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Earnings Per Share (EPS) Analysis for Investing in Equity Market (A Tool for Individual Investor)

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Abstract **Investment in equity shares is considered as most risky option as in equity market only the probability of earning more return on investment increases and there is no guarantee of increased return on investment. On the contrary, there are chances of total loss of even the invested amount, leave aside the loss of returns. Amongst all investment avenues available for individual investor, equity market is the trickiest one and requires knowledge of share market. There are many tools to analyze the equity shares and find out the ones which can be considered for investment. Analysis of earnings per share (EPS) is also one such technique which can be applied by an individual investor to select equity shares for investment. The selection of equity shares for investment is the art an individual investor need to learn if he is interested in investing in equity market. What should be the criteria to be followed for the purpose of analysis of equity shares, which is easier to understand and apply? Earnings per share (EPS) is such a technique helpful to individual investor in the analysis of equity shares, which is also easy to comprehend. The following paragraphs discuss the technique of EPS analysis as a tool of selecting equity shares, which can be used by individual investor for the purpose of making investment in equity share market.**

***Keywords* —Earnings per share, EPS, equity market, equity analysis, investor's analysis, tool for equity analysis**

I. INTRODUCTION

Each individual yearns for a financially safe future for himself and for his family. In this endeavour, every one saves money and look for different investment avenues. The investment decision by any individual is based on many factors. The first important factor would be the amount to be invested. Secondly, the duration for which amount can be invested and third important consideration would be the risk appetite of the individual. The amount of investment and the time duration are usually well defined but the amount of risk an individual can take is varying from one investor to another. A conservative investor would prefer to invest his money in comparatively safer investment avenues like government securities. Aggressive investor would like to invest in risky avenues of investment like equity shares. It would be note worthy here that with increase in the amount of risk, only the probability of earning more returns increases and there is no guarantee of earning higher returns. The behaviour of risk averter and risk taker investor is different. Equity market if the play field of risk taker, aggressive investor. The investor who invests in equity shares adopts various majors to pick the equity shares for investment. These majors range from very simple techniques to really technical methods of equity analysis. Earnings per share (EPS) is one such technique, used by the investor to select equity shares for investment. EPS as a technique of equity share analysis is simple to understand and apply. For the purpose of selection of equity shares, a comparison of EPS of different equity shares is made and the equity share with more EPS is selected for investment. However, EPS should be analyzed along with the market price of the share as a higher EPS does not mean a higher return to the investor, if the investor buys the equity share from the secondary market. If the equity shares are purchased from secondary market, the market price would affect the individual's return on investment (ROI). For example, if the face value of equity share sold through Initial Public Offer (IPO) is Rs 25 per share, the EPS of the company is Rs 20, the Dividend per share (DPS) is Rs 15, market price of the equity share is Rs 130, the original investor is getting 60% return on his investment while the investor who has purchased the equity share from the secondary market, the individual's return on investment would be only 12%. Another situation can be that an individual who has originally purchased equity share for Rs 25 and now, receives dividend of Rs 15 and suppose he sells the share at Rs 130, his return would be Rs 15 + (Rs 130 – Rs 25) = Rs 120, i. e. 4.8 times of the invested amount or 480% ROI, assuming that Rs 130 is the ex-dividend price of the equity share. Thus, it can be observed that the return of an individual investor is affected by the fact that whether the individual investor purchases equity share from primary market or the secondary market.

