

Donaldson Company (DCI)

\$60.39 (As of 02/01/21)

Price Target (6-12 Months): **\$69.00**

Long Term: 6-12 Months

Zacks Recommendation:
Outperform

(Since: 12/28/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

2-Buy

Zacks Style Scores:

VGM:B

Value: C

Growth: A

Momentum: B

Summary

Donaldson seems well positioned to benefit from solid product offerings, focus on innovation, supply-chain optimization and a diversified business structure in the quarters ahead. Also, strength in replacement parts and process filtration businesses as well as expense management is likely to be beneficial. For second-quarter fiscal 2021, the company expects sales to improve sequentially and for the second half of the fiscal, it anticipates the same to grow year over year. Gross margin in the year is expected to improve. It dedicatedly follows a sound capital-deployment strategy. In addition, the company's shareholder-friendly policies will work in its favor. In the past three months, its shares have outperformed the industry. However, the company is wary of the pandemic-led challenges and has refrained from providing detailed projections.

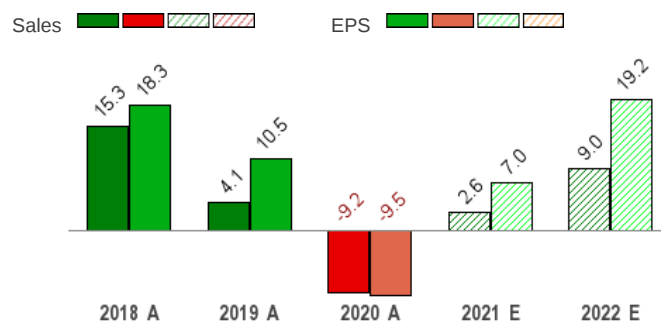
Price, Consensus & Surprise



Data Overview

52-Week High-Low	\$60.93 - \$31.08
20-Day Average Volume (Shares)	488,542
Market Cap	\$7.5 B
Year-To-Date Price Change	6.4%
Beta	1.36
Dividend / Dividend Yield	\$0.84 / 1.4%
Industry	Pollution Control
Zacks Industry Rank	Top 43% (108 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	6.7%
Last Sales Surprise	3.5%
EPS F1 Estimate 4-Week Change	1.4%
Expected Report Date	03/04/2021
Earnings ESP	-0.7%

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2022					2,887 E
2021	637 A	654 E	667 E	683 E	2,648 E
2020	673 A	662 A	630 A	617 A	2,582 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2022					\$2.55 E
2021	\$0.48 A	\$0.51 E	\$0.56 E	\$0.59 E	\$2.14 E
2020	\$0.51 A	\$0.50 A	\$0.50 A	\$0.50 A	\$2.00 A

*Quarterly figures may not add up to annual.

P/E TTM	30.0
P/E F1	28.2
PEG F1	2.7
P/S TTM	3.0

The data in the charts and tables, including the Zacks Consensus EPS and sales estimates, is as of 02/01/2021. The report's text and the analyst-provided price target are as of 02/02/2021.

Overview

Headquartered in Bloomington, MN, Donaldson Company, Inc is engaged in manufacturing and selling of filtration systems and replacement parts across the world. It was founded in 1915.

Leading filtration technology, strong customer relationships and solid presence across diverse geographies are the company's three core strengths. Notably, it has operations in the United States; Europe, Middle East and Africa (EMEA); Asia Pacific and Latin America.

