This Ratio Could Be Key to Your Investment Performance

Description

While there are a number of important ratios for investors to consider, there is one ratio which is often overlooked. Although it may not be particularly exciting or popular, the operating margin shows the state of a business versus its recent past, as well as when compared to its sector peers. It also shows whether management's strategy is working and the state of the industry in which a company operates.

A simple ratio

Calculating a company's operating margin is relatively straightforward. It is simply operating profit dividend by sales, which gives a percentage figure. Since operating profit is arrived at after a wide range of costs have been deducted, it provides guidance on how successful a business is on an underlying basis. In other words, before the effect of borrowing costs and tax are deducted. Therefore, it can be a simple means of assessing how a company's profitability has changed over time, without changes to tax rates and interest rates affecting the results.

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Management strategy

A company's operating margin also shows how successful a company's strategy has been. It can easily be compared to its historic levels, which provides guidance on whether a business has become more or less efficient. This is useful because many companies seek to grow simply by boosting sales, which may improve investor sentiment. However, no business can grow sales in perpetuity. So if sales growth is not being matched by improving efficiency, it may be worth avoiding the company in question.

Comparison versus peers

Of course, a low operating margin versus sector peers could indicate the company in question is relatively inefficient. It could also equate to a buying opportunity as long as the company's valuation includes a discount for its apparent lack of efficiency versus peers. If a new management team or a refreshed strategy has the potential to improve a company's operating margin, a potential recovery play could be on offer. However, there may also be the added risk of failure to turn a business around, which may lead to a share price fall.

Trading environment

A company's operating margin and its change in recent years can also provide guidance on the conditions within a particular industry. For example, during a recession the operating margins of retailers and other cyclical companies would be expected to reduce as they seek to boost sales with investment in pricing. This could indicate that it is an unfavourable time to invest for the short term, but could also indicate a low point in the economic cycle which means upside potential is at its highest.

Takeaway

Investigating a company's operating margin may not be particularly exciting, but it can tell an investor a great deal of information about the performance of a business versus its recent history and when compared to its peers. It can also help to show whether it is an opportune moment to invest. In other words, it is a relatively simple means of assessing the underlying performance of a business, which could help Foolish investors to generate index-beating returns in the long run.

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