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THE FUNDAMENTAL ANALYSIS-THE BEST WAY TO EVALUATE EQUITY SHARES

Maneesh Arora
Assistant Professor in Commerce in DAV College, Jalandhar, Punjab.
professormaneesh@yahoo.in

Abstract- The best way to invest your surplus money and take back the best rate of return among all financial investment avenues is to invest in the Stock Market. And stock markets give us the most common, the most successful way of Investment i.e. Equity shares. We have a fixed Income bearing Securities. But when it comes to analysis part, the equity shares become the most difficult part. Equity shares have two great features and that of Risk lunation inherent in it and the growth that market forces of demand and supply provide it.

As an investor you should know that what your top priority as an investor is. There are many ways of doing investment. Every investment decision has two parts – Risk and Return. The article is an attempt to improve your ability in the fields of investments especially for equity shares or equity stock or which represents the direct ownership securities. So try to know the intrinsic value of the equity stock, not only mathematically but try to measure how fundamentally strong the equities going to be in which you will be investing.

Key Words: Fundamental Analysis, Economic Analysis, Industry Analysis, Company Analysis, Equity Shares, Dividend

I. INTRODUCTION

Stock Markets – the best way to invest your surplus money and take back the best rate of return among all financial investment avenues. And stock markets give us the most common, the most successful way of Investment i.e. Equity shares. We have a fixed Income bearing Securities. But when it comes to analysis part, the equity shares become the most difficult part. When the securities that have a fixed Income stream have 2 distinct characteristics- (a) A fixed predetermined Income stream. (b) The age of such securities is also limited. Now Equity shares have none of these peculiar features. But in addition, Equity shares have 2 great features and that of Risk lunation inherent in it and the growth that market forces of demand and supply provide it.

The Evaluation of Equity Shares with prominent factors has been explained as under—

As the Equity Share holder ------

1) I expect a return(s) in the form of dividends, no age limit, potentially long in future.
2) I also expect a discount rate(d) at which I'll receive the return on my investment in Equity share.
3) Can I get its Intrinsic Value? --- Yes, why not? – If r1, r2, ------- n are the returns (dividends) received at the end of years, (Y1, Y2 and so on)---and d is the discount rate expected from the equity shares unde4r consideration.

4) Intrinsic value (IV) =

$$\frac{r1}{(1+d)} + \frac{r2}{(1+d)^2} + \_\,\_\,\_\,\_ + \frac{rn}{(1+d)^n}$$

5) Assumption of growth (g) of Return (dividend) so the formula of IV becomes.

$$IV = \frac{r1}{(1+d)} + \frac{R1\ (1+g)}{(1+d)^2} + \frac{r1\ (1+g)^2}{(1+d)^3} + \text{------------} + \frac{r1\ (1+g)^{n-1}}{(1+d)^n}$$

(no growth rate added)

GR added in Y2 [Return of Y1] +GR

GR added in Y3 [Return of Y1 & Y2] +GR

GR added in Yn

6) Simplify the eq.2

$$IV = \frac{r1}{d-g} \quad \text{------------------- --------} \quad \textbf{Eq. 3}$$

7) If EPS is earning per share,DPR is Dividend Payout Ratio then

r1 = EPS X DPR

8) Simplify the eq. 3

$$IV = \frac{EPS\ X\ DPR}{d\ -\ g} \quad \text{\_\_\_\_\_\_\_} \quad \textbf{Eq. 4}$$

9) For example, let's put light on the eq. Shares of Ashokarishth LTd.

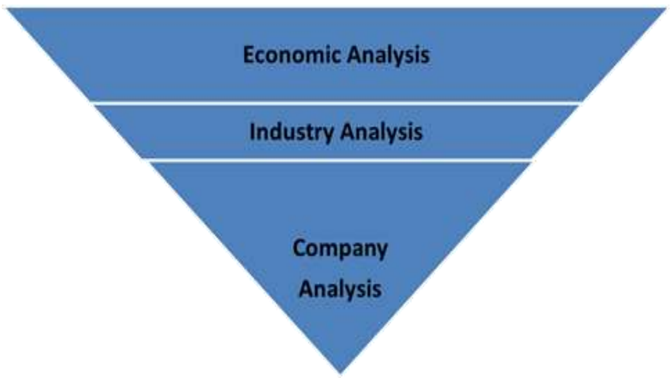
EPS =4
DPR =50%

d =20%
g =5%

10)Fill in eq. 4

$$IV = \frac{4 \times 50\%}{20\%-5\%} = Rs.13.34$$

As we have just discussed, that the Intrinsic Value of an equity share is a function of EPS, DPR, GR & Rate of return of the company in question. Now, all these factors are dependent upon the good perspective of the Industry of its Universal set. The good perspective of the industry is in turn dependent upon the economic health of the country. It can be better understood if we make a reverse pyramid and use this approach as a yard stick for measuring the Intrinsic Value of equity stock.



The reverse Pyramid Approach Called 'The Fundamental Analysis'

After many research studies empirical evidence suggests that economic circumstances account for 30% of the effect on evaluation and Industrial circumstances account for 15% of the effect and individual company factors account for again 30% of the effect and if there are any miscellaneous factors 25% weightage will be given to them for evaluation of equity stock.

