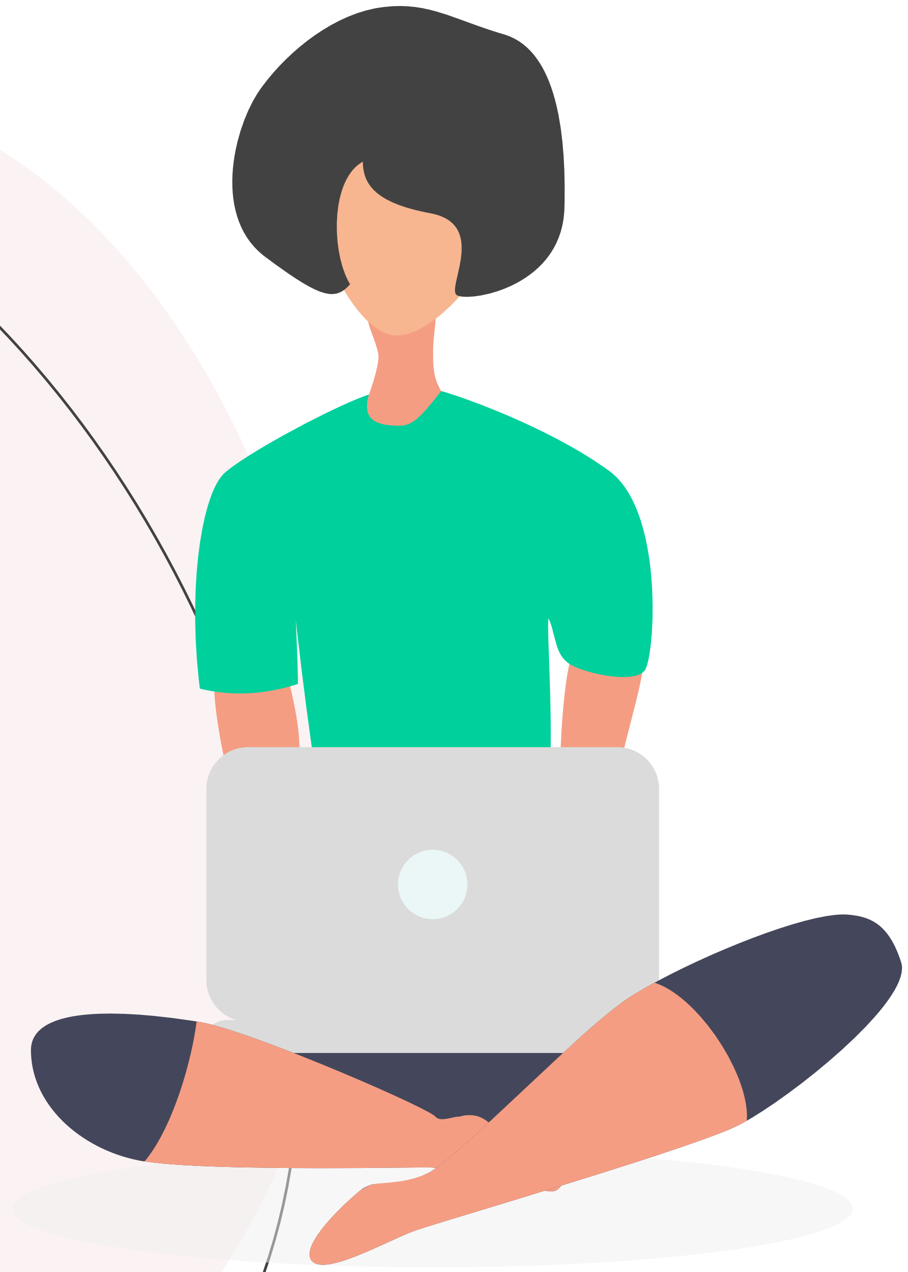
5 financial ratios every **stock investor** should know