II. EARNINGS PER SHARE (EPS) AND ITS CALCULATION

The investors need to analyze the pros and cons of every

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investment avenue. The choice of Investment Avenue would depend more upon the risk appetite of the individual. The amount of risk taken also decides upon the amount of return, to some extent. The probability of return is more if the investment is made in equity shares. Any individual investing in equity share would pick the company after comparative analysis of different equity shares using one or the other technique of equity share analysis. EPS is also a technique to compare the shares of companies, either from same industry or from different industry. The organizations calculate earnings from the profit and loss statement. Profit can be gross profit, net profit, earnings before interest and taxes (EBIT), earnings before taxes (EBT) and earnings after taxes (EAT). It is much evident that the objective of any organization is either to maximize wealth or to maximize profits. The value of the firm is maximized when the market price of the equity share of the firm is higher. In practice, the financial performance of a firm is better judged in terms of earnings per share (EPS). EPS is considered as an effective measure of economic performance analysis of any company [1]. Many equity share market investors lack the inside knowledge of the company and rely on the information displayed in financial statements of the companies. In such cases, EPS is really helpful in making comparisons between equity shares of various companies. EPS is an indicator of better capital productivity. EPS is an important ratio which measures the exactly net profit earned on each share. EPS The dividend policy is affected by the EPS of the organization. Even the market price of the equity shares of the firm is affected by EPS of that firm. EPS is actually a tracker of profitability of the company. EPS is calculated by dividing net profit after tax and after preference dividend by number of equity shares of the company.

$$EPS = \frac{\text{Net profit after tax and preference dividend}}{\text{Number of equity shares}}$$

EPS is also useful in measuring the profitability of equity share holder's investment. EPS depicts the profitability of the company on per share basis. EPS is very commonly used profitability ratio, to understand the profit condition of the firm [2].

Companies focus on maximum market value of their equity shares as this aligns with their objective of value maximization. But just looking at the market price does not give any idea to the individual investor. The individual investor who basically is an outsider to the organization, thus uses EPS as his decision making tool. EPS gives him a better picture of capital utilization. EPS serves as an effective measure of understanding capital productivity of the company as it considers net profit earned per share.

III. INVESTMENT AND INVESTMENT AVENUES

Money has multiple uses. If a person has some amount in hand he can consume it in many ways. If he has to invest this amount he would have to fore go his present consumption. Then this amount would be invested for a specified duration in want of certain return on investment. This means that there would be an increased amount in hand on a future date. Thus, investment can be understood as postponement of present consumption and departing from money for some time and getting an increased amount for consumption at a future date. [3]. Investment has three prominent features viz. postponement of present consumption, departing from one's money and getting an increased amount for consumption at a future date. Money is also invested due to the fact that idle cash does not earn anything; rather it looses its value due to inflation [4].

Let us understand the concept of investment using the following hypothetical example. Suppose a person has Rs 2,000, which he can either spend or he can invest. He chooses to invest and invests Rs 2,000 in a bank fixed deposit paying @ 9% per annum. After one year, this particular investor gets Rs 2,000 + 9% of Rs 2,000, that is total Rs 2,180. So, after one year, the purchasing power of this individual has increased by Rs 180 because he has sacrificed his consumption for one year and he has departed from his money for one year. His reward for this sacrifice and for taking risk is the return of Rs 180, paid to him along with his originally invested amount of Rs 2,000. This way the investor gets Rs 2,180 after one year.

The first motive of any investment is the safety of principal amount. The second motive of the investment is to earn a satisfactory return which should commensurate with the amount of risk taken by the investor [5]. It would be worthy to mention here that risk involved in the investment can be minimized by diversification. However, risk cannot be totally eliminated.

Depending on the virtues of investment, there are a number of investment avenues available to an investor. These investment avenues vary on account of maturity period and the return on investment (ROI). ROI depends on the amount of the risk taken by the investor in investing his money. By all means, investment in government securities like central or state government bonds, fixed deposit public sector banks and deposits and accounts of post offices, is considered the safest. At the opposite end, investment in equity shares is considered as the riskiest one. In between fall other investment avenues like fixed deposit in private or foreign banks, bonds, debenture, preference shares etc. With increase in the degree of risk associated with a particular investment avenue, there is increase in the probability to get higher returns. There is no assurance of earning higher returns. Risk and return are correlated in terms of the probability of higher returns with increase in the risk in investment. Riskier the investment avenue, higher is the probability of earning more returns, but it is only the probability as there is no assurance. Equity shares

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represent equity capital of the company. Equity shareholders are the ultimate owners of the company. [6]. In lieu of the investment in equity shares, the equity share holder receives dividend. Another

Besides financial investment, there can also be physical investment like investment in real estate, in gold, in diamonds, in silver or in other metals. These physical assets are purchased and sold to earn a profit over the invested amount. Usually, the investment is discussed with the focus on financial; investment due to the reason that physical assets need to be held for longer duration in comparison to financial assets.

