

Preferred Procedure



Mini Investment Class by the OKI Tri-State Chapter

Courtesy Cincinnati Model Investment Club

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NON-PROFIT VOLUNTEER BASED MEMBER DRIVEN



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SSG Projections

- **After studying side one and section 2 of the SSG, we make projections for the company:**
 - **Projected Growth in Sales for the next five years**
 - **Projected Growth in EPS for the next five years**
- **We have much more confidence in our sales projections than in our EPS projections:**
 - **Sales are very fundamental**
 - **Not many ways management can fudge sales**
 - **EPS is influenced by many factors**

Rules for Projecting EPS

- **Not greater than historical growth in EPS.**
- **Not greater than projected growth in Sales.**
- **Not greater than 15% (20% for small companies with very high growth rates).**
- **After making EPS growth projection as we teach in the SSG class**
 - **Try the Preferred Procedure**

Preferred Procedure

- **The Preferred Procedure is another way to make five year projections for EPS.**
- **We pretend we are the CFO of the company five years from now, and fill out the Profit and Loss sheet:**
 - **We accept the five year projections for Sales**
 - **We compute pre-tax profits**
 - **We compute taxes paid and net profit**
 - **We compute number of shares and EPS**

Example

- **Sales of \$44.525 Billion**
- **Sales growth projected to be 12.0%**
- **Sales (5 year) projected to be \$78.468 Billion**
- **EPS of \$1.74**
- **EPS growth projected to be 12.0%**
- **EPS (5 year) projected to be \$3.07**
- **Analyst's projected 5 year EPS to be \$3.28**

Company in Five Years (Part 1)

- **Accept projected sales of \$78.468 Billion**
- **Pre-tax Profit Margin has averaged 34.1%, so we expect pre-tax profit to be:**
 - **34.1% times \$78.464 Billion = \$26.756 Billion**
- **Taxes are averaging 23.0%, so we expect to pay taxes of:**
 - **23.0% times \$26.756 Billion = \$6.154 Billion**
- **This leaves \$20.602 Billion for net profit**

Company in Five Years (Part 2)

- **Projecting \$20.602 Billion for net profit**
- **Project that company will have 7631.5 Million shares in five years.**
- **Thus, we project the company will have an EPS of:**
 - **\$20.602 Billion divided by 7631.5 Million**
- **This is an EPS of \$2.70**
- **Compare this to 12.0% growth EPS of \$3.07**

Example Preferred Procedure

	Projection	Value
Sales	12.0%	\$78,468
Pre-Tax Profit	34.1%	\$26,758
Taxes	23.0%	\$ 6,154
Pref. Dividends	0	\$.00
Net Profit		\$20,603
Shares	7,631.5	7,631.5
EPS		\$ 2.70

Benefits

- **Preferred Procedure uses:**
 - **Sales projections which are usually more accurate than EPS projections**
 - **Projected Pre-Tax Profit Margin (Row 2A)**
 - **Projected Income Tax Rate**
 - **Projected Dividends for Preferred Stock**
 - **Projected Number of Shares Outstanding**
- **Projecting a growth rate for EPS is not explicit about all these projections**

Conclusion

- **Use Conservative projection for growth rate of both sales and EPS**
- **Use Preferred Procedure, using conservative values for:**
 - **Pre-Tax Profit Margin (Row 2A)**
 - **Income Tax Rate**
 - **Preferred Dividends**
 - **Number of Shares Outstanding**
- **Then use the smaller of the two EPS projections.**

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