

FINANCIAL ANALYSIS OF COMPANIES ON THE CAPITAL MARKET

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Abstract: In the current context of economic globalization, financing through the capital market has become a modern alternative against financing through the monetary market, therefore investors shall be the main users of financial information.

Financial analysis has to be able to offer also to this category of users of financial information the adequate instruments to fundamental decision making of investing on the capital market through the so-called market ratios¹.

Market ratios are the most comprehensive means of measurement of a company as they reflect the corroborated influence of risk and profitability financial ratios.

This paper issue the main market ratios calculated by the investors on the market capital by help of two types of analysis methods (fundamental and technical methods).

Keywords: Market ratio, investors, fundamental analysis, technical analysis, market capital.

I. Introduction. General approaches regarding the financial analysis on the capital market.

Market ratios are the most comprehensive means of measurement of a company as they reflect the corroborated influence of risk and profitability financial ratios.

These ratios are more important because they reflect the general confidence and trust of the **market** in a company's management, but said confidence and trust depends upon many economic, social, and political factors. Therefore, when investors fundament their decisions, they take into consideration a variety of indicators, not only internal performances achieved by a company, and established by analyzing the information reflected in its financial statements.

When choosing a certain type of investment, the factor that determines investors' decisions depends on the *horizon of interest* pursued in a certain company. Therefore:

- If the company's **development prospective** is pursued, respectively the **long-term horizon**, potential investors (or majority shareholders, in case of existing investors) shall be interested in the operating result that would generate an increase in the value of shares in the future.

¹ In related literature they are also called "profitability ratios of capital investments" – Bătrâncea I. Coord. "Balance Sheet Based Financial Analysis" Published by Presa Universitara Clujeana, Cluj-Napoca, 2001, pg.158, or "stock market yield ratios" – Buglea Al. "Analysis of the Company's Financial Statements", Published by Mirton, Timisoara, 2004, pg.160, or "investors' indicators" – Gaskin T. "Perfect Financial Indicators", Published by National, 1998, pg. 62.

- If **immediate gain** is pursued, obtained in a horizon of less than 12 months, i.e. a gain in the form of dividends distributed and gains from the differences in quotations, potential investors (or minority shareholders, in case of existing investors) shall be interested in the level of this type of gain.

II. Types of financial analysis on the capital market methods.

In either case of decision to invest on the capital market, current and potential investors as well as capital market professionals use two categories of analyses, namely: **fundamental analysis and technical analysis**

a) Fundamental analysis

This is made through a comparative study of ratios obtained by analyzing the financial statements. The end goal of this analysis is to select the shares that have an intrinsic potential to grow, thus creating the premises for the market to recognize in the future the real value of said company (the one resulting from the analysis) and consequently the price would rise.

It involves a calculation of market ratios by investors and capital market professionals in order to assess the company's potential to grow. Among the most widely used ratios can be mentioned:

1. Market capitalization (MC) is calculated by multiplying the current market price (CMP) of a share by the total number of shares issued by the company (NS), with the formula:

$$MC = CMP \times NS$$

Market capitalization represents the market value of a listed company and it reflects the public opinion on the net worth of the company, and it is a basic determinant in evaluation of shares. It does not always reflect the real worth of the company, as in case of take over and acquisition offers, when the company is assessed based on several factors that give value to its business.

Market capitalization is one of the best liquidity indicators; it reveals how easily can the company's shares be traded, especially from the prospective of an investor who invested large amounts of money in shares and wishes to know how easily can a counterpart be found if he wishes to sell said shares. This feature becomes extremely important when selecting the securities in a portfolio according to their market capitalization. From this point of view, companies are divided in three large categories: large companies (large-caps), medium companies (mid-caps), and small companies (small-caps).

Market capitalization is also the first indicator taken into consideration when the size of a stock exchange is in discussion, in which case it is referred to as the sum of market value (market capitalization) of all the companies listed on an organized market. Hence, market capitalization is one of the basic indicators characterizing a capital market.

2. Earning per share (EPS) indicates the net result produced by a share during the financial period.

$$EPS = \frac{\text{Net profit}}{\text{Number of shares}}$$

Investors can do the **interpretation** of the **EPS** indicator as follows:

- A **high level** of this indicator may reflect:
 - investors' trust in the company's management, or
 - a lack of investors' trust in the company's current management, but it is estimated that there is a possibility to transfer the company's assets to another company with a more reliable management.
- A **low level** of this indicator may reflect:
 - may indicate a lack of trust in the current management, or
 - the management is dealing with issues that cannot be easily overcome.

