5 Variables Every Investor Must Consider When Evaluating a Stock

Description

Sometimes, with all the hype that surrounds the market and certain stocks, it's hard to know what to focus on when looking for a good buy for our investment portfolios. I know how easy it can be to get lost in all the information that is put out there on a daily basis. So let's take a step back and go through a checklist of very important variables to look at when considering and evaluating a stock. While there are also many qualitative factors to look at, this checklist is a great starting point.

Strong and growing free cash flow generation

Earnings can be misleading, as they are affected by many non-cash items such as depreciation, amortization, and depletion, all of which can be subjective to a degree because they depend on assumptions and this can lead to manipulation by management. There is less room for manipulation with cash flows so investors should start there when evaluating a company. But more than this, we need to consider the capital investment that goes into a business. Which brings us to free cash flow, which is defined as operating cash flow minus capital expenditures.

Celestica (TSX: CLS) is a good example of a company that has generated free cash flow in the last 5 years. In 2012, Celestica generated free cash flow of $206 million, an increase of 73% over 2008 free cash flow of $119 million.

Negative free cash flow is a warning sign because it basically means that the company is spending too much money in order to generate those earnings. And this is not sustainable. For example, **Strongco Corp.** (TSX: SQP), which sells, rents and services equipment used in sectors such as construction, infrastructure, mining, oil and gas, and a variety of other industries, has been free cash flow negative for each of the last 2 years. If I was considering investing in this company, this would serve as a red flag.

Strong Balance Sheet/Manageable debt levels

We all know that in our personal financial lives, too much debt is risky. Same goes for companies. Every individual and every company must have room and flexibility in their balance sheets to cover the hard times and ensure sustainability. Appropriate debt levels depend on the industry that a company is in, because some industries are by their very nature more capital intensive.

A good example of a company who is deep into debt and whose share price is more at risk because of it is **Barrick Gold** (TSX: ABX). With nearly $14 billion of debt, Barrick has more debt than any other major gold miner. Because of this, it is even more vulnerable now at this time of declining gold prices. So now, the company has delayed capital expenditures, sold assets, and cut the dividend. While all gold miners are experiencing troubling times, Barrick's debt situation is making its situation more urgent, and that can lead to bad decisions.

Reasonable valuations

Generally we should stay away from those companies that are priced for perfection. High valuations make the risk versus reward dynamic of a stock less attractive. The higher the valuation on a stock, the higher the growth rate that the company must maintain in order to support the stock price. And sometimes, the market gets carried away. When multiples are too high, the stock becomes more risky, as to support the price, the company must maintain growth rate expectations that are sometimes too aggressive to meet. When the market gets ahead of the company's fundamentals, this leaves the company's stock at risk for a big fall should results fail to meet the market's aggressive expectations.

Canadian Pacific Railway (TSX: CP) stands out at this time as having an extremely rich valuation. The stock is trading at a price to earnings ratio of almost 32. The market is obviously expecting great things from this company. The other Canadian railway company, **Canadian National Railway** (TSX: CNR) is trading at a P/E multiple of 17.6 times. So if we are looking to get into a stock that will benefit from the fact that crude is increasingly being transported via rail, this information is one piece of the puzzle to bring us to the best decision.

High Shareholder Returns

A company that is focused on shareholder returns is aligned with your interests. Look out for companies who are growing simply for the sake of growing and companies who are making decisions that are too short term oriented. Companies who have consistently high Returns on Equity (ROE), are generating real value that investors can hang their hats on.

Bottom Line

The goal is to cover all important bases to ensure that companies that we invest in have an attractive risk/reward profile. And we cannot look at any of these variables in isolation, but rather as a group and let them guide us in our research and serve as signposts.

Why would we want to take on extra risk when we can just move on and find another company/stock that would provide us with a better, lower risk investment? Investing is as much, if not more, about capital preservation as it is about blowing the lights out. A balance between risk and reward.

Fool contributor Karen Thomas owns shares of Celestica. David Gardner owns shares of CN Rail. The Motley Fool doesn't own shares in any companies mentioned.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:ABX (Barrick Mining)
2. TSX:CLS (Celestica Inc.)
3. TSX:CP (Canadian Pacific Railway)

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