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Fundamental Analysis done by an Investor to Purchase Equity Shares

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A B S T R A C T

Fundamental analysis remains one of the most widely used methods to evaluate the intrinsic value of equity shares. This study explores the role of fundamental analysis in the evaluation of equality shares by considering factors like financial statements, key performance ratios, qualitative factors such as management quality to help investors assess companies long term growth prospects and make informed investment decision by combining both quantitative and qualitative assessments, the research employs a top down approach to fundamental analysis highlight the impact economic indicators such as GDP, interest rates, inflation on stock prices. Also to help investors identify overvalued and undervalued stocks the study incorporates company valuation techniques and industry analysis like discounted cash-flow analysis and PE ratio. The study aims to increase investors' understanding so that they can identify undervalued stocks that have huge growth potential in the future.

Keywords: Fundamental analysis, stock valuation, equity investment, financial statements, economic indicators, industry analysis.

1. INTRODUCTION

Investing in equity shares requires in-depth analysis of the macro-economy, the industry and the company's financial health. Fundamental analysis is used by investors for long-term investment in companies. This analysis is used to calculate the intrinsic value of a particular stock. Increasing market volatility and trading done with the help of speculation many retail investors focus on short term price movements rather than focusing on long term wealth creation hence fundamental analysis highlights the importance of rational investment decision making and teach investors how to reduce risk and achieve long term financial goals.

2. OBJECTIVES OF THE STUDY

The objective of the study is listed below:

- To understand the importance of fundamental analysis in selecting a stock.
- Analysis of the key financial statements used in fundamental analysis.
- To analyze the role of both quantitative and qualitative factors in assessing a company's financial health.
- To analyze how macroeconomic factors and industry factors affect the stock price.
- To provide insights into valuation techniques such as discounted cash flow, PE ratio, PB ratio.
- To help investors to identify overvalued or undervalued stock.

3. ABOUT THE TOPIC

Fundamental analysis is used by an investor to identify the real worth of a company's share unlike technical analysis that focuses on charts and patterns and historical price movements fundamental analysis assess the real worth of a company and its future growth potential.

Investors can either do top-down approach or bottom-up approach- In top-down approach first the investor analyses the macroeconomic factors after studying the macroeconomic factors the investor does industry analysis after which he does company analysis, in bottom-up approach the investor starts from company analysis and goes up to economic analysis an investor can do either of the 2 approaches.

This study uses the top-down approach for fundamental analysis:

3.1 Economic analysis-

Is the part of fundamental analysis in which the macroeconomic factors of a country is taken into consideration whether the economic conditions are favorable or not for companies to prosper.

If the economic activity of a country is low example -GDP is low, production is decreasing, and high unemployment and inflation is prevailing in such a situation the stock prices are low but if the economic activity of a country is high stock prices tend to rise.

- Inflation- Increase in the price of goods and services that is purchasing power of money is reducing, high inflation effects the stock market negatively negative inflation is also bad for the economy of a country if the inflation levels are mild that is good.
- Savings and investment- Investment is done through savings done by individuals these savings help in investment which in turn help the stock market to grow.
- GDP- Gross domestic product is the total value of all goods and services in monetary terms produced within a country's borders in a specific time. It is the most used economic indicator that reflects the economic condition of a country GDP indicates the rate of growth of the economy high GDP growth rate is more favorable to the stock market.
- Interest rates- Interest rates effect the cost of borrowing low interest rates means low cost of borrowing which leads to more profitability of a company which leads to the rise in the price of shares under interest rates there are 2 important terms that is first repo rate second Bank rate. Repo rate is the rate at which the RBI lends to commercial banks this hike is transferred by the banks to the customers as a result loans like personal, car, house loans, become more expensive leading to people to spend less this will reduce the supply of money in the economy this reduction of money supply will indirectly control inflation interest rates are controlled by the central bank if inflation is too high that is when the central banks will raise the interest rates. When commercial banks require funds, they borrow funds from RBI the rate at which RBI gives out funds to these banks is called repo rate that is the interest rate that has to be paid sometimes RBI borrows funds from banks, banks get interest on that money that is given this interest is called reverse repo rate. Repo rates are changed time to time by RBI which is the central bank of India all other banks are commercial banks that must comply by the rules and regulations laid out by the Reserve Bank of India. Bank rates are the loans offered by the RBI to the commercial banks without any collateral. If the interest rates are not hiked up that will create excessive supply of money causing inflation hence to control inflation money supply has to be controlled.
- Tax structure- Tax policy concession to certain industries and government tax policies effects the profitability of many companies.
- Monsoon and agriculture- Many industries get their raw material from agriculture like sugar industry, cotton industry, food industry bad monsoon leads to bad agriculture production which effects certain industries negatively that depends on agriculture.
- Infrastructure facilities- Transportation system, banking, school system, sewage system, railway, airport all the above comes under infrastructure good infrastructure development is essential for the growth of various industries and stock market.
- Demographic factors- Like age, income. education, gender are all helpful to forecast the demand, workforce estimation etc.