The equity share investors approach the stock market with different objectives. Basically, there are four types of approaches. The first one is the fundamental approach. Fundamental approach says that every security has an intrinsic value and the market price of the security may always not be equal to the intrinsic value of that security. Fundamental approach suggest that buy those securities whose intrinsic value is more than their market prices and sell those securities whose intrinsic value is less than their market prices. Another approach to investment in securities is the psychological approach. Psychological approach suggests that each security has a psychic value. It further says that it is more advantageous to understand that how investors tend to behave as the share market is driven by the waves of optimism and pessimism. This would help in deciding upon the investing or disinvesting issues pertaining to the equity shares. Third approach is the academic approach. This approach is driven by academic community who has studied the share market with certain investigative techniques. This approach says that stock market fastly corrects itself and is fairly efficient in reacting to the flow of information in the market. Thus, the market price of the stock reflects its intrinsic value reasonably well and the return on the equity share is linearly related to the non diversifiable market risk. Fourth and last approach is eclectic approach. This approach is actually considering all the three approaches explained above. The approach followed by an investor is also dependent his risk taking attitude. A risk averter investor is more supposed to follow fundamental or academic approach and a risk taker investor has more chances to follow psychological or eclectic approach. It is sure that investors follow any one of these approaches [7].

IV. EPS ANALYSIS

Investment culminates from savings. One can invest only if there is surplus of income over expenses. Saving is not investing. There is significant difference between saving and investing. Saving is the surplus amount of income over expenditure that has been put aside. It can be placed in house or it may be deposited in bank. In both the cases, it would not be considered as investment as it cash lying idle, although a nominal interest is paid by bank if the money is deposited in bank. However, if the money is put into fixed deposit of a bank, it would be called as saving. Savings are converted into investment when it has certain characteristics like return on investment, there is certain risk involved, there is a certain degree of safety in the investment, the investor is departing from his savings and the investment is saleable or marketable or is easily convertible into liquid without loss of value. Investment is done with the objective of either maximization of return or minimization of risk. Investment is done for wealth maximization and to combat inflation [8]. An investor need to be very prudent while investing his savings. For analysis of securities, an investor applies various analytical techniques. EPS is also an analytical technique.

Earnings per share is a very comprehensive technique of equity shares analysis. It is simple to understand and also easy to calculate. The earnings after taxes and preference dividend is divided by total number of equity shares of the company to arrive at earnings per share. More number of equity shares would reduce EPS of the company and vice versa [9]. An individual investor can very easily analyze EPS of different companies as it is provided in the final statements of the companies. A particular company's EPS may appear higher only because it has less number of equity shares although it's earnings after taxes and preference dividend may not be that much higher. EPS considers divisible profit. Divisible profit is the amount available for distribution as dividend. It is also worthy to mention here that dividend can be paid out of current year's divisible profit. [10]

Let us consider following example:

Table 1: EPS of Some Companies

Company Name/Year	Mar ' 18	Mar ' 17	Mar ' 16	Mar ' 15	Mar ' 14
Tata Motors	-3.05	-7.15	-0.18	-14.72	1.04
Infosys	33.75	73.97	60.16	55.26	105.91
HDFC Bank	67.38	56.78	48.64	40.76	35.34
TCS	131.86	120.04	117.11	98.31	94.17
SBI	-7.34	13.15	12.82	17.55	14.59
Maruti	255.62	243.32	177.58	122.85	92.13
ITC	9.2	8.4	12.23	11.99	11.05

Source: Websites

Looking at the above figures, it is observed that EPS of companies can be positive as well as negative. The first company Tata Motors is having negative EPS since last four years and it had positive EPS only in the year 2015. Second company Infosys has shown mixed trend in EPS. In the year 2014, it was highest and then in the year 2015, the EPS dropped to almost half of the year 2014. EPS marginally increased in the year 2016 and 2017. Again, in the year 2018, EPS dipped to 45% of the year 2017. Third company is HDFC Bank and its EPS is showing an upward trend from the year 2014 to the year 2018. EPS increased