If the net profit is reinvested the indicator must show an increasing trend because the profit retained by companies are used to generate a higher profit.²

² Gaskin T., *Perfect financial indicators*, National Ed., 1998, page 64

Interpretation of this indicator and its significance in market analysis has certain **limitations**.

➤ *Measuring the performance in time:*

- The indicator relies on historical profits. The management might have taken certain decision in the past in order to foster an increase of the current profit on account of future growth, such as reducing research and development investments.
- This is the reason why reliable forecasts regarding the company's future growth rate cannot be based on EPS growth.

➤ *Measuring the performance in space:*

- Profits are influenced by decisions of the management of different companies regarding accounting policies (e.g. depreciation method)
- Earning per share is influenced by the capital structure of different companies (e.g. changes in the number of shares by issuance of shares with a premium)

3. Price-to-earnings ratio (PER or P/E) indicates how much are investors willing to pay per a monetary unit of earnings. It is calculated as the ratio of the company's current share price (or market value per share MVS) compared to its per-share earnings (EPS).

$$\text{PER (P/E)} = \frac{\text{MVS}}{\text{EPS}}$$

The PER indicator estimates the number of years during which the investment can be recovered assuming that the entire profit is distributed to shareholders as dividends (its is relevant especially when dividends are paid in cash).

The PER indicators show how much has an investor to invest in order to obtain a monetary unit from the company's profit.

Investors can do the **interpretation** of the **PER** indicator as follows:

- A relatively **low PER** indicates a cheap share, therefore adequate to be purchased.
- A relatively **high PER** indicates an expensive share that can also be overvalued.

Interpretation of this indicator and its significance in market analysis has certain **limitations**.

- In case of a static approach it is obvious that a share with a low PER is preferred against a share with a high PER. But the owner of a share is entitled to future incomes to the same extent as to current ones, and the current profit generated by the security can be very different from its future profits. In such a case, it is possible that a *share with a higher PER to be more profitable than a share with a lower PER* if there are possibilities for the profit and dividends to grow rapidly during the following operating periods. In such a case, a higher indicator level can be explained through the expected higher growth rate or a reduced risk.
- Therefore, in the PER analysis one also has to take into account the increase or decrease of the share prices in the future. Because investors are interested in the future achievements of a company, the historical PER becomes unimportant, and the *PER based on forecasts of future earnings becomes more interesting*.

4. Price-to-Book Ratio (P/B or PBR) is the ratio of the company's current share price (or market value per share -MVS) compared to the book value per share (BVS). It is another important ratio because it indicates the value conferred by financial markets to a company's management. It is calculated with the formula:

$$\text{PBR} = \frac{\text{MVS}}{\text{BVS}} \quad \text{where,}$$

$$\text{BVS} = \text{Equity capital} / \text{Number of shares} = (\text{Total assets} - \text{Debts}) / \text{Number of shares}$$

Investors can do the **interpretation** of the **PBR** indicator as follows:

- If PBR is **less than one**, it reflects a "safe" investment in that company, because it says that the book value is a "support" level of the market price. The book value is considered the level below which the market price shall not fall, because the company shall always have the

possibility to liquidate or sell its assets at their book value. It is considered that *a low PBR* can ensure a “safety margin”, that is why many analysts avoid shares with a high PBR in the first stage of building a portfolio. They rely on the idea that if all other conditions remain similar for two different shares, than the share with lower PBR is safer.

- If PBR *is above one*, i.e. the book value is lower than the market price, it might be an indication that the shares are overvalued, which is a signal to sell, that shall incur an adjustment by falling prices.

5. Price-to-Sales Ratio (P/S or PSR) reflects the ratio between the market value per share (MVS) and the net turnover (NTS) per share or is defined as the ratio between market capitalization (MC) and the company’s turnover (NT).

$$PSR = \frac{MVS}{NTS} = \frac{MC}{NT}$$

For investors the **interpretation** of PSR come to complete the interpretations of the other indicators, as follow:

- In practice it has been proven that this indicator is more useful to identify non-profitable investments rather than discover profitable ones. Moreover, analysts who use this ratio state that it is especially useful in assessing companies with low profit or with no profit, especially because in such cases the PER indicator cannot be calculated.
- This indicator is useful when other indicators cannot be used, either because the company registered losses or because its profitability or margins are extremely low. Turnover based evaluation is relevant in situations when a company’s estimation is intended at a certain moment when it registers very small or negative margins, but it is expected that it will return to its normal activity or it will be taken over by another company.

As **limits** of PSR we can invoke:

- It is not recommended to compare PSR between different industrial sectors; instead it is useful to compare the ratios of companies with very similar activity or with the average of the sector.