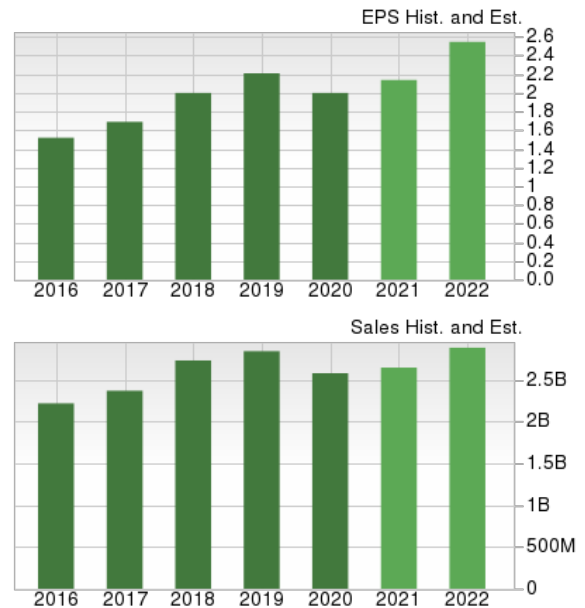
The company has two reportable business segments — Engine Products and Industrial Products. A brief discussion on the segments is provided below:

- **Engine Products** (accounted for 68.5% of net sales in first-quarter fiscal 2021): The segment engages in the manufacturing and selling of air filtration systems, liquid filtration systems (for hydraulics, fuel and lube applications), exhaust and emissions systems, and replacement filters.

The segment's products are mainly used by original equipment manufacturers (OEMs) in the agriculture, construction, aerospace, defense, mining and truck markets. Products are also sold to independent distributors, private label accounts, OEM dealer networks and large equipment fleets.

- **Industrial Products** (31.5%): The segment manufactures and sells dust, mist and fume collectors; air filtration systems (for gas turbines); compressed air purification systems; PTFE membrane-based products; and specialized air and gas filtration systems.

The products are sold to various OEMs (for replacement filters and specific markets), dealers and distributors.



Source: Zacks Investment Research

Reasons To Buy:

- ▲ In first-quarter fiscal 2021, Donaldson's earnings beat estimates by 6.7%, while its sales surpassed the same by 3.5%. In the quarters ahead, the company might benefit from its solid portfolio of replacement and process filtration products, focus on innovation and supply-chain optimization actions, growing e-commerce business and growth investments. Also, a diversified business structure — with exposure in various geographies and end markets like construction, mining, aerospace, defense, and food & beverage — will be a boon for the company. For second-quarter fiscal 2021, the company expects sales to improve sequentially. Also it predicts year-over-year growth for the second half of fiscal 2021, driven by healthy sales at the Advance and Accelerate portfolio.
- ▲ Managing costs is a priority for Donaldson. In first-quarter fiscal 2021, its cost of sales fell 6.2% from the year-ago quarter and operating expenses are down 5% year over year. Its gross margin expanded 60 basis points (bps) on a year-over-year basis, driven by lower raw material costs and favorable sales mix. Operating margin increased 50 bps in the quarter. For fiscal 2021, the company expects operating expenses as a percentage of sales to be flat year over year. For fiscal 2021, its gross margin is expected to improve, driven by healthy sales and benefits from optimization actions. This, in turn, will help in boosting operating margin in the year on a year-over-year basis.
- ▲ Strong cash flows allow Donaldson to effectively deploy capital for repurchasing shares and paying out dividend. In first-quarter fiscal 2021, the company's free cash flow increased 124.7% to \$110.1 million on a year-over-year basis. In the quarter, it repurchased shares worth \$15.6 million and paid out dividends worth \$26.6 million. For fiscal 2021, the company expects free cash flow conversion to be more than 100% and it remains committed toward buying back shares, intending repurchase to be at least 1% of its outstanding shares. Also, the company declared to pay a dividend of 21 cents pertaining to the fourth quarter of fiscal 2021.
- ▲ Donaldson's debt at \$576 million at the end of the first quarter reflected a 6.7% decline from the previous quarter. Its times interest earned were 21.4X, better than 20.3X at the end of the previous quarter. In the past three months, the company's shares have gained 22.2% compared with the industry's growth of 17%. In the past 60 days, the company's earnings estimates improved 6.3% for second-quarter fiscal 2021, 4.4% for fiscal 2021 and 5.8% for fiscal 2022.

Diversified business structure, growth investments and supply-chain optimization actions are anticipated to aid Donaldson in the quarters ahead. Also, its share buybacks and dividend payments bode well.

