the latter sections of Chapter 9.

For instance in chapter 9 I calculated how much I should pay for a stock based on my desired rate of return and future value after 4 years. We predicted that the future value of the stock was $41 and that I wanted to earn at least 10% annually. From this example we know that $41 is equal to FV, 10% is equal to I/Y, and 4 years is equal to N. The unknown is PV (present value) or what we are willing to pay for this stock.

THE VARIABLES

N = NUMBER OF YEARS OR PERIODS

I/Y = INTEREST/YEAR

PV = PRESENT VALUE

FV = FUTURE VALUE

Let solve the example above based on the variables step by step.

1. *In the calculator type 4 then press N.*
2. *Type 10 then press I/Y.*
3. *Type 41 then press FV.*
4. *Finally, press CPT then press PV.*
5. *You should get -28.00355, which equates to $28.*

Notice that the PV (present value) will always be represented by a negative number or minus sign in front of the value.

To find out more about the capabilities of BAII calculators or financial calculators in general check out the website listed below:

http://www.tvmcalcs.com/tvm/tvm_intro.htm

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