So the most prominent procedure of fundamental analysis involves three way analyses such as:

- How does macro- Economic environment develop in an economy?
- How does the Industry paradigm change the evaluation?
- How the future performance of the company going the demonstrate the Intrinsic Value of equity stock?

So this 3 parts scrutiny starts as follows:

A. The Macro Economic Analysis

1) GNP (Gross National Product)

GNP means the aggregate value of goods and services produced in the economy. It depends upon personal consumption expenditure, private domestic investment, public expenditure on goods & services and Net exports of goods and services (E-M).

The official estimates of GDP growth rate are available after a couple of years but basic estimates are available from time to time by bodies like CMIE (Centre for Monitoring Indian Economy), NCAER (National Council For Applied Economic Research) and RBI (Reserve Bank of India).

The more the rate of growth for GNP, ceteris paribus, the more favorable it is for the stock markets and value of equity stock will be high.

2) Saving & Investment

It is that portion of GNP which is saved after due consumption and then Invested. The Indian mentality is basically of 'Save, Save, Save---- Save for the rainy day.' The rate of saving in India has hovered around 25% which compares with the best in the world. It goes without saying that higher the level of saving /investment, ceteris paribus, the more favorable it will be stock markets and the value of equity stock will be high.

3) The Inflation Rate

The effect of inflation on the corporate sector tends to be uneven. While certain Industries may benefit, others tend to suffer Industries that enjoy a strong market for their products and which don't come under price control regime. May get the advantage whereas Industries with e more than one or which come under the price control regime are on the losing streak. In Indian economy the secular inflation rate has been around 7% but in recent years it has dipped a lot. The result gathered is that a mild level of inflation is good for the stock market.

4) India Relies on Monsoons

Agriculture accounts for a major share of the Indian economy and is connected to the Industry - this way or that. A spell of good monsoon imparts dynamism to the industrial sector and boost to the stock market. In turn on the industrial sector and hence the stock market suffers.

5) Interest Rate Risk Analysis

Interest rate always under goes a change whether it is the time of maturity or whether it is a case of default of payment or maybe there is a risk of rise in price level or may be fluctuation in the productivity of capital etc. For a long time, the interest rate in our country has been a pretty high but in the last few years, interest rates have come down significantly. A rise in interest rates depresses corporate profitability and also leads to an increase in the discount rate applied by equity investors, both of which have an adverse effect on the stock market pricing behavior. On the contrary, a fall in interest rates improves corporate profitability and also leads to a decline in the discount rate applied by equity stock investors, both of which have positive effect on the stock prices.

6) Fiscal and Monetary Frame Work

The critical factors are :

1. The Size and Composition of the Budget
2. The quantum of Budgetary surplus / deficit
3. The levels of Internal and External debt
4. The BOP (Balance of Payment) position
5. The Tax Structure
6. The Money Supply
7. The Interest Rate structure and credit Policy

It is difficult to say unconditionally that how the above elements affect the stock markets but general expert opinion distinguishes these as follows:

1. A high deficit budget or high surplus budget is unfavorable and vice-versa.
2. If the debt can be serviced properly then it is favorable otherwise unfavorable.
3. A satisfactory BOP position better whereas contrary situation is negative.
4. The tax structure should motivate savers and investors that will be quite encouraging.
5. If money supply is within reasonable limits it means that inflation is within permissible limits is good.
6. If the interest rate structure is stable and equitable than it will be better for the economy and stock markets.
7. The credit policy should be framed in such a manner that it should accommodate reasonable business demands.

Diffusion Index (DI) –

It is a composite or consensus index. The diffusion index consists of some leading indicators, coincidental indicators and some lagging indicators. The leading indicators can be for e.g. average weekly hours of production, contract and orders for plant and equipments, change in material prices, stock prices of 500 common stock, index of consumer expectation etc. similarly the composite index of coincidental indicators can be employee pay rolls of non agricultural sectors, industrial production, manufacturing and trade sales etc. Now if we come to the composite index of lagging indicators, the examples can be average unemployment, change in consumer price index for services, commercial and industrial loans outstanding and average prime rate charged by banks.

These types of index have been constructed by NBER (National Bureau of Economic Research) in USA. An examination of these variables will give an investor a useful reference in figuring out the direction of the economy and the stock market. This professional sense will lead the stock market investor for finding out the intrinsic value of the equity stock.

B. The Broad Industry Analysis

Look at the term ICM, where I stands for Information Technology Companies, C stands for Communication Companies, and M stands for Media Companies, which includes television production companies and film production companies. Now these industries are the most upcoming industries in the economy. Now our focus becomes a bit narrow and from the Macro Economic Analysis Stage, our analysis shifts to the industry level where we have a three part approach which runs as follows:-

1) The Life Circle Approach

The thinkers on economy believe that analysis of every industry depends upon the stage of development of its life circle. The following well defined stages can be enumerated:-

#The Start up Stage- Technology is new, product is new, incentives are better, early bird advantage is there, this stage attracts many but a few survive.