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by 91% in the five years of study. TCS, the fourth company is also showing an increasing trend in EPS trough out the period of study. TCS is doing well. The next company SBI has not been able to maintain a steady EPS in the year 2018SBI is having negative EPS. For remaining four years, though the EPS is positive it is not depicting any trend. Maruti has shown very good growth rate in EPS and it has grown by 178% in four years. Maruti is the only company which has exhibited impressive growth during this period. Last company, ITC, has also not shown any signs of growth during the period of study. Rather, EPS of ITC reduced in the year 2017 and increased only marginally in the year 2018. Considering the EPS figures of all these seven companies, it can be said that Maruti can be ranked first and TCS can be ranked second. Tata Motors can be fully avoided for the purpose of investment as it has exhibited negative EPS during the period of study. If the investor selects SBI, he has to be cautious as though for four years but in the year 2018, its EPS is negative. HDFC Bank can also be the pick of investor. Thus, after doing EPS analysis of these seven companies, it can be said that three companies can be selected for investment viz. Maruti, TCS and HDFC Bank. These three companies have done well in the years under consideration. This selection is based on EPS analysis only. For further analysis, Market price, number of shares, DPS etc. can be considered for these companies. There may come a change in the selection of company after DPS analysis. There is possibility that combined analysis of EPS and DPS gives a better picture.

V. A WORD OF CAUTION

A company would exhibit a higher EPS if it has less number of equity shares. EPS is actually affected by two things. Firstly, earnings after taxes and preference dividend and secondly, the number of equity shares of the company. Along with EPS analysis, the investor need to check these two attributes as well. EPS does not disclose the amount of dividend paid to the equity share holder by the company. [11]. EPS is only earnings per share and it is not dividend per share (DPS). It may be possible that the company might have paid fewer dividends despite a higher EPS. So along with EPS, DPS should also be analyzed. This would help in providing a better picture of the companies. Dividend payout ratio or the retention ratio can also be helpful in analyzing the equity shares of different companies. The word of caution is just that the decision regarding investment in equity shares should not be based on only EPS but DPS or dividend payout ratio or retention ration should also be considered for the purpose of analysis.

VI. CONCLUSION

Investment is done basically with the objective of earning returns on the invested amount. This is done with the purpose of either fighting inflation or for making the future financially safe. However, any investor needs to understand that the return on any investment is associated with the risk involved in that particular investment avenue. With increase in the degree of risk in a particular investment avenue, only the probability of earning higher return increases and there is not any assurance to earn increased higher returns. Investment in equity shares is done by the investors who are risk takers. Risk averters would invest in safer investment avenues like government securities, post office and bank fixed deposits etc. The investors approaching equity share market analyze the equity shares of various companies using different techniques. EPS is one such technique used by investors to analyze the equity shares for investment. It is found in the above discussions that companies can have negative EPS, even though the amount of earnings seems to be handsome. The findings also reveal that the companies which are maintaining a growing EPS are preferred by the individual investors. In the above discussion, Maruti and TCS are found to be maintaining a growing EPS and any individual investor would prefer to invest in these companies. It is also found that a strong company like Tata Motors is not able to achieve a positive EPS. Tata Motors is having a negative EPS throughout the five year period of study. Any company having negative EPS cannot be the choice of the investors. The findings from above discussion have also surfaced that HDFC Bank is also doing good and is able to maintain a growing EPS. Any individual investor would now have to choose between the sector, as Maruti is in automobile sector, TCS in IT sector and HDFC in banking sector. Once the sector is selected, the company can be picked by EPS analysis. In the above discussion, it is also found that the companies like Infosys, ITC and SBI having uneven EPS can also be avoided. These conclusions are drawn on the basis of EPS analysis of EPS pertaining to five years, of these seven companies.

EPS is a simple yet powerful technique. EPS is calculated by dividing residual earnings after taxes and preference shares by number of equity shares. EPS is affected by total earnings, amount of taxes, amount of preference dividend and number of equity shares. EPS of different equity shares can be compared and equity share with higher EPS is selected. A word of caution is that along with EPS, DPS should also be analyzed, to arrive at a better picture of the company whose equity share is under consideration.

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