Twitter Thread by Screening Stocks Enjoy 'My StressBusters'

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@Coolfundoo

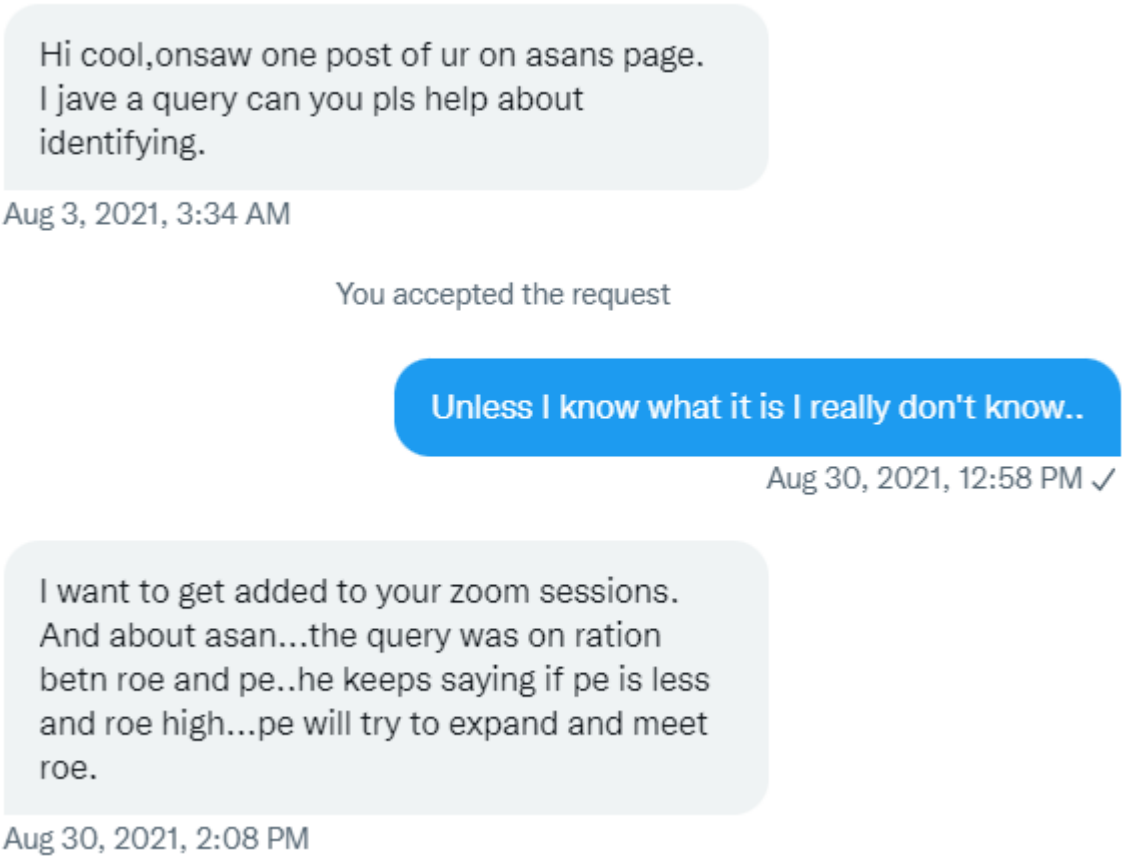
Q&A 161

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.