3.2 Industry analysis-

Industry is a group of companies that produce similar product or service example -pharma industry, information technology industry, automobile industry, fast moving consumer goods industry, steel and cement industry etc.

The factors that must be considered or studied by an investor in industry analysis-

- Nature of the product of the industry- Cement industry, steel industry health depends on the health of the construction industry.
- Cost structure- Fixed and variable cost influences profitability for example the oil and natural gas industry and steel industry have huge fixed cost hence greater sales is required to break even the airlines industry needs a huge amount of revenue for profitability.
- Nature of competition- Many firms present in a particular sector cause competition hence high competition leads to decline in the price of the product.
- Government policy- Government policy may differ from industry to industry for example ITC stock price depends on the tax policy on tobacco.
- Research and development- Research and development for any industry to survive is very important major players that do a lot of R&D include automobile industry, pharma industry.
- SWOT analysis- In SWOT analysis the strengths, weaknesses, opportunities and threats of a particular industry is analysed, and investment decision is made.

3.3 Company analysis-

By doing industry analysis the investor selects a particular industry in which the investor is interested to invest in, once this process is done the investor needs to decide which company has to be selected for investment hence company analysis is done by the investor in company analysis investor collects data related to the company the risk associated with the company and the return potential of the company's stock.

In company analysis the factors that must be considered or studied are as follows-

- Earning of the company-after tax net income in a given quarter or year is to be analysed.
- Capital structure-in this the debt equity mix of the company is to be analysed, if the debt component of a company is high that means the company is highly leveraged and is using a lot of debt to boost its return on equity which might be a good thing when the economy is booming but puts the company at great risk during a recession because during economic recessions companies might not earn as per expectations which might lead to defaulting on loans this puts the company at a huge financial risk which comes under unsystematic risk or company specific risk.
- Management-the management of a company should be efficient and honest with its stakeholders and shareholders to create transparency Among all stakeholder's poor management might put the company under business risk which again comes under unsystematic risk or company specific risk.
- Financial performance-financial analysis is crucial for example analysing the income statement balance sheet or cash flow statement of a company is very important historical financial statements help the investor to predict future profits and future revenue growth and future cash flows.
- Ratio analysis-in ratio analysis investor uses various ratios to assess performance of a company like profitability ratios, valuation ratios, liquidity ratios, debt ratios, activity ratios.
- Other than these the various valuation techniques used to determine whether a stock is undervalued or overvalued is PE ratio, PB ratio, discounted cash flow analysis in which the present value of a share is calculated using future cash flows and dividend yield.

4. FINDINGS

Table 1 - The table represents the key findings of fundamental analysis.

Factors:	**Key insights:**
Macroeconomic conditions	Stocks performed well when the company was growing e.g.- when the GDP was growing significantly. But under performed when the interest rates were hiked, or the inflation rate was high.
Industry conditions	Investing in growing industries like technology and healthcare yielded better returns.
Financial health	Investing in companies having strong balance sheets and low debt to equity ratios were considered less risky.
Valuation	Stocks with low PE and PB ratio had great investment potential as they are undervalued.
Cash flows	Companies that maintained a positive free cash flow and had stability in maintaining efficient cash balance, this indicated strong company sustainability in the long run.
Management quality	The quality of management also affected the performance of the stock in the long run.

5. CONCLUSION

In conclusion, Fundamental analysis gives a framework for an investor in which the investor might either do a top-down approach or bottom-up approach in which the investor may start from economic analysis and go down to company analysis or may start from company analysis and go up to economic analysis. Fundamental analysis gives an investor a long term view about the company and its growth prospects hence by doing this the investor might generate huge returns in the coming years through proper analysis and interpretation of companies. While fundamental analysis provides a strong framework for long term investment, it does not guarantee short term profits as short term profits may depend on multiple factors like market sentiments or new economic policies or new tax policies for industries. By using various valuation tools like PE ratio, PB ratio and discounted cash flow analysis undervalued stocks can be identified to maximize returns.

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