

*How to analyze company earnings reports to generate profits for your investment portfolio.*

Debbie Snelling



"You get out of an investment what you put into it, so the first decision you have to make is how much time you are prepared to devote to the initial task of acquiring a basic knowledge of investment."

– James D. Slater

# Definitions

- Earnings Report
  - Report showing the financial results (earnings) of a company
  - Issued quarterly (10-Q)
  - Annual Report is issued at fiscal year end (10-K)
- Fiscal Year End
  - Year end of a company, normally 12 months
  - Most companies have a calendar year fiscal year
  - Wal-Mart has a January fiscal year
- Earnings
  - How much a company made or lost during a given period of time (quarterly or annually)
  - Revenue less Expenses

# Definitions

- Share = Stock
  - Ownership in a company represented as shares
  - Shares Authorized: the number of shares that can be issued (sold)
  - Shares Issued: the number of shares sold
  - Shares Outstanding: the number of shares sold and not repurchased by the Company
  - Treasury Stock: stock that has been bought back by the Company and is held “in Treasury”
    - usually done to increase Earnings Per Share
    - another way to increase EPS is with stock splits
- Gross Margin = Revenue less Cost of Goods Sold
- Cost of Goods Sold = costs directly associated with revenue generation, e.g. product and direct labor

# Earnings per Share (EPS)

Earnings

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Shares Outstanding

Allows you to compare companies of different sizes

# Definitions

- Market Capitalization
  - The market value of a company
  - Share price x number of shares outstanding
- Dividend
  - A distribution of the company's earnings to its shareholders
  - Indicated as dividend per share
  - Decided upon by the Board of Directors
  - Usually paid quarterly
- Assets
- Liabilities
- Equity (Book Value) = Assets - Liabilities

# Components of Earnings Report

- Financial Highlights
- Management estimates and expectations
- Financial Statements
  - Income statement
  - Balance Sheet
  - Statement of Cash Flows
- Financial information to note
  - Sales = Revenue
  - EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization
  - Extraordinary Item = an non-recurring, unusual, item
  - Earnings per Share
  - Auditor Opinion

# Components of Annual Report

- Financial Highlights
- MD&A – Management Discussion & Analysis
- Comparative Financial Statements
  - Income Statement (5 years)
  - Balance Sheet
  - Statement of Cash Flows
- Risk Analysis of the Company
- Auditor Opinion

# Estimates

- Analysts review the company and make estimates about the expected future earnings of the company.
- This is published as the earnings estimates.
- The public then has an idea of what to expect. You should do your own analysis as well.
- Companies that do well are rewarded (stock price goes up) and those that do not do well are punished (stock price goes down).

# Management Discussion & Analysis

## MD&A

- The only thing that can be more important than earnings numbers is management comments about the future.
- Earnings are strange. You might get a company who beats their earnings estimate and the stock falls. You might see the exact opposite where a company misses estimates but the stock rallies. What causes this? Management comments about the future.

# What to Look For

- Trends
  - Earnings
    - P/E ratios vs. expected growth rates
    - Growth (trending upward)
      - For “buy and hold”, look for stable upward earnings trends
      - For more active investors, look for faster growth
    - Declining earnings or unexplained losses
      - Not tolerated well on the market
  - Share price
  - Market share increase/decrease
  - Industry & competitor activity and results
- Expectations
  - MD&A
  - Analyst estimates
- Liquidity (things readily convertible into cash)
  - Cash
  - Inventory
  - Accounts receivable

# What to Look For

- Same store sales
- Geographic footprint
  - Where are stores, restaurants, widgets?
  - Can the company use economies of scale to acquire and deliver product?
  - Is the company exposed in the event of disaster?
- Debt
  - Debt to Equity Ratio (debt / equity)
    - Is debt high compared to competitors?
    - Has a recent acquisition made an otherwise favorable company unfavorable?
- Consistent and effective management
- Other financial ratios
  - Return on Investment (ROI)
  - Return on Assets (ROA)
- The things you can look at and analyze are endless.

# Volatility

- The more volatile the markets, the better it is for your option trades. The market over the last few months has been extremely volatile, which makes this earnings season all the more lucrative.
- Why do we like volatility?
  - It causes big moves in stocks.
  - When you buy an option, you want the biggest move possible, in the shortest amount of time.
  - These big moves help amplify your profits.
- If GE makes an important announcement, the stock might move (up or down) \$3, \$4 or even \$5. If Google makes an important announcement the stock might move up or down \$30 or \$40 or \$50!
- If you're trading in options, secret number one is look for stocks with volatility.

# P/E Ratio

Price-Earnings Ratio

Market value per share (share price)

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Earnings per share (EPS)

# P/E Ratio

- A company trading at \$51.79/share with EPS of \$3.40 has a P/E ratio of 15.23
  - Price / Earnings =  $\$51.79 / \$3.40 = 15.23$
- EPS is usually from the last four quarters (trailing twelve months = ttm)
- It can be taken from the estimates of earnings expected in the next four quarters (projected or forward P/E)
- A third variation uses the sum of the last two actual quarters and the estimates of the next two quarters.

# But it doesn't mean anything!

- In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E.
- No ratio tells the whole story by itself.
- It's usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E.
- It would not be useful for investors using the P/E ratio as a basis for their investment to compare the P/E of a technology company (high P/E) to a utility company (low P/E) as each industry has much different growth prospects.

# PEG ratio

- Projected Earnings Growth
  - The market wants a way to look at the future

$$P/E = \text{share price} / \text{EPS}$$

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Projected Growth in Earnings

The higher the PEG, the greater the outlook for the future.

# P/S = Price to Sales

We still have the problem of needing some measure of young companies with no earnings, yet worthy of consideration. After all, Microsoft had no earnings at one point in its corporate life.

Market Cap

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Revenues

Much like P/E, the P/S number reflects the value placed on sales by the market. The lower the P/S, the better the value.

However, this is definitely not a number you want to use in isolation. When dealing with a young company, there are many questions to answer and the P/S supplies just one answer.

# WAL MART STORES

## (NYSE: WMT)

- After Hours: 51.73 down 0.06 (0.12%) 7:37PM ET
- Last Trade: **51.79**
- Trade Time: Aug 14
- Change: 0.09 (0.17%)
- Prev Close: 51.88
- Open: 51.87
- Bid: N/A
- Ask: N/A
- 1y Target Est: 60.05
- Day's Range: 51.54 - 52.25
- 52wk Range: 46.25 - 63.85
- Volume: 17,238,882
- Avg Vol (3m): 17,764,600
- Market Cap: 201.81B
- P/E (ttm): 15.23
- EPS (ttm): 3.40
- Div & Yield: 1.09 (2.10%)
- Information from Yahoo! Finance

# ROE

- Return on Equity = Net Income / Book Value (Equity)
  - ROE is a useful tool in identifying companies with a competitive advantage. All other things roughly equal, the company that makes more profits with their assets, will be a better investment in the long run.
  - Raising capital by issuing stock will increase book value, while raising capital by borrowing will reduce book value.
    - A lower book value means you're dividing by a smaller number so the ROE is artificially higher.
    - There are other situations such as taking write-downs, stock buy backs, or any other accounting slight of hand that reduces book value, which will produce a higher ROE without improving profits.

# WalMart Competitors

## Competitors

### DIRECT COMPETITOR COMPARISON

	WMT	Pvt1	COST	TGT	Industry	
Market Cap:	201.81B	N/A	21.15B	31.62B	1.95B	
Employ-ees:	2,100,000	490,0002	75,000	351,000	13.60K	
Qtrly Rev Growth (yoy):	-0.70%	N/A	-4.90%	0.20%	6.90%	
Revenue (ttm):	404.91B	124.35B1	72.14B	64.98B	4.79B	
Gross Margin (ttm):	24.63%	N/A	12.51%	28.40%	32.16%	
EBITDA (ttm):		29.86B	N/A	2.53B	6.13B	341.33M
Oper Margins (ttm):	5.69%	N/A	2.53%	6.57%	4.63%	
Net Income (ttm):	13.26B	2.17B1	1.11B	2.13B	N/A	
EPS (ttm):	3.400	N/A	2.519	2.810	2.02	
P/E (ttm):	15.23	N/A	19.31	14.96	15.26	
PEG (5 yr expected):	1.23	N/A	1.71	1.11	1.23	
P/S (ttm):	0.50	N/A	0.29	0.49	0.42	

Pvt1 = Carrefour SA

COST = Costco Wholesale Corporation

TGT = Target Corp.

Industry = Discount, Variety Stores

1 = As of 2008 2 = As of 2007

# Return on Investment (ROI)

Gain from Investment

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Cost of Investment

- Very popular metric because of its versatility and simplicity.
- Positive ROI = likely to be a good investment (and vice versa)
- This flexibility has a downside: ROI calculations can be easily manipulated to suit the user's purposes, and the result can be expressed in many different ways.
- When using this metric, make sure you understand what inputs are being used.
- What is included in Return and what is included in Investment?

## Walmart Does More With Less

By Ryan C. Fuhrmann

Retail behemoth Walmart (NYSE:WMT) demonstrated in its second quarter earnings release that it doesn't need sales growth to keep profit expansion chugging along. Anemic top-line trends will cost it over the longer term, but it has a number of levers to pull to keep shareholders happy.

### Quarterly Review

Reported sales fell 1.4% to \$100.1 billion as U.S. sales grew a minimal 0.3% (64% of total sales), international sales fell 5.1% (24%), and Sam's Club sales fell 3.2% (12%). Excluding foreign exchange fluctuations, sales rose 2.7% as international sales were hit to the tune of \$4.2 billion from a strong U.S. dollar. Walmart provides same store sales for its U.S. and Sam's Club segments. Comps fell 1.5% in the U.S and grew 0.6% at Sam's Club, and overall comps fell 1.2% in the U.S., excluding fuel sales.

Management detailed that sales came in lower than expected, but comparable sales outperformed the retail sector average. Archrival Target (NYSE:TGT) continues to struggle and posted another month of negative high single digit comps in July while Sears Holdings (Nasdaq:SHLD) reported negative double-digit comps at its namesake store base. Walmart no longer reports comps on a monthly basis.

Sam's Club continued to struggle somewhat on the profit front as operating income fell 5% to \$419 million, but management boasted that Sam's had strong inventory control and "had a strong showing compared to its competitors in the warehouse club sector." This includes Costco (Nasdaq:COST), which just reported another month of struggling sales as July comps fell 7%. BJ's Wholesale Club (NYSE:BJ) will report its second quarter results on August 19.

Walmart remained focused on expense controls as U.S. operating income advanced 5% to just under \$5 billion. International profits were also dented from currency fluctuations, falling 6.2% to \$1.1 billion. The end result was earnings of 88 cents per diluted share, which was up a penny from last year's quarter and came in at the high end of Walmart's earnings guidance range. Walmart also boosted forward guidance and expects full-year earnings from continuing operations to fall between \$3.50 and \$3.60 per share.

### Bottom Line

Shares of Walmart jumped back over \$50 on the solid earnings report and now trade at close to 15 times forward earnings. Consumers may trade back up to Target and rivals considered to be more fashionable and less cost focused, which may dent overall sales in the U.S. But international prospects remain bright and will get a boost if the dollar's ascent against other currencies stalls out. On balance, I wouldn't expect major expansion to continue, but earnings growth should continue in the high single digits for the foreseeable future.

# Tax Implications

- Remember that all stock transactions have tax implications.
- Stock trades are subject to capital gains tax.
  - Beneficial because capital gain rates are lower than rates on ordinary income.
  - Losses may only be restrictively used if they exceed gains.

Debbie Snelling

404-944-3172

[thesnellingreport@bellsouth.net](mailto:thesnellingreport@bellsouth.net)