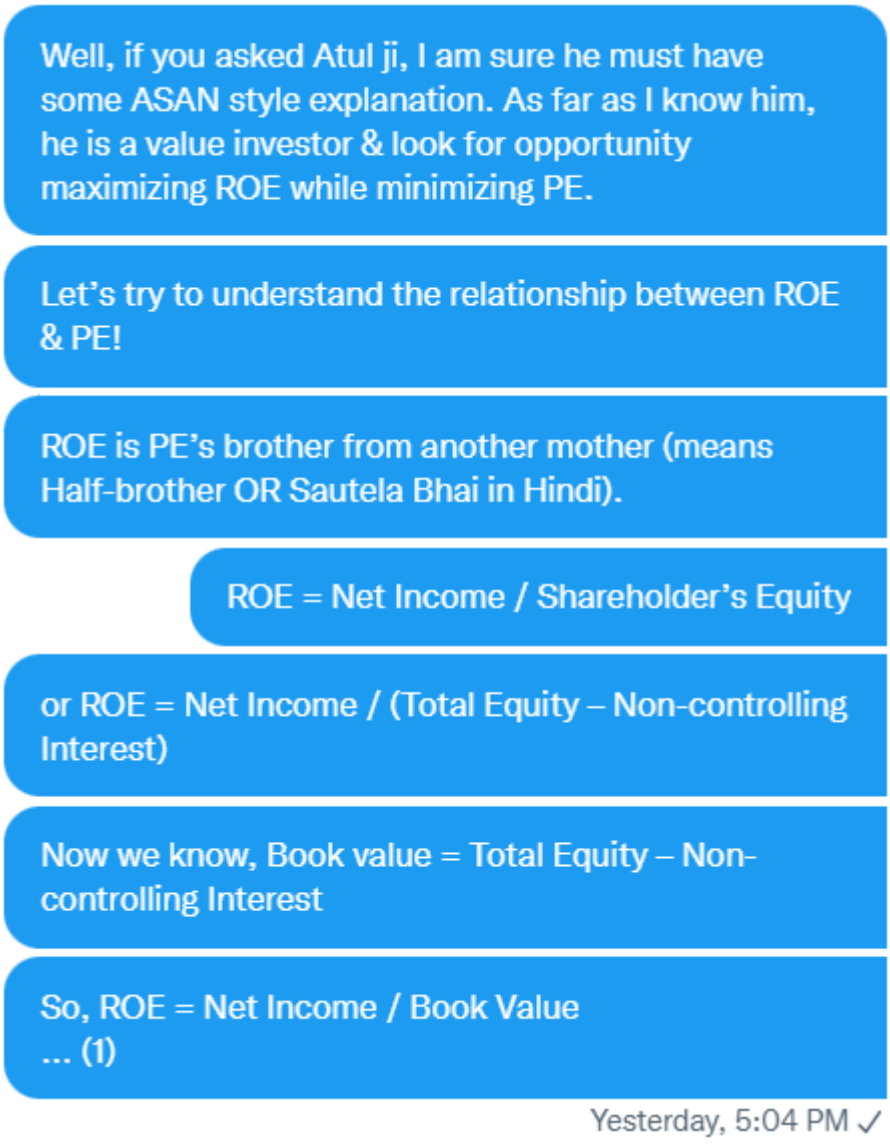
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ROE is PE's brother from another mother / Half-brother (Sautela Bhai)