#The Grow-all Stage—Characterized by survival from the cut throat competition situation of startup stage, the dust begin to settle and the industry achieve the rapid streak of growth. It witnesses great expansion of sales and profits.

#The Pause and Think Approach- Under this the industry is achieving a kind of maturity and growth rate of the chosen industries can be compared to the macro economy growth rate. In fact this is the time to pause and rethink on the strategy adopted and set our eyes on the greener pastures.

#The Touch Y-axis Stage- Demand satiated, new products throng the market, consumers preferences, tastes and fashion change, in short the industry is stagnating and showing the inclination to touch Y-axis.

The above analysis brings us to the concluding massage that from the birth to death there are many implications for the concerned investors. So we must:

1. Prioritize the industry analysis in our investment selection process.
2. During the start up stage we must be very conscious and should not invest unless we are speculators.
3. During the grow all stage expand and diversify your investment with a quick reflex action.
4. Consolidate our portfolio if the pause and think stage is on.
5. Disinvestment is the watch word if you ever get a clue of the industry coming down.

2) Structure and Hallmarks of the Industry under Consideration—

 # Here consider the competitive nature as well as structure of the industry e.g. :

------ The number of operative firms and the ranking of top 4 or 5 firms.

------ Government licensing policy: open hearted or distractive.

------ Government entry barriers if any.

------ Competition from foreign firms.

------ Firms pricing policy if any.

------ Differentiation among products.

 # Demand and Customer profile e.g. :

------- Needs and requirements of the customers.

------- Chief determinants of demand.

------- The flexibility of demand.

------- Rate of growth in the near future.

 # Cost and Profit Balance when Efficiency is the key factor e.g.:

------- Element of cost like input, labour, power and fuel etc.

------- Labour Efficiency and productivity.

------- Inventory turnover ratio, debtors turnover ratio and the quantum of fix assets.

------- Inputs and outputs operate in controlled and decontrolled Environment.

------ The inflationary conditions put pressure on the prices of inputs and outputs. What is the return like GP, NP as well as operating profit.

 # Advancement in Technological Field as well as research and Innovation e.g.:

------- The important technological changes and their prospective Effects.

------- Stabilization of technology.

------- Fluctuation in technological advancement.

------- The ratio of R & D expenditure to the sales in industry.

------- If innovation brings us new products, does it mean growth of sales also.

C. The Micro Analysis at the Company Level

To make up and compute the intrinsic value of equity stock now comes the part of the study and scrutiny of the financial information at the company level as well as the evaluation of its management wisdom. So this part can be separated into two basis:

1) *Scrutiny of Accounting and finance at the company level:*

This can be done in the form of the following hypothetical table containing major information on finances of a hypothetical company called Tachymart Ltd.

The table has been displayed on the next page (Table 1)

Table 1.

(Rs. in Crore)

Particulars	2005	2006	2007	2008	2009	2010
Total Assets	94.8	98.4	99.3	91.7	96.6	200.00
Total Liabilities	44.8	51.4	43.3	41.7	36.6	100.00
Net Worth	50.0	47.0	56.0	50.0	60.0	100.00
Net Sales	136.2	125.6	142.2	190.1	195.5	225.00
EBIT	20.2	18.6	15.4	14.6	16.0	30.0
Interest	2.2	2.6	1.4	3.6	3.0	4.0
PBT	18.0	16.0	14.0	11.0	13.0	26.0
Tax	9.0	8.0	7.0	5.5	6.5	13.0
PAT	9.0	8.0	7.0	5.5	6.5	13.0
Dividends	4.5	4.0	3.5	2.75	3.25	6.5
Retained Earnings	4.5	4.0	3.5	2.75	3.25	6.5
EPS (RS.)	2.78	2.80	3.0	2.0	3.68	5.68
BPS (Rs.)	1.60	1.60	1.75	1.80	1.85	2.25

2) *The level and decision making capability of management:*

It has become a matter of great discussion that management should be considered as an independent factor in company analysis or not. Most of the Management Thinkers and Gurus are of the opinion that the performance of a business is largely dependent upon the performance or non-performance of the managements- present, past or future. Under this heading the analytical questions that can be asked are as follows:

------- The grand strategy of the management.

------- The mission statement of the management.

------- Expansion or diversification- which way to go.

------- Time bound programs or no boundaries.

------- Organizational structures—centralized or decentralized.

------- Management is investor friendly or not.

II. CONCLUSION

Without doubt, stock markets are a confusing labyrinth and if you have more money than you need for current consumption, you are a potential investor. And as an investor you should know that what your top priority as an investor is. Once you start on this path, there are many ways of doing investment. It is up to you how foolishly or wisely you invest and that will lead to your economic well being. Every investment decision has two parts – Risk and Return. Risk now for a future return while the sacrifice occurs in the present and is certain, the benefits come in future and may be uncertain. The article is an attempt to improve your ability in the fields of investments especially for equity shares or equity stock or which represents the direct ownership securities. So try to know the intrinsic value of the equity stock, not only mathematically but try to measure how fundamentally strong the equities going to be in which you will be investing. In fact the fundamental analysis is the way to evaluate that how equity stock measures up to our expectations intrinsically.

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