Risks

- In first-quarter fiscal 2021, Donaldson's results were adversely impacted by the pandemic — with earnings declining 5.9% year over year due to a 5.4% fall in sales. Notably, organic sales in the quarter declined 6.4%. For the quarters ahead, the company is wary about the uncertainties associated with the pandemic and, therefore, refrained from providing detailed projections for fiscal 2021.
 - Despite dedicated toward expense management, Donaldson believes that its performance in the second half of fiscal 2021 might face headwinds from the rise in incentive compensation. Also, a hike in those expenses that got subdued due to the pandemic might be concerning for the company.
 - Donaldson intends to become more competent on the back of overseas business expansion. However, this exposes the company to several economic, political and environmental headwinds as well as movements in foreign currencies. It is worth mentioning here that the company's businesses were down 12.5% in the United States; 3.5% in Europe, Middle East and Africa; and 6.5% in Latin America in the first quarter of fiscal 2021. The pandemic-related challenges might be concerning for the company's geographical performances.
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Last Earnings Report

Donaldson Q1 Earnings & Sales Top Estimates, Decline Y/Y

Donaldson reported impressive results for the first quarter of fiscal 2021 (ended October 31, 2020). Its earnings surpassed the Zacks Consensus Estimate by 6.7% and sales exceeded the same by 3.5%.

The company's earnings in the reported quarter were 48 cents per share, surpassing the Zacks Consensus Estimate of 45 cents. However, the bottom line decreased 5.9% from the year-ago quarter's figure of 51 cents due to sales weakness caused by the pandemic, partially offset by margin improvements.

Quarter Ending 10/2020

Report Date	Dec 03, 2020
Sales Surprise	3.51%
EPS Surprise	6.67%
Quarterly EPS	0.48
Annual EPS (TTM)	1.98

Top-Line Results

In the fiscal first quarter, Donaldson's net sales were \$636.6 million, reflecting a year-over-year decline of 5.4%. The results suffered from a 6.4% fall in organic sales due to the adverse impacts of the pandemic, partially offset by a 1% gain from movements in foreign currencies. However, the top line surpassed the Zacks Consensus Estimate of \$615 million.

On a geographical basis, the company's net sales in the United States decreased 12.5% year over year. Results also suffered from a 3.5% decline in Europe, Middle East and Africa's sales, and 7.9% growth in the Asia Pacific sales. Sales in Latin America declined 6.5% year over year.

The company reports revenues under the following segments — Engine Products and Industrial Products. A brief snapshot of the segmental sales is provided below:

Engine Products' sales were \$436.2 million, reflecting a year-over-year decline of 5%. The results were adversely impacted by a 5.6% fall in Off-Road, 21.4% in On-Road and 0.7% in Aftermarket sales. Also, the company recorded a 26.5% fall in Aerospace and Defense sales.

Revenues generated from Industrial Products were \$200.4 million, decreasing 6.1% from the year-ago quarter. Results suffered from a sales decline of 9% in Industrial Filtration Solutions and a 4.4% fall in Special Applications' sales, partially offset by an 11% rise in Gas Turbine Systems sales.

Margin Profile

In the reported quarter, Donaldson's cost of sales decreased 6.2% year over year to \$413.9 million. It represented 65% of net sales versus 65.6% in the year-ago quarter. Gross margin in the quarter was 35%, up 60 basis points (bps) year over year. The margin results benefitted from sales mix and lower costs related to raw materials.

Operating expenses dipped 5% year over year to \$135.5 million. It represented 21.3% of net sales versus 21.2% in the year-ago quarter. Operating margin in the quarter under review was 13.7%, up 50 bps year over year. Effective tax rate in the quarter was 24.7% as compared with 24.9% in the year-ago quarter.

Balance Sheet & Cash Flow

Exiting first-quarter fiscal 2021, Donaldson's cash and cash equivalents were \$270 million, up 14.4% from \$236.6 million recorded in the last reported quarter. Long-term debt was down 6.7% sequentially to \$576.3 million. In the first quarter, the company repaid the long-term debt of \$40 million.