@Atulsingh_asan

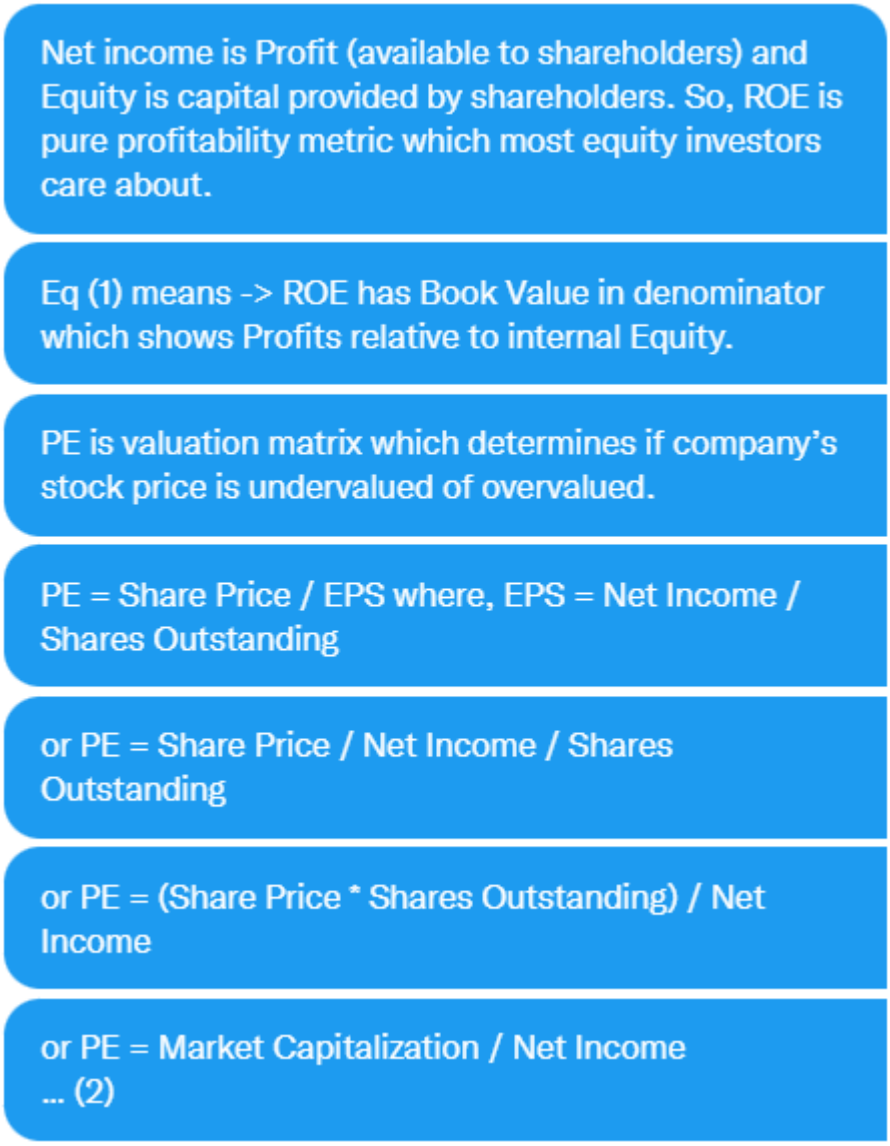
2



ROE & PE definition continued..

Keep an eye on Equations !

3



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)

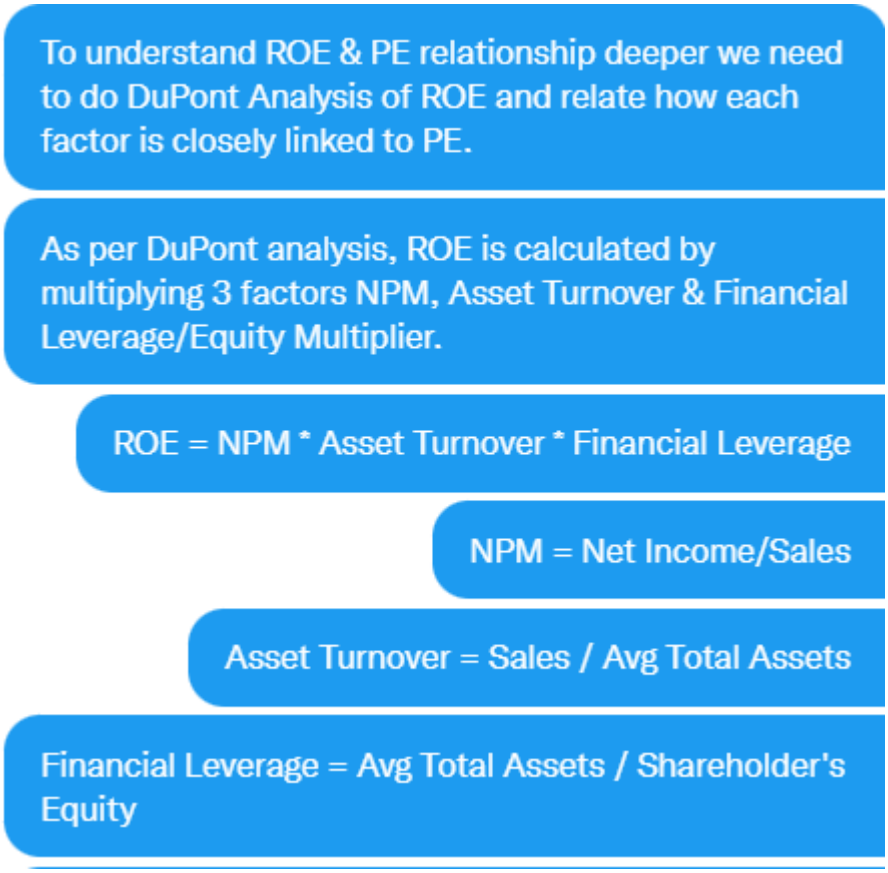
or EY = Net Income / Market Capitalization
... (3)

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.



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

ROE = NPM * Asset Turnover * Financial Leverage.

Impact of NPM of ROE & relationship with PE.

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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.

