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How to value companies' shares

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Building your own portfolio of shares can be fun and profitable. Individual investors are not subject to many of the constraints that restrict professionals, such as the size of company or the liquidity of its shares. But with over 2,000 companies' shares traded on the London Stock Exchange and the Alternative Investment Market, how do you identify the right ones?

Some investors use technical analysis, others use momentum indicators, but for most stockpickers it all comes down to valuation – either finding a company whose shares trade for less than they should, or verifying that a good-quality company is being bought at a reasonable price.

Beware profits and EPS

Perhaps the most ubiquitous method of valuing companies is the price/earnings (p/e ratio), which is the most recent year's earnings per share (EPS) divided into the share price. It effectively measures how many years of post-tax profit each share "costs". Its inverse – the EPS divided by the price – is known as the earnings yield, and is sometimes preferred because it allows for easier comparisons with bonds.

P/e ratios are easy to understand, easy to calculate and can be forward looking as well as retrospective, by using an estimate for future earnings, widely available on websites such as ft.com.

But they can also be misleading, and are easily distorted or manipulated. Earnings per share are affected by tax rates, non-cash items such as depreciation, and by one-off charges or gains which may artificially inflate or depress earnings in a particular year. They are an indicator of the value the market places on profits, but take no account of the capital involved in generating them.

A variation is enterprise value to earnings before interest, taxation, depreciation and amortisation, or EV/Ebitda. This tends to be popular for those companies with high levels of depreciation or where debt plays a big role in the financial structure. Enterprise value is the market value of the equity plus net debt, so unlike EPS it includes debt as well as equity in the valuation. However, it's less readily available; an investor may often need to work out net debt, or look it up in a company's financial statements.

Allow for growth

Fast-growing companies may have volatile earnings, and their shares may look expensive relative to past profits. But they may still offer value if their profits are set to grow rapidly. The price/earnings to growth or Peg ratio attempts to capture growth rates in the valuation. The peg ratio was popularised by high-profile investors like Peter Lynch in the US and Jim Slater in the UK. It is calculated by taking the p/e ratio and dividing it by the expected rate of earnings growth over a set number of years. A value below one suggests a company may be undervalued.

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Look at dividends

Since dividends form such a large part of long-term returns, there's a case for using them as a valuation tool. They are also less subjective and more tangible than profits. Dividends are either paid or not, and they are a cash return that is not distorted by accounting conventions.

Dividend yield is the last full year's payout divided by the share price, and is easy to compare to something like the redemption yield on a bond or the rental yield on a property. Yields on ft.com are expressed on a trailing 12 months (TTM) basis, which incorporates the most recent interim and final payments even if they were made in different financial years.

However, dividend yields can be misleading. An anomalously high yield can be a sign that the market is expecting a cut in the payout rather than an indicator of a bargain stock. A dividend that looks generous now may be eroded over time if it is not progressively increased; dividend growth is just as important as yield. Finally, not all companies pay dividends, so they are of limited use in valuing small or high-growth businesses.

Look at assets

Buying something for less than it's intrinsically worth is the basis of value investing, as popularised by the likes of Benjamin Graham and Warren Buffett. This can be done either by estimating the likely returns from a company over its lifetime, or more simply, by looking at the value of assets on its balance sheet.

Book value or net asset value is the most straightforward way to work out what a company is "worth". It is the accounting value of a firm, calculated by adding up its assets and then subtracting liabilities and intangible assets such as goodwill or brand value. Effectively, it is what shareholders would own if the company were wound up and its creditors repaid.

It's particularly useful for companies with lots of physical assets, but because it doesn't include intangibles it may not work so well with companies whose value is defined more by their intellectual property – such as software, biotechnology or media companies.

Dividing book value by the number of shares in issue gives a book value per share, which can be compared to the share price. Buy a company's shares at a price-to-book ratio of less than one and you are effectively getting the assets for less than their accounting value.

Returns on investment

Anyone can boost revenues by acquiring another business, increase EPS by buying back shares, or inflate dividends by paying them from reserves rather than operating cash flow. But the most effective company managers make investment and capital allocations that consistently generate excess returns for their shareholders.

Calculating returns on investment or capital is more difficult than simply looking at dividend yields, p/e ratios or book values, but potentially more rewarding. Unlike many of the other metrics, it does not utilise the share price or market value. It measures only the effectiveness of the business.

More sophisticated stock screening tools like Sharescope or Stockopedia often include returns on investment as a metric.

Discounted cash flow

For the more mathematically adventurous, discounted cash flow (DCF) analysis is the technique used by many analysts and fund managers to ascertain the "right" price at which to buy a company's shares.

It effectively entails totalling the expected returns over a period, then discounting them back to a per-share value in today's money that can be compared to the share price.

DCF is complex to calculate and requires the investor to make a number of assumptions about costs of capital and future growth rates. Up to three quarters of its value comes from the "terminal value" – an estimate of the company's worth at the end of the period under consideration. Critics say the inputs can simply be adjusted to give the desired output.

A dividend discount model is simpler; it is the dividend per share divided by the difference between the chosen discount rate and the rate of growth in the dividend.

investopedia.com/university/dcf/