Below are the average values of the most important market ratios for different business sectors from Romania:

Business sector	Average PER	Average PBR	Average PSR
Banking	30.54	3.31	1.63
Consumer goods	14.48	2.02	1.59
Chemical industry	30.06	1.27	1.14
Equipment	22.77	2.06	1.33
Pharmaceutical industry	27.25	2.54	4.06
Materials	15.03	2.21	1.20
Oil industry	12.43	1.28	1.10
Energy services and equipment	34.26	2.59	1.46
Tourism	35.83	1.74	8.05
Others	36.15	1.27	1.77
Financial investment and services	15.84	0.76	-
BVB average	20.08	2	-

Table 1: Average PER/PBR/PSR for the main business sectors from Romania

Source: authors’s adaptations after www.bvb.ro

From the table below one can see that PER is very high for tourism, energy services and equipment, banking, and chemical industry. In other words, investors' trust in these sectors is quite high. The opposite side is represented by the oil industry, consumer goods industry and materials sector, which have a low PER indicator.

When considering the PBR ratio, the highest value is approached by the banking sector, where the market value per share is three times the book value per share. The pharmaceutical industry and energy services and equipment have a PBR ratio of about 2.5. Upon analyzing the PSR ratio one can notice that tourism is above 8, followed at a great distance by the pharmaceutical industry with a ratio just above 4, whereas for the other fields this indicator is between 1 and 2.

b) Technical analysis

This type of analysis aims at gain targets obtained by investors on the short-term (within a few weeks or up to one year). It relies on identifying the collective behavior of buyers and sellers based on price charts based on which the immediate evolution of shares is estimated. Therefore, technical analysis does not strictly rely on the real intrinsic performances of a company but on the daily results offered by the ratio between the daily trading price and the volume of shares traded in that day. More exactly, these results consist in a series of measures determining trends, support thresholds, resistance thresholds, price averages for different time periods, issues that shall be referred to in this paper.

III. Conclusions

In practice, these two types of analysis are used simultaneously. Fundamental analysis gives information about a company's financial situation, whereas technical analysis indicates the most appropriate moment to buy. One can consider technical analysis a practical application of the fundamental analysis. In other words, fundamental analysis helps us **to select the securities** that we want to have in our portfolio and which are valuable from fundamental point of view, and technical analysis allows us **to determine the right moment** to buy those specific securities. These two categories of analysis are completely independent one from another, and their indications differ. Therefore it is more desirable to make a decision to buy when the indications of both categories converge.

A very synthetic presentation of the decision scheme to invest on the capital market is as follows:

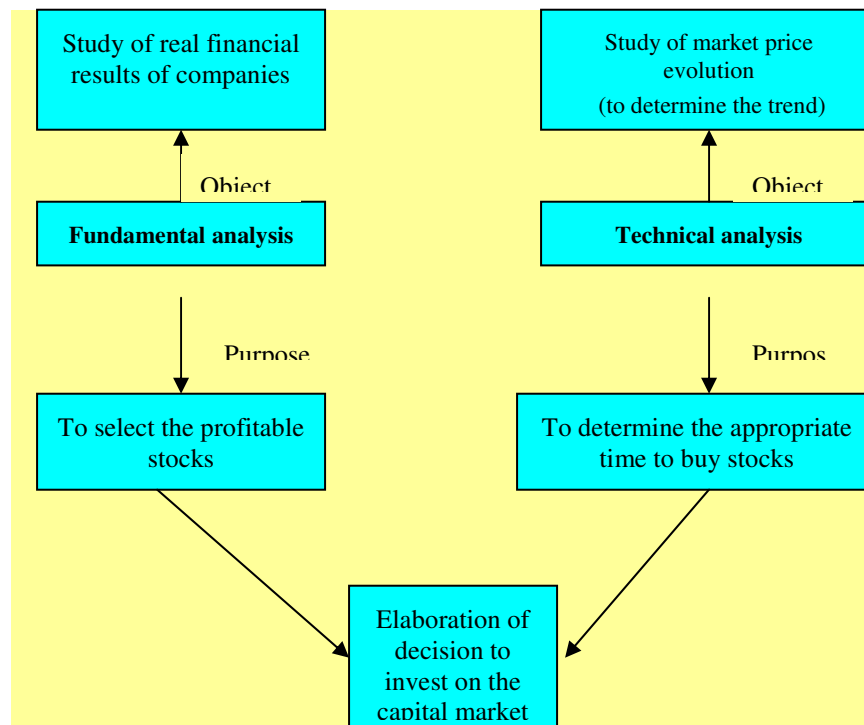


Figure 1: The scheme of the analysis of decision to invest on the capital market

Source: authors' s adaptation

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