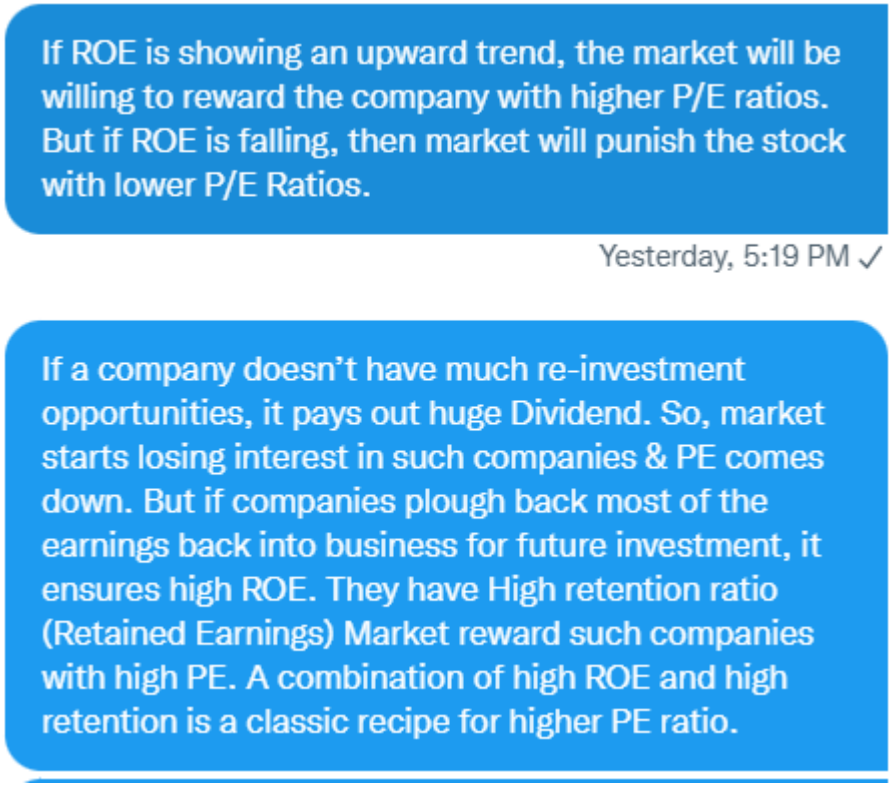
Impact of ->

1) Rising or Falling ROE on PE.

2) High Dividend Payout on ROE & growth.

3) High Retention Ratio (Retained Earnings).

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

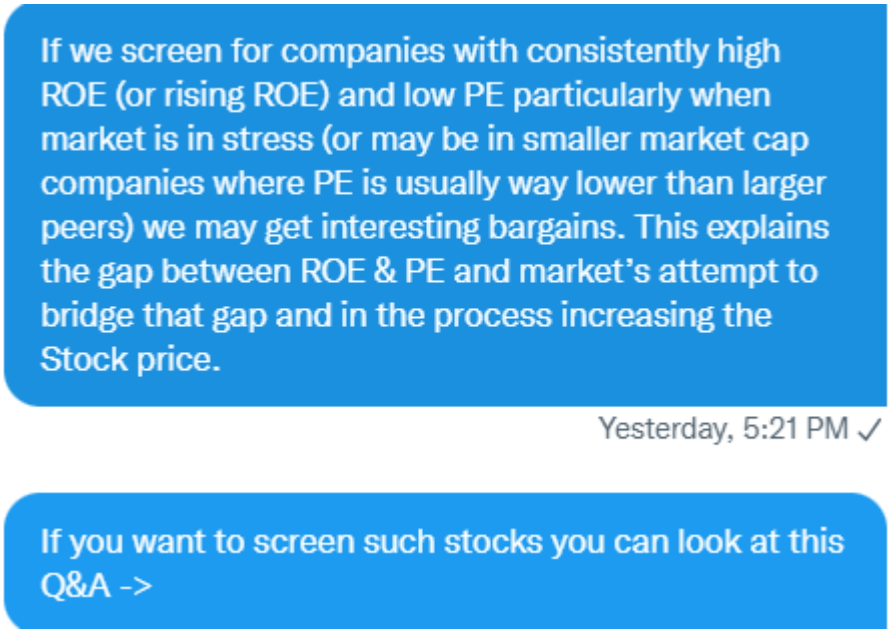
You may find the gap ->

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

@Vivek_Investor

https://t.co/qDshtA6lMJ

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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