

Chapter 14

Market measures of performance and value

Introduction

In this chapter, we round off our introductory treatment of accounting and finance with a look at a range of tools for evaluating accounting information in a market context and in particular the types and significance of the 'investor ratios'. We will apply these ratios to Marks & Spencer plc, measuring the performance of this company both internally and in the market. An important issue discussed in this chapter is why markets often value firms at many times their book value. Part of the explanation for this is that book values do not represent the current market value of all the assets listed in the balance sheet. However, this explanation is a bit too glib given that some firms are valued by the market at up to ten times their book value. We will explore some of the reasons for this discrepancy in value. Building upon the investor ratios we then develop a straightforward method for the valuation of the equity shares in companies. This is useful for testing the prices of shares in the market as well as for estimating the value of target companies for acquisition. A key component of the measurement of value is the expected growth rate of the firm. This we explore using two broad approaches for estimating growth: an exogenous approach using external market forces and an endogenous approach using internal measures of management's reinvestment of earnings.

Learning objectives

Investor ratios

- To understand the nature and significance of the investor ratios.
- To be able to retrieve the relevant and most up-to-date information required to calculate the investor ratios.
- To be able to calculate the investor ratios.

Valuing the firm

- To be able to value the firm using the dividend growth model.
- To be able to value the equity market using the dividend valuation models.

Measuring the performance of firms

- To be able to summarise the concepts of value management and shareholder value-added.
- To be able to calculate the shareholder value added for a company.

Investor ratios

There are a number of important ratios that are used to help the investor. Some are mixed ratios in that they require access to figures both in the accounts and from market sources. The income statement and the current quoted price per share for the company provide most of the information that is required. To illustrate these ratios we return to Marks & Spencer's accounts, previously discussed in Chapter 7. For the purposes of this chapter we have used the accounts for the year-end 31 March 2007. The income statement, balance sheet and cash flow statement is shown as an appendix to this chapter.

Dividend per share

Dividend per share is the dividends (both paid and declared) during the year divided by the number of ordinary shares in issue and entitled to receive a dividend in the year in question. Most companies declare both an interim and a final dividend in order to smooth the impact of the distribution on cash flow.

Dividend yield

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

Dividend yield is the ratio of dividend to current share price and gives the percentage return that an investor can expect from distributions by the company. The current share price of Marks & Spencer is 583.50p per share and the dividend is 16.60p per share. The dividend yield is:

$$\text{Dividend yield} = 16.60/583.50 \times 100 = 2.84 \text{ per cent}$$

This means that currently Marks & Spencer's shares offer an annual cash return to the investor just in excess of 2.8 per cent. However, in order to obtain the full return we need to add to this yield the capital gain or loss in holding this company's shares. You should also note that

Exhibit 14.1 Marks & Spencer plc – statement of earnings

| | 52 weeks ended 31 March 2007 £m | 52 weeks ended 1 April 2006 £m |
|---|---------------------------------------|--------------------------------------|
| Profit for the year attributable to shareholders | 659.9 | 523.1 |
| Basic earnings per share | 39.1p | 31.4p |
| Diluted earnings per share | 38.5p | 31.1p |
| Basic earnings per share from continuing operations | 39.1p | 31.3p |
| Diluted earnings per share from continuing operations | 38.5p | 31.0p |