In the first quarter of fiscal 2021, Donaldson generated net cash of \$128.9 million from operating activities, reflecting an increase of 49.7% from the year-ago figure. Capital expenditure totaled \$18.8 million versus \$37.1 million in the year-ago quarter. Free cash flow in the reported quarter increased 124.7% year over year to \$110.1 million. In the quarter, the company used \$15.6 million for repurchasing shares and \$26.6 million for paying out dividends.

Outlook

Donaldson is wary about the uncertainties related to the pandemic and thus refrained from providing detailed financial projections for fiscal 2021 (ending July 2021).

For second-quarter fiscal 2021 (ending January 2021), the company predicts sales to improve from the previous quarter and expects change on a year-over-year basis to be (4%)-1%. Further, it expects healthy sales at the Advance and Accelerate portfolio and improving economic conditions to aid top-line results in the second half of fiscal 2021.

Also, gains from optimization actions and improved sales are predicted to boost the company's gross margin performance in the quarters ahead.

For fiscal 2021, it expects operating expenses (% of sales) to be flat year over year. Its effective tax rate is expected to be 24-26%, while capital expenditure is likely to be lower year over year and free cash flow conversion is anticipated to exceed 100%. Share buybacks will be 1% of outstanding shares.

Recent News

On **Jan 28, 2021**, Donaldson's board of directors approved payment of a quarterly cash dividend of 21 cents per share to shareholders on record as of Feb 11, 2021. The payment will be made on Feb 26.

Valuation

Donaldson's shares have increased 8.1% in the year-to-date period and 15.2% over the trailing 12-month period. In the year-to-date period, the Zacks sub-industry increased 5%, while the Zacks Industrial Products sector moved up 1.9%. Over the past year, the Zacks sub-industry increased 21.5%, while the Zacks Industrial Products sector moved up 24.4%.

The S&P 500 Index has moved up 0.8% in the year-to-date period and 17.9% in the past year.

The stock is currently trading at 25.74x forward 12-month earnings per share, which compares to 27.42x for the Zacks sub-industry, 22.82x for the Zacks sector and 22.23x for the S&P 500 Index.

Over the past five years, the stock has traded as high as 28.02x and as low as 15.44x, with a 5-year median of 22.64x. Our Outperform recommendation indicates that the stock will perform better than the market. Our price target of \$69 reflects 29.6x forward 12-month earnings.

The table below shows summary valuation data for DCI.

Valuation Multiples - DCI					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	25.74	27.42	22.82	22.23
	5-Year High	28.02	27.95	22.98	23.8
	5-Year Low	15.44	14.29	12.64	15.3
	5-Year Median	22.64	19.03	17.89	17.83
P/S F12M	Current	2.75	2.01	3.43	4.4
	5-Year High	2.77	2.01	3.43	4.4
	5-Year Low	1.56	0.85	1.62	3.2
	5-Year Median	2.26	1.34	2.12	3.68

As of 02/01/2021

Source: Zacks Investment Research

Industry Analysis Zacks Industry Rank: Top 43% (108 out of 253)



Source: Zacks Investment Research

Top Peers

Company (Ticker)	Rec	Rank
CECO Environmental Corp. (CECE)	Neutral	3
Casella Waste Systems, Inc. (CWST)	Neutral	3
Energy Recovery, Inc. (ERII)	Neutral	3
Eaton Corporation, PLC (ETN)	Neutral	3
HeritageCrystal Clean, Inc. (HCCI)	Neutral	3
Sharps Compliance Corp (SMED)	Neutral	2
Tetra Tech, Inc. (TTEK)	Neutral	3
Vertex Energy, Inc (VTNR)	Neutral	3

The positions listed should not be deemed a recommendation to buy, hold or sell.

