

Edexcel

A Level

Accounts

CODE: (4AC1)

Unit 02 - Section 02

Investment ratios



Chapter 04 – Investment ratios

INTRODUCTION

Before studying investment ratios, it is highly recommended that you return to the ratios studied at International Advanced Subsidiary, as an understanding of these ratios is required at International Advanced Level. These ratios covered profitability, liquidity and use of assets.

returns an investor requires can take two forms:

- 1 a return from the investment in the form of dividend payments
- 2 capital growth from the increase in the value of the shares.

Ratios give you a quick insight into the financial health of a business, and they allow for comparisons over time and between companies. However, it must be remembered that ratios are based on historical data and therefore do not inform investors about the future performance of a company.

PROFITABILITY RATIOS

These ratios measure performance and examine the extent of the profit in relation to the size of the business and the amount of capital invested. They allow an investor to evaluate the effectiveness of management in how it uses the many resources at its disposal. Profitability ratios you have already studied are:

- Gross profit as a percentage of revenue
- Net profit for the year as a percentage of revenue
- Return on capital employed (ROCE).

These are ratios you should already be familiar with. However, the formula for return on capital employed is slightly different for companies. The formula used is the same but the capital employed calculation is different to reflect the different capital structure of companies.

Return on capital employed % =

$$\frac{\text{net profit before interest}}{\text{capital employed}} \times 100$$

where capital employed = issued shares + reserves
+ non-current liabilities.

CAPITAL GEARING

Although the capital gearing of a company is not technically an investment ratio, it is an important consideration in investment decisions. Capital gearing was covered in Chapter 2, so it would be appropriate now to review this. The formula for gearing is:

$$\text{Gearing \%} = \frac{\text{fixed cost capital}}{\text{total capital employed}} \times 100$$

Investment ratios

Usually, the value of an investment depends on future returns and not those made in the past. However, this does not mean that these ratios cannot be used where only past information is available. If nothing else, at least the trend of a business can be established and an investment decision can be made based on that trend.

Earnings per (ordinary) share (EPS)

$$\text{Earnings per share} = \frac{\text{net profit for the year after tax} - \text{preference share dividend}}{\text{number of issued ordinary shares}}$$

This ratio is expressed as **pence per share (£0.xx/share)**.

What does it show?

Earnings per share (EPS) is a measure of the profit (earnings) produced by each ordinary share the company has issued. There are two important things to consider when calculating this ratio. The first is to use only the issued ordinary shares; these issued shares are those that have been sold by the company to ordinary shareholders and are therefore eligible for a dividend. You should not use the authorised share capital (explained in Chapter 2).

EPS is useful when investors use the price-earnings ratio and dividend **per share as well**.

Price-earnings ratio (PE ratio)

$$\text{Price-earnings ratio} = \frac{\text{market price per share}}{\text{earnings per share}}$$

This ratio is expressed as a **multiple (x times)**.

What does it show?

The price-earnings ratio helps investors see whether the shares are overpriced or inexpensive. It shows how many years of current earnings an investor is willing to pay for a share. A high PE ratio, relative to other companies, indicates that future growth is expected, for which investors would pay a higher multiple. If it is low, then growth prospects are considered poor by investors.

Dividend per share (DPS)

$$\text{Dividend per share} = \frac{\text{total ordinary share dividend paid}}{\text{number of issued ordinary shares}}$$

This ratio is expressed as **pence per share (£0.xx/share)**.

What does it show?

This ratio calculates the amount of profit that has been distributed to ordinary shareholders for each issued share. Therefore, it is a measure of the profits distributed by the company to its owners, the ordinary shareholders.

A high dividend per share will indicate a good return for the shareholder. A higher dividend per share might make one company appear a better investment than another. Increasing dividends per share over time should keep investors happy, as they will see an increase in the actual returns of profit to them.

Make sure you use the number of ordinary shares issued and the ordinary dividend paid.

Dividend yield

$$\text{Dividend yield} = \frac{\text{dividend paid per share}}{\text{market price of share}} \times 100$$

This ratio is expressed as a **percentage (x%)**.

What does it show?

This ratio is important if an investor is seeking an income from share ownership rather than capital growth (an increase in the value of the share). It is a measure of the real return on the investment, as it uses the market price of the share that the potential investor would need to pay for the share.

Generally, this ratio is an indicator of dividend policy and not performance. All too often a company will pay out only a proportion of its profits. Dividend yield reflects this approach. The yield on ordinary shares gives the shareholders a method of comparing what their dividend really represents based on the market value of the shares.

Dividend cover

Dividend cover = $\frac{\text{profit for the year after tax} - \text{preference share dividend}}{\text{total ordinary dividend paid}}$

This ratio is expressed as a **multiple (x times)**.

What does it show?

Dividend cover measures the number of times a company could have paid the dividend from its profits. A high dividend cover may attract investors but may increase the risk of future dividend cuts. It doesn't consider a company's ability to pay a dividend in cash, as a shortage of cash may limit the dividend paid and the dividend cover.

SUBJECT VOCABULARY

dividend cover the number of times a company could pay the ordinary share dividend from profit after paying the preference share dividend

dividend per share the amount of money a shareholder will receive for each share owned

dividend yield the dividend per share expressed as a percentage of the current market value of the share

earnings per share a measure of the profit (earnings) produced by each ordinary share that the company has issued

gearing ratio measures the relationship between the long-term borrowing of a company and the equity

price-earnings ratio a comparison between the earnings per share and the current price of the share

return on capital employed the percentage return on the capital invested in the business