

BETTERINVESTING™
 Rocky Mountain Chapter

Powerful 5: Ratios to Screen Stocks



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Gross Profit Margin

Gross Profit Margin =

$$(\text{Revenue} - \text{Cost of goods sold}) / \text{Revenue}$$

Derived from income statement

Classified as one of the profitability ratios

Reveals fundamental business quality

Indicates scalability potential

Signals pricing power

Harder to manipulate metric

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Operating Margin

Operating Margin =

$$\text{Operating income} / \text{Revenue}$$

$$\text{Operating Income} = \text{Revenue} - \text{Cost of goods sold} - \text{Operating Expenses}$$

- Derived from income statement
- Measures how efficient the company manages its operations
- Excludes any impact of financing decisions and taxes
- Better indicator of sustainable earnings than net margin and is less affected by non-operational items

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Current Ratio



Current Ratio =

$\text{Current Assets} / \text{Current Liabilities}$

- Derived from balance sheet statement
- Measures a company's ability to pay short-term obligations
- Indicates short-term financial health
- Shows working capital efficiency

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Debt to Equity Ratio



Debt to Equity =

$\text{Total liability} / \text{Shareholders' equity}$

- Derived from balance sheet statement
- Reveals financial risk profile
- Affects the quality of return on equity
- Higher leverage means higher borrowing costs which affects company's ability to generate attractive returns over time

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Free Cash Flow Yield

FCF yield =

Total liability / Shareholders' equity

- Derived from cash flow statement
- Shows real value generation
- Reveals true return potential
- Indicates capital allocation flexibility
- Forward looking
- Filters out accounting noise

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