

Tips, Tricks, & Techniques

Preferred Procedure

The purpose of this procedure is to assist the analyst in forecasting EPS five years in the future. It should be used by all except beginners.

It is called the "Preferred" Procedure because [1] It uses future *sales* forecasts [not past earnings] to forecast future EPS [sales are usually more stable because they have fewer factors influencing them] and [2] The analyst can change individual entries [eg., taxes, profit margins, etc.] in the course of calculating

On the following page the top chart is the initial screen of the preferred procedure. Its process is to display projected sales five years out [based on the analyst's forecast of 19% growth rate, from the graph on the front of the SSG], then subtract out cost of goods sold, then subtract taxes, subtract preferred stock dividends [if any]. Finally, divide this figure by the number of outstanding shares of common stock to reach EPS.

In this particular example, EPS from this calculation is \$3.71. However, the analyst should then look at the trend of recent profit margins, *Value Line* forecasted tax rates and shares outstanding five years out to see if any of these values should be changed in the Preferred Procedure.

In the bottom chart, notice that by clicking in the box for profit margins, the actual profit margin figures for each of the last five years appears on the right. You can see the definite trend upwards, culminating in 4.2% for 1999.

Based on this trend the analyst has changed the profit margin from the default figure of 3.2% [the average of the last five years] to 4.0%. This is a value judgment that the recent trend upward will continue.

This change in the projected profit margins gives an EPS five years out of \$4.64 instead of \$3.71. Notice how close this comes to the previously forecast EPS [from front of SSG] of \$4.71. *Please note that you should work from the top down and let the figures fall where they may. Don't "game" the system by manipulating the top figures so that the "EPS from the Preferred Procedure" comes close to the "Projected EPS."*

You will find that as you use this procedure, the items you will change the most often are profit margins and projected common shares outstanding. Few companies have preferred stock and most tax rates stay about the same

Preferred Procedure

Initial Screen

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator)

Preferred Procedure Calculation

Projected 5 Year Sales @:	19.0%	<input type="checkbox"/>	0.0	\$ 51,261.3
Less Expenses(5 Yr Avg % Pre Tax Profit Margin):	3.2%	<input type="checkbox"/>	0.0	-49,620.9
Less Taxes(Last yr. Tax Rate):	36.6%	<input type="checkbox"/>	0.0	-600.4
Less Preferred Dividends (Current Pref'd Div):	\$0.0	<input type="checkbox"/>	0.0	0.0
Projected 5 Yr Total Earnings				\$ 1,040.0
Divided by Shares Outs. (Current Sh's. Outs.(M)):	280.3	<input type="checkbox"/>	0.0	3.71

Annual Sales

1990	1,184.3
1991	1,647.6
1992	1,966.6
1993	1,967.0
1994	5,790.4
1995	7,806.1
1996	8,862.4
1997	10,968.0
1998	12,927.0
1999	21,481.0

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by 'Preferred Procedure':	3.71	12.5
<input checked="" type="radio"/> Projected EPS:	4.71	18.0
<input type="radio"/> Other:	0.00	0.0
Analysts' Estimate:	0.00	

Buttons: OK, Cancel, ?

Changing Profit Margin

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator)

Preferred Procedure Calculation

Projected 5 Year Sales @:	19.0%	<input type="checkbox"/>	0.0	\$ 51,261.3
Less Expenses(5 Yr Avg % Pre Tax Profit Margin):	3.2%	<input checked="" type="checkbox"/>	4.0	-49,210.8
Less Taxes(Last yr. Tax Rate):	36.6%	<input type="checkbox"/>	0.0	-750.5
Less Preferred Dividends (Current Pref'd Div):	\$0.0	<input type="checkbox"/>	0.0	0.0
Projected 5 Yr Total Earnings				\$ 1,300.0
Divided by Shares Outs. (Current Sh's. Outs.(M)):	280.3	<input type="checkbox"/>	0.0	4.64

% Pretax Profit Margin (2A)

1990	2.4
1991	2.5
1992	2.6
1993	0.0
1994	1.8
1995	1.9
1996	3.0
1997	3.4
1998	3.6
1999	4.2

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by 'Preferred Procedure':	4.64	17.6
<input checked="" type="radio"/> Projected EPS:	4.71	18.0
<input type="radio"/> Other:	0.00	0.0
Analysts' Estimate:	0.00	

Buttons: OK, Cancel, ?

Profit margin has upward trend. Based on this, I revised the projected profit margin to 4.0%, up from the five-year average of 3.2%. This increases forecast EPS from \$3.71 to \$4.64.