Toolkit Tips

Starting Points for EPS Projections

In the Stock Selection Guide, Part 1, Visual Analysis [Graph], the analyst is asked by Toolkit to project the yearly earnings per growth rate for the next five years.

We spend a lot of time in class discussing rules of thumb for figuring out which growth rate [ie, 12%, 15%, etc.] we should use. This is a very important part of our analysis, and spending class time is to learn this is very important.

However, there is a related procedure that many do not give much thought to. Just as it is important to use a realistic and thoughtful forecasted growth rate for EPS, it is also important to figure out from which point to project that growth rate.

In companies that have consistent growth rate [ie, the EPS line is fairly straight], the different projection points do not matter that much. However, in companies that are cyclical, or are coming out of a downturn, selection of the proper projection point is critical to proper analysis.

In the example on the next page, the company has had consistent growth until the latest quarter. The downturn can be clearly seen. Unfortunately, there are no real rules of thumb to use here. If the analyst thinks the downturn is only temporary, he or she should project from the last yearly date [ie, before the downturn.] If the analyst thinks the downturn may continue, he or should project from a more conservative point, such as the last quarterly point in this example.

In the example, projecting from the last quarterly point yields an EPS figure of $3.62. Although not shown, projecting the 18% growth rate from the latest annual point yields an EPS of $4.71. This is a 23% difference, and will change Total Return significantly. With EPS of $3.62, TR = 18.7% [not actually shown in the example] annually. EPS of $4.71, TR=26.1%. $1000 invested for five years with the lower TR = $2356; $1000 invested at the higher TR=$3188. Clearly a huge difference!!

BOTTOM LINE: Give careful thought to projection points.

Roger S. Cannon
rogercannon@naicspace.org
6/9/02

Starting Points for Projections

Great care should go into starting points for forecasted sales and EPS.

Starting the 18% forecasted growth for EPS at the last quarterly data point instead of the last annual data point reduces the EPS from $ 4.71 [not shown] down to $ 3.62. This is a drop of 23%, which will have a major effect on the forecasted high price in section 3 of the SSG.

In the case below, the analyst has decided to use a conservative approach, by projecting EPS from a lower point.