

## EXPERTS' QUOTE

"Design a portfolio you are not likely to trade... akin to premarital counseling advice; try to build a portfolio that you can live with for a long, long time."

– Robert D. Arnott,  
President, First Quadrant Corp.

## NSE at a glance (For week ended November 3rd)

Index:	36,325.86	-13.27%
Cap:	N7.97trn	-13.37%
Volume:	1.09 billion	+10.43%
Value:	N7.19bn	-14.8%



# Analysing Offer Prospectus for effective investing

... Continued from last week

Last week we began to look at analysis of financial information provided by the Issuers in the Public Offer Prospectus. We also began to talk about financial indices or ratios that investors need to know and how to calculate them to determine the viability or otherwise of an investment option. This week, we continue with more financial ratios.

### Asset Turnover

The amount of sales generated for every naira's worth of assets. It is calculated by dividing sales value by assets value.

$$\text{Asset Turnover} = \frac{\text{Revenue}}{\text{Assets}}$$

Asset turnover measures a firm's efficiency at using its assets in generating sales or revenue - the higher the number the better.

### iii. Fixed Asset Turnover Ratio

Fixed Assets include property, plant and equipment (PP&E), furniture and fittings, motor vehicles, computers etc. These represent another of the "big" numbers in a company's balance sheet. In fact, it often represents the single largest component of a company's total assets. Readers should note that the term fixed assets is the financial professional's shorthand for PP&E, although investment literature sometimes refers to a company's total non-current assets as its fixed assets.

A company's investment in fixed assets is dependent, to a large degree, on its line of business. Some businesses are more capital intensive than others. Natural resource and large capital equipment producers require a large amount of fixed-asset investment. Service companies and computer software producers need a relatively small amount of fixed assets. Mainstream manufacturers generally have around 30-40% of their assets in PP&E. Accordingly, fixed asset turnover ratios will vary among different industries.

The fixed asset turnover ratio is calculated as:

$$\text{Fixed Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Fixed Assets}}$$

Average fixed assets can be calculated by dividing the year-end PP&E of two fiscal periods by two (e.g. 2004 and 2005 PP&E divided by 2).

This fixed asset turnover ratio indicator, looked at over time and compared to that of competitors, gives the investor an idea of how effectively a company's management is using this large and important asset. It is a rough measure of the productivity of a company's fixed assets with respect to generating sales. The higher the number of times FA turns over, the better. Obviously, investors should look for consistency or increasing fixed asset turnover rates as positive balance sheet investment qualities.

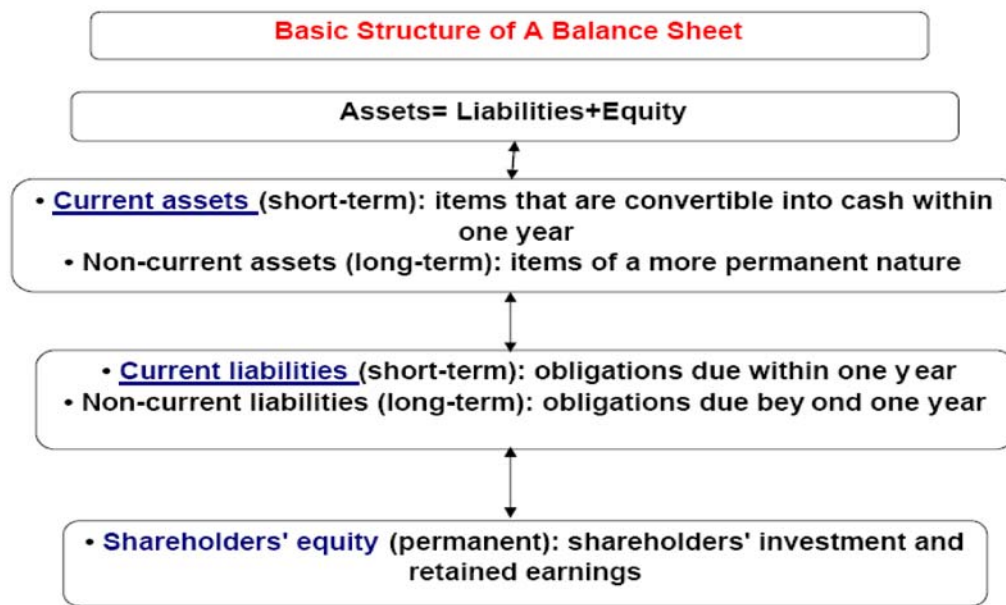
### iv. The Return on Assets Ratio

Return on assets (ROA) is considered a profitability ratio - it shows how much a company is earning on its total assets. Nevertheless, it is worthwhile to view the ROA ratio as an indicator of asset performance. The ROA ratio (percentage) is calculated as:

$$\text{ROA} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

Average total assets can be calculated by dividing the year-end total assets of two fiscal periods by two.

