Ratios—Are they really important?

Well, yes. Let's define four—a couple we use regularly and two we don't. We'll learn what they are and what they tell us, then discover where they are available and how to use them. Usage depends on our understanding of the relationship of one data item to another and what those relationships tell us.

First the boring stuff—we'll define them.

Return on Equity Ratio (ROE)
ROE is used to evaluate management's performance. We are probably well acquainted with this ratio as it's what we analyze in Section 2B of the SSG form (Stock Selection Guide). It's the amount of net income returned as a percentage of shareholders equity. ROE measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. If ROE is well above the current lending rate and the Debt to Equity isn't too high (less than about 30%) it means the company is using debt to grow earning faster, which can be good. If all those factors aren't in place, debt is bad news. The financing of this debt (interest paid) may outweigh the return the company generates on the debt and become too much for the company to handle. This can lead to bankruptcy. A serious disadvantage of the ROE ratio is it does not include debt. As a result, and a consequence of the interest paid on the debt, ROE can increase as debt increases, leading the investor to a false sense of security.

Debt to Equity Ratio
This is another ratio we are acquainted with, in Section 2C of the SSG. It's a measure of a company's financial leverage calculated by dividing total liabilities by stockholders' equity. It indicates what proportion of equity and debt the company is using to finance its assets. We recognize it as being too high if over about 30%. A high debt/equity ratio generally means that a company has been aggressive in financing its growth with debt.

Long Term Debt To Capitalization Ratio
This is a variation of the traditional debt-to-equity ratio described above. Instead of comparing debt to Shareholder Equity however it compares debt to Capitalization. The Capitalization figure is the total dollar value management has available to grow the company and produce earnings. Compare this ratio to other companies in the same industry—the lower the ratio the better, meaning less debt. Companies that finance a greater portion of their capital via debt are considered riskier than those with lower leverage ratios. It is calculated by dividing long-term debt by the amount of capital available. Unlike ROE, it includes debt, providing a more accurate measure of how well management is utilizing the total worth of the company to grow.

Return On Capital – ROC (Sometimes called Return on Investments (ROI)
Total capital includes long-term debt, and common and preferred **shares**. Invested capital can be in buildings, projects, machinery, other companies etc. One downside of Return On Capital is that it tells nothing about where the return is being generated. For example, it does not specify whether it is from continuing operations or from a one-time event, such as a gain from foreign currency transactions. Therefore observe it over a period of time so any one-time events can be recognized. It includes debt, making it, arguably, a more true indication of growth than ROE, which, again, does not include debt.

How to use them:
Observe any of these ratios over a longer period of time to get the best read on the company. Each should track the others and not show wild swings up or down.

Now that we know what they are, how can we use them? Use the first two, Return on Equity (ROE) and Debt to Equity, to compare your company to the industry averages. The ratios for your company are found in Section 2B and 2C of the SSG. To find industry averages go to: www.iclub.com/investing/stock_watch_list_industry.asp
Scroll down to find the industry for the company you're studying and compare the ROE and Debt to Equity results. Is your company doing better than the industry average? If not, maybe you should find another company, or at least find out why it's underperforming the industry.

ROC and ROE ratios can be found in a spreadsheet tool at: www.bob-adams.net/annual report.aspx , or you can calculate them. The formulas are below. To see the information on the website you'll need Excel on your computer. Download the file, save it to your computer, open it in Excel and type in the ticker symbol. Graph 6 shows five years and five quarters as a comparison of all three data. (Click the tab G-6 at the bottom of the page) The relationship between each ratio is what is important. Verbiage under each graph explains what to look for and how to analyze the relationships. Oh, there's another ratio shown on the graph—Return On Assets (ROA). It's very similar to ROC and shows how profitable a company is in relative to its total assets (including debt)—another measurement of the efficiency of management in turning assets into earnings.

ROE and Debt to Equity is shown in Section 2 of the SSG. The other ratios are not. The formulas for determining those are shown below.

Long Term Debt to Capitalization =

$$\frac{\textbf{Long Term Debt}}{\textbf{Long Term Debt + Preferred Stock + Common Stock}}$$

Return on Capital (ROC) =

$$\frac{\textbf{Net Income – Dividends}}{\textbf{Total Capital}}$$

Return on Assets (ROA) =

$$\frac{\textbf{Net Income}}{\textbf{Total Assets}}$$

These ratios should only be compared to companies within the same industry—peer companies. A comparison to companies outside the industry isn't meaningful. Comparing Return on Equity (ROE) to the interest rate at which companies can borrow is always helpful. For example, if ROE is 15% and a company can borrow at 6%, that's a good return on the borrowed funds. Even then, too much debt can be harmful. If the economy drops or there is a problem with a product, the debt can become a serious burden.

Bob Adams
Director, InvestEd Inc.