What are earnings per share?

By Eric LeRiche

Let's start with earnings:

First of all, it’s all about earnings! When you come to the bottom line, that’s what investors want to know. How much money is the company making and how much is it going to make in the future.

Earnings are profits. It may be complicated to calculate, but that’s what buying a company is about. Increasing earnings generally leads to a higher stock price and, in some cases, a regular dividend.

When earnings fall short, the market usually "punishes" the stock. Every quarter, companies report earnings. Analysts follow major companies closely and if they fall short of projected earnings, communicate the shortfall to the investment community.

One of the challenges of evaluating stocks is establishing an “apples to apples” comparison. What I mean by this is setting up a comparison that is meaningful so that the results help you make an investment decision.

Comparing the price of two stocks is meaningless. Similarly, comparing the earnings of one company to another really doesn’t make any sense, if you think about it. Using the raw numbers ignores the fact that the two companies undoubtedly have a different number of outstanding shares.

For example, companies A and B both earn $100, but company A has 10 shares outstanding, while company B has 50 shares outstanding. Which company’s stock do you want to own?

It makes more sense to look at earnings per share (EPS) for use as a comparison tool

You calculate earnings per share by taking the net earnings and divide by the outstanding shares.

EPS = Net Earnings / Outstanding Shares
Using our example above, Company A had earnings of $100 and 10 shares outstanding, which equals an EPS of 10 ($100 / 10 = 10). Company B had earnings of $100 and 50 shares outstanding, which equals an EPS of 2 ($100 / 50 = 2).

So, you should go buy Company A with an EPS of 10, right? Maybe, but not just on the basis of its EPS. The EPS is helpful in comparing one company to another, assuming they are in the same industry, but it doesn’t tell you whether it’s a good stock to buy or what the market thinks of it. For that information, we need to look at other ratios like the Price to book ratio, the price to earning ratio, the price to sales ratio, PEG, ROE,etc... (see these articles at www.investorrules.com)

You should note that there are three types of EPS numbers:

* Trailing EPS – The sum of a company's earnings per share for the previous four quarters. The descriptive word "trailing" implies "previous years" versus a present or forward EPS. Most recorded and quoted EPS values are trailing.

* Current EPS – this year’s numbers, which are still projections
* Forward EPS – future numbers, which are obviously projections

I don't want to complicate things here but here's a quick definition of a related term which once you become more familiar with EPS you'll likely want to consider when doing due diligence:

Diluted Earnings Per Share (Diluted EPS)

A performance metric used to gauge the quality of a company's earnings per share (EPS) if all convertible securities were exercised. Convertible securities refers to all outstanding convertible preferred shares, convertible debentures, stock options (primarily employee based) and warrants. Unless the company has no additional potential shares outstanding (a relatively rare circumstance) the diluted EPS will always be lower than the simple EPS.

Remember that earnings per share is calculated by dividing the company's profit by the number of shares outstanding. Warrants, stock options, convertible preferred shares, etc. all serve to increasing the number of shares outstanding. As a shareholder, this is a bad thing. If the denominator in the equation (shares outstanding) is larger, the earnings per share is reduced (the same profit figure is used in the numerator).

This is a conservative metric because it indicates somewhat of a worst-case scenario. On one hand, everyone holding options, warrants, convertible preferred shares, etc. is unlikely convert their shares all at once. At the same time, if things go well, there is a good chance that all options and convertibles will be converted into common stock. A big difference in a company's EPS and diluted EPS can indicate high potential dilution for

the company's shares, an attribute almost unanimously ostracized by analysts and investors alike.

While earnings are important, by themselves they don't tell you anything about how the market values the stock. To begin building a picture of how the stock is valued you need to use some fundamental analysis tools. These ratios are easy to calculate, but you can find most of them already done on sites like cnn.money.com or MSN MoneyCentral.com.

With Earnings per Share, the most popular tools of fundamental analysis are listed below. They focus on earnings, growth, and value in the market:

1. Price to Earnings Ratio – P/E
2. Projected Earning Growth – PEG
3. Price to Sales – P/S
4. Price to Book – P/B
5. Dividend Yield
6. Return on Equity

None of these mean much on their own but when you combine some of them together and adapt your combinations based on the sector the company you're analizing is in you will find that they are very good identifying the true value of a stock, thus find you identify the "ticket price" of your potential investment and to determine if your current investments are at or near their full potential...

As an example and in my opinion, for a company in the retail sector you'd favor the P/E ratio and the P/S ratio and for the oil sector I would privilege the P/B and the P/E ratios.

What ever you decide, remember that fundamental analysis is only a part of the wise investor/trader armamentarium.

Yours truly

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