Industry Comparison Industry: Pollution Control				Industry Peers		
	DCI	X Industry	S&P 500	CWST	HCCI	TTEK
Zacks Recommendation (Long Term)	Outperform	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	2	-	-	3	3	3
VGM Score	B	-	-	C	C	B
Market Cap	7.50 B	124.74 M	26.43 B	2.90 B	520.65 M	6.59 B
# of Analysts	7	3	13	4	4	4
Dividend Yield	1.41%	0.00%	1.47%	0.00%	0.00%	0.56%
Value Score	C	-	-	C	B	C
Cash/Price	0.04	0.08	0.06	0.01	0.10	0.02
EV/EBITDA	18.01	16.05	14.74	23.74	16.05	22.62
PEG F1	2.69	2.34	2.38	NA	2.14	2.34
P/B	7.14	2.83	3.59	19.62	1.92	5.96
P/CF	22.22	21.13	14.94	21.13	12.74	27.94
P/E F1	28.22	35.11	19.57	57.47	32.15	35.11
P/S TTM	2.95	1.65	2.86	3.78	1.26	2.22
Earnings Yield	3.60%	2.85%	4.98%	1.75%	3.13%	2.85%
Debt/Equity	0.55	0.12	0.68	3.59	0.11	0.25
Cash Flow (\$/share)	2.72	0.15	6.83	2.73	1.71	4.44
Growth Score	A	-	-	B	D	B
Historical EPS Growth (3-5 Years)	9.28%	20.81%	9.46%	58.93%	24.80%	16.82%
Projected EPS Growth (F1/F0)	6.93%	18.57%	12.64%	18.57%	152.34%	6.21%
Current Cash Flow Growth	-6.61%	18.75%	4.97%	18.75%	23.35%	3.40%
Historical Cash Flow Growth (3-5 Years)	3.19%	14.42%	8.19%	57.80%	46.55%	3.19%
Current Ratio	2.73	1.64	1.38	0.84	1.87	1.37
Debt/Capital	35.81%	17.75%	41.49%	78.21%	9.84%	19.98%
Net Margin	9.97%	-0.20%	10.61%	4.85%	1.08%	6.04%
Return on Equity	25.84%	5.36%	15.23%	33.65%	3.29%	18.12%
Sales/Assets	1.12	0.95	0.50	0.80	0.90	1.26
Projected Sales Growth (F1/F0)	2.58%	5.05%	5.74%	6.91%	9.57%	3.72%
Momentum Score	B	-	-	C	D	A
Daily Price Change	1.60%	0.99%	1.27%	0.75%	0.32%	2.02%
1-Week Price Change	0.07%	-3.90%	-4.02%	-4.14%	-3.90%	-14.64%
4-Week Price Change	9.96%	38.60%	1.41%	-4.69%	3.13%	8.63%
12-Week Price Change	16.25%	61.27%	5.46%	-1.84%	0.88%	9.14%
52-Week Price Change	15.18%	36.33%	8.48%	13.41%	-23.85%	42.16%
20-Day Average Volume (Shares)	488,542	96,745	2,080,548	357,543	62,731	384,398
EPS F1 Estimate 1-Week Change	0.00%	0.00%	0.00%	0.00%	0.00%	6.61%
EPS F1 Estimate 4-Week Change	1.35%	0.00%	0.30%	0.00%	0.00%	6.61%
EPS F1 Estimate 12-Week Change	5.80%	5.80%	1.44%	-0.90%	-3.23%	7.32%
EPS Q1 Estimate Monthly Change	0.91%	0.91%	0.12%	20.00%	0.00%	1.36%

Source: Zacks Investment Research

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we maintain a balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	A
Momentum Score	B
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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Returns quoted represent past performance which is no guarantee of future results. Investment returns and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than their original cost. Current performance may be higher or lower than the performance shown.

Investing involves risk; principal loss is possible. There is no guarantee that companies that can issue dividends will declare, continue to pay or increase dividends.

Glossary of Terms and Definitions

52-Week High-Low: The range of the highest and lowest prices at which a stock has traded during the past year. This range is determined based on the stock's daily closing price which may differ from the intra-day high or low. Many investors use it as a technical indicