

Twitter Thread by Screening Stocks Enjoy 'My StressBusters'



Screening Stocks Enjoy 'My StressBusters'

@Coolfundoo



Q&A 161

Read this ■to understand ROE, PE & relationship between them.■

PE expansion to bridge the Gap (if any) between ROE & PE.

RT if you find this helpful.

1

Hi cool,onsaw one post of ur on asans page.
I jave a query can you pls help about
identifying.

Aug 3, 2021, 3:34 AM

You accepted the request

Unless I know what it is I really don't know..

Aug 30, 2021, 12:58 PM ✓

I want to get added to your zoom sessions.
And about asan...the query was on ration
betn roe and pe..he keeps saying if pe is less
and roe high...pe will try to expand and meet
roe.

Aug 30, 2021, 2:08 PM

ROE is PE's brother from another mother / Half-brother (Sautela Bhai)

@Atulsingh_asan

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Well, if you asked Atul ji, I am sure he must have some ASAN style explanation. As far as I know him, he is a value investor & look for opportunity maximizing ROE while minimizing PE.

Let's try to understand the relationship between ROE & PE!

ROE is PE's brother from another mother (means Half-brother OR Sautela Bhai in Hindi).

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

or $\text{ROE} = \text{Net Income} / (\text{Total Equity} - \text{Non-controlling Interest})$

Now we know, Book value = Total Equity – Non-controlling Interest

So, $\text{ROE} = \text{Net Income} / \text{Book Value}$
... (1)

Yesterday, 5:04 PM ✓

ROE & PE definition continued..

Keep an eye on Equations !

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Net income is Profit (available to shareholders) and Equity is capital provided by shareholders. So, ROE is pure profitability metric which most equity investors care about.

Eq (1) means -> ROE has Book Value in denominator which shows Profits relative to internal Equity.

PE is valuation matrix which determines if company's stock price is undervalued or overvalued.

$PE = \text{Share Price} / \text{EPS}$ where, $EPS = \text{Net Income} / \text{Shares Outstanding}$

or $PE = \text{Share Price} / \text{Net Income} / \text{Shares Outstanding}$

or $PE = (\text{Share Price} * \text{Shares Outstanding}) / \text{Net Income}$

or $PE = \text{Market Capitalization} / \text{Net Income}$
... (2)

Establishing Relationship between ROE (profitability) & PE (valuation).

Replace Market Capitalization with Book value in Earnings Yield (or PE) we get ROE.

Now if we flip PE, it becomes Earnings Yield.

So $EY = 1/PE$

or $EY = 1/Market\ Capitalization/Net\ Income$ ---
- derived using (2)

or $EY = Net\ Income / Market\ Capitalization$
... (3)

In Eq (3) Earnings Yield (reciprocal of PE) has Market Capitalization (Market value of Equity) in denominator this shows how much Profit business makes as per the value assigned by market (A valuation concept). So more the Earnings Yield (or lesser the PE) better value it is.

Now, if we just have a look at ROE Eq (1), PE Eq (2) & EY Eq (3) together the relationship between ROE & PE (EY) is clear. If we just replace Market Capitalization with Book value in Earnings Yield (or PE) we get ROE.

Yesterday, 5:09 PM ✓

Understanding ROE & PE deeper with Dupont Analysis.

To understand ROE & PE relationship deeper we need to do DuPont Analysis of ROE and relate how each factor is closely linked to PE.

As per DuPont analysis, ROE is calculated by multiplying 3 factors NPM, Asset Turnover & Financial Leverage/Equity Multiplier.

$$\text{ROE} = \text{NPM} * \text{Asset Turnover} * \text{Financial Leverage}$$

$$\text{NPM} = \text{Net Income} / \text{Sales}$$

$$\text{Asset Turnover} = \text{Sales} / \text{Avg Total Assets}$$

$$\text{Financial Leverage} = \text{Avg Total Assets} / \text{Shareholder's Equity}$$

DuPont analysis can help identify whether its Profitability, Use of Assets, or Debt that's driving ROE or a combination of them.

$$\text{ROE} = \text{NPM} * \text{Asset Turnover} * \text{Financial Leverage}.$$

Impact of NPM of ROE & relationship with PE.

Dupont analysis can help identify whether its Profitability, Use of Assets, or Debt that's driving ROE or a combination of them.

Now let's take each of the 3 factors one by one & see it's impact on ROE & PE.

Yesterday, 5:13 PM ✓

Profitability (NPM) can be improved by either increasing Prices of Goods sold or Decreasing the Costs. So, if Company management makes a change in guidance for future margins & costs (lets says better margins or lower costs), the Stock Prices will experience a high volatility. Stock Price is Numerator in PE; hence it will tend to increase the PE in this case.

Yesterday, 5:15 PM ✓

Impact of Asset Turnover & Financial Leverage (or Debt) on ROE & relationship with PE.

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Asset Turnover determines how efficiently company is using its assets to generate sales. Sales is in Numerator & Avg Total Assets in denominator which includes components like Inventory. So, it can signal slowing or speeding sales before other metrices. If asset turnover rises, its ROE will improve. Shareholder's will be willing to pay higher Price for Speeding sales & hence it tends to increase PE

Yesterday, 5:17 PM ✓

Financial Leverage is company's use of debt to finance its assets. If Debt rises too much, then it may be solvency risk. If debt isn't used, it may be disadvantage as company may lose market share to peers. Hence, Debt is trade-off & needs to be used appropriately. If company can increase Earnings/Profits by adding debt without any solvency risk, the EPS will rise which brings PE down & hence good chance of PE re-rating.

Impact of ->

- 1) Rising or Falling ROE on PE.
- 2) High Dividend Payout on ROE & growth.
- 3) High Retention Ratio (Retained Earnings).

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If ROE is showing an upward trend, the market will be willing to reward the company with higher P/E ratios. But if ROE is falling, then market will punish the stock with lower P/E Ratios.

Yesterday, 5:19 PM ✓

If a company doesn't have much re-investment opportunities, it pays out huge Dividend. So, market starts losing interest in such companies & PE comes down. But if companies plough back most of the earnings back into business for future investment, it ensures high ROE. They have High retention ratio (Retained Earnings) Market reward such companies with high PE. A combination of high ROE and high retention is a classic recipe for higher PE ratio.

Gap between ROE & PE. PE attempt to bridge the gap.

You may find the gap ->

- When Market in Stress (like March to June 2020)
- In Smaller Market Cap companies.

@Vivek_Investor

<https://t.co/qDshtA6IMJ>

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If we screen for companies with consistently high ROE (or rising ROE) and low PE particularly when market is in stress (or may be in smaller market cap companies where PE is usually way lower than larger peers) we may get interesting bargains. This explains the gap between ROE & PE and market's attempt to bridge that gap and in the process increasing the Stock price.

Yesterday, 5:21 PM ✓

If you want to screen such stocks you can look at this Q&A ->

Q&A 144

Q-> How to #screen undervalued stocks in terms of ROE & PE at @screener_in where ROE is 50% higher than PE ?

Me->

Return on Equity > 1.5 * Price to Earning

Retweet for larger audience ! pic.twitter.com/FwVeJiUtWr

— Screening Stocks Enjoy 'My StressBusters' (@Coolfundoo) July 2, 2021