The ROA ratio is expressed as a percentage return by comparing net income, the bottom line of the statement of income, to average total assets. A high percentage return implies well-managed assets. Here again, the ROA ratio is best employed



as a comparative analysis of a company's own historical performance and with companies in a similar line of business.

### v. Return on Equity – (ROE)

This is a measure of a corporation's profitability that reveals how much profit a company generates with the money shareholders have invested.

Calculated as:

$$\text{ROE} = \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

of equity and debt the company is using to finance its assets.

$$\text{Debt/Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$$

Note that sometimes only interest-bearing, long-term debt is used instead of total liabilities in the calculation.

A high debt/equity ratio generally means that a company has been aggressive in financing its growth with debt. This can result in volatile

earnings as a result of the additional interest expense.

If a lot of debt is used to finance increased operations (high debt to equity), the company could potentially generate more earnings than it would have without this outside financing. If this were to increase earnings by a greater amount than the debt cost (interest), then the shareholders benefit as more earnings are being spread among the same amount of shareholders. However, the cost of this debt financing may outweigh the return that the company generates on the debt through investment and business activities and become too much for the company to handle. This can in the long-run lead to insolvency, which would leave shareholders with nothing.

### viii. Interest Coverage Ratio

A ratio used to determine how easily a company could pay interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's profit before interest and taxes (PBIT) of one period by the company's interest expenses of the same period:

$$\text{Interest Coverage} = \frac{\text{PBIT}}{\text{Interest Expenses}}$$

The lower the ratio, the more the company is burdened by debt expense. When a company's interest coverage ratio is 1.5 or lower, its ability to meet interest expenses may be questionable. An interest coverage ratio below 1:0 indicates the company is not generating sufficient revenues to satisfy interest expenses.

... To be continued next week

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**Investors should be wary of companies with high proportion of 'other assets' in their balance sheet. Any asset worthwhile in a company's possession should be used to generate income for the company. Apart from deferred charges and intellectual property, any other item in 'other assets' in a company's balance sheet should be properly investigated to know its value to the company.**

The ROE is useful for comparing the profitability of a company to that of other firms in the same industry.

### vi. The Debt Ratio

The debt ratio compares a company's total debt to its total assets, which is used to gain a general idea as to the amount of leverage being used by a company. A low percentage means that the company is less dependent on debt, i.e., money borrowed from and/or owed to others. The lower the percentage, the less leverage a company is using and the stronger its equity position. In general, the higher the ratio, the more risk that company is considered to have taken on.

### vii. Debt to Equity Ratio

This is a measure of a company's financial leverage calculated by dividing its total liabilities by stockholders' equity. It indicates what proportion

## INVESTORS' EDUCATION

### Stock Investing: Dealing with Capital Losses

Many investors have a hard time dealing with falling stock prices but for the wrong reasons. No matter how often you preach the virtues of the buy-and-hold method, the true test of courage comes when you watch your holdings nose dive twenty percent in one afternoon. Anyone who has been through a bear market knows that it takes tremendous discipline and dedication to stick to your guns while everyone else liquidates their holdings. Plagued by images of depression, recession, and corporate layoffs, manic Wall Street becomes a breeding ground for chaos and faulty logic. Perfectly good companies begin selling for fractions of their true value, despite a lack of change in the long-term economics of the business.

#### Own a business, not a stock

What you hold in your portfolio should be a piece of a business, not just a stock. Investors who purchase shares of stock simply because they are going "up" or are going to be the "next big thing" are essentially gamblers. They buy a commodity with the belief (rational or not) that the next person in line will pay a higher price for it than they did. The problem is, this cycle cannot go on forever, and at some point, someone is going to look around, realize what happened, and bail ship.

#### Be a long-term investor, not a gambler

The only time a bear market is bad for you is when you need your money immediately. For those who are investing with a time frame of ten or more years, declining prices represent only one thing: the opportunity to

buy more of their favorite company at a lower price. It's kind of like a giant garage sale where the lady of the house decides she wants new drapes and, as a result, decides to sell all of her living room furniture for half price. It doesn't have to make sense to the buyer. Indeed, a smart one would jump at the opportunity. All too often, investors try to convince the woman that she shouldn't be selling her coffee table to them for so cheap.

#### Rebalance Your Portfolio

When the markets experience an extended period of growth or decline, it can throw your portfolio out of its original investment mix, or asset allocation. For example, if you've determined that a 70% stock and 30% bond portfolio is suitable for you and the stock market has taken a bit of a dive, you might find that after just six months, your investment mix might be at 60% stocks and 40% bonds.

#### Do not Chase the Market

You have probably heard the saying "buy low and sell high" many times, and we all know that is how you make money, but the reality is that most people do just the opposite. The average investor will happily put more and more money into the market, and take on more risk when the market and economy is strong, and pull back or stop investing at all when the markets are heading south.

This is the opposite of what you want to do. If you are only saving and investing when the markets are doing well, and investing little or selling stocks when the markets are down, you are buying high and selling low, which is a very ineffective way to make money.