NAIC's Preferred Procedure: Projecting Earnings Per Share

The Stock Selection Guide is a two-sided paper form developed by the National Association of Investors Corporation (NAIC) to evaluate a stock for potential purchase. One of the main purposes of the SSG is to identify companies that have historically grown at a faster rate than the market in general, and thus are more likely to do so in the future. By identifying historical trends for the company's growth of both Revenues and Earnings, and then projecting a future growth rate for each, the SSG can be used to predict how the company is likely to perform over the next five years.

What is the Preferred Procedure?

The "Preferred Procedure" is a method of projecting future earnings per share (EPS) of a stock. The NAIC recommends that investors always use the Preferred Method to calculate future Earnings Per Share when completing the Stock Selection Guide (hence the nomenclature "Preferred").

The Preferred Procedure usually provides a higher measure of accuracy than trend line projections for two reasons:

- It is usually easier to discern a historic trend from the company's past Revenues growth, and thus project what the future growth rate may be.

- You can apply separate judgments for each of the variables in the calculations.

Variables in the Calculation

You need to make five-year projections for five different figures before you can calculate Earnings Per Share using the Preferred Procedure.

1. Revenues
2. Percentage Pre-Tax Profit *(also known as the Profit Margin)*
3. Tax Rate
4. Preferred Dividends
5. Number of Shares Outstanding

The first number you need to know is your 5-year Revenue projection, from the trend line you drew in Section 1 of the Stock Selection Guide, "Visual Analysis."

Now, look at Section 2, "Evaluating Management," Part A: "Pre-Tax Profit On Sales." Compare the figures for all ten years, as well as the computed average for the last five. Is there a trend? Is there a reasonable median figure? You need to choose a value for the pre-tax profit; for a conservative analysis, choose a percentage on the low end of the range.

Value Line provides a three to five year tax rate projection, which in most cases will suffice for this calculation. You can compare the most recent tax rates to the projected figure to get a feel for the range of numbers. Select a higher tax rate for a more conservative projection, remembering that taxes usually go up and not down.

You also need to know if the company has preferred stock on which it pays dividends. Preferred dividends are paid before Earnings Per Share are calculated.

Finally, you need to estimate the number of shares of common stock that will be outstanding in five years. The current number of outstanding shares is listed in the left hand tables of the Value Line report, but the data table also includes the outstanding shares for each year and a five-year projection. If there is a discernible trend for the historic growth or reduction in the number of shares outstanding, you will want to take this into account when you make your calculations.

Now, use all these numbers to do the computations:

$$\text{PRE-TAX PROFIT} = \text{Revenues} \times \%\ \text{Pre-Tax Profit on Sales}$$

$$\text{NET PROFIT (AFTER TAX)} = \text{Pre-Tax Profit} \times (1 - \text{Tax Rate})$$

$$\text{EARNINGS PER SHARE} = \frac{(\text{Net Profit} - \text{Preferred Dividends})}{\#\ \text{of Shares Outstandnig}}$$

Conclusion

Experienced investors always use the Preferred Procedure to double-check the Earnings Per Share projections on their Stock Selection Guides. Often, the Preferred Method will reveal that the projected earnings per share determined by the trend line may be over-optimistic, and should be adjusted to reflect a more realistic expectation.