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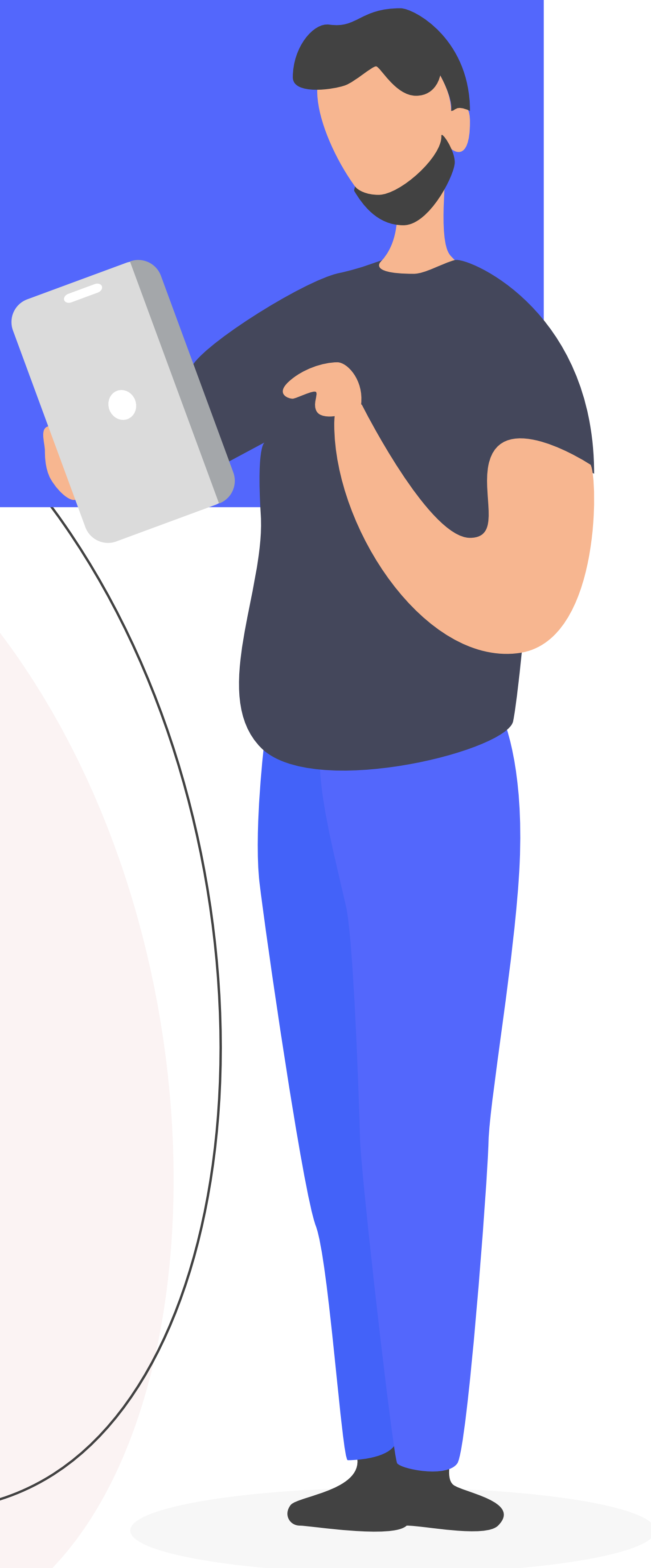
P/E ratio

P/E ratio is the price an investor pays for Re.1 of the company's earnings. It is the ratio of the current share price to the company's earnings per share. Every industry/sector has benchmarks for average P/E ratios. Since stock prices are governed by market sentiment, P/E ratios can tell investors if the stock is overpriced or underpriced with respect to its earnings.



Example:

Overall earning of a company = Rs.1000

Shares trading in the market = 100

Earning per share = Rs.10

Current share price = Rs.100/share

P/E ratio = Current share price/Earning per share
= 100/10 = 10

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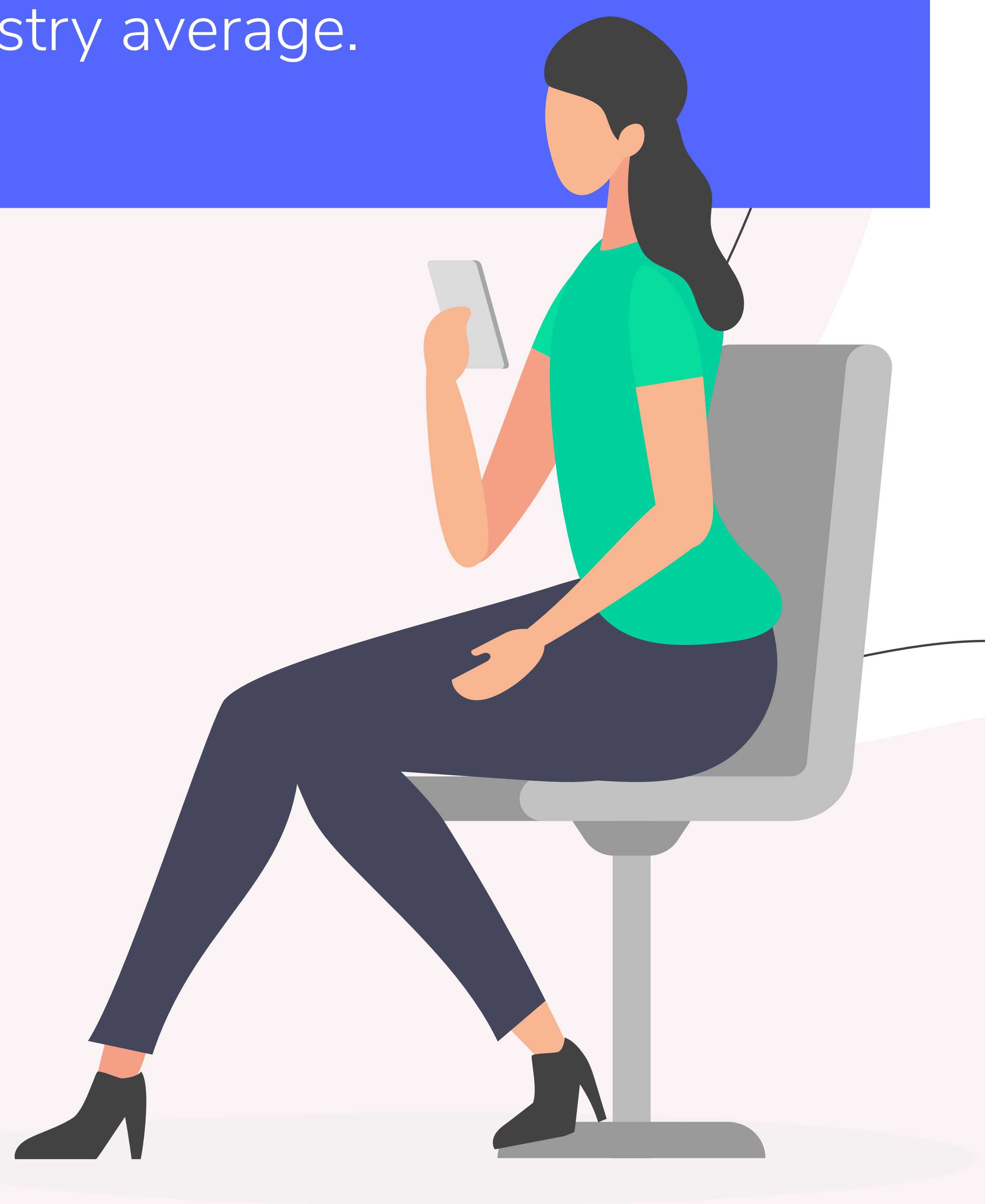
ROE ratio

Return on Equity (ROE) ratio is the measure of a company's ability to turn equity investments into profit. It is a ratio of the net income to the total shareholders' equity in the company. Every industry/sector has benchmarks for average ROE ratios.Investors can understand how efficiently the company is turning shareholders' equity into profits by comparing it with the industry average.



Example:

Total shareholders' equity = Rs.100

Income generated by the company = Rs.20

ROE ratio = Net income/Total shareholders' equity

= 20/100= 20%

P/B ratio

The Price-to-Book (P/B) ratio tells an investor if he is paying too much for what will be left if the company went bankrupt. It is a ratio of the company's current share price to book value per share. Sometimes, stock prices can skyrocket without any corresponding asset base of the company. This ratio helps identify such companies by comparing it with the industry average before making a decision.

Example:

Value of a company = Rs.1000
If the company shuts down,
Loan repayment = Rs.400
Selling of assets = Rs.200
Total book value = 1000 - 400 + 200
Total outstanding shares = 100
Book value per share = Total Book Value/Total outstanding shares = Rs.800/100 = Rs.8
Market price of a share = Rs.80

P/B ratio = Market price of a share/Book value per share
= 80/8 = 10

Dividend yield

Dividend yield is a measure of the dividend earnings an investor can make by buying a company's stock. It is a ratio of the total dividend distributed by a company to its current stock price. While higher dividend yields imply a better chance to earn more dividends, investors must compare the yield with the industry average to assess if it is worth investing in.

Example:

Annual company profit = Rs.1000
From this,
Business expansion cost = Rs.600
Distribution to shareholders = Rs.400
Number of shares in the market = 100
Dividend received by each shareholder = 400/100 = Rs.4
Current share price = Rs.20

Dividend yield = Share price/Annual dividend
= 20/4 = 5%

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D/E ratio

The Debt-to-Equity (D/E) ratio tells investors the degree to which the company is funding its operations through debt as opposed to owned funds. It is a ratio of the company's total liabilities to its total shareholders' equity. A high D/E ratio is usually associated with a company that aggressively seeks to fund its growth with debt. Investors can determine if the D/E ratio is high or not by comparing it with the industry average.

Example:

Total liabilities of the company = Rs.1000

Total shareholders' equity = Rs.800

D/E ratio = Total liabilities/Total shareholders' equity

= 1000/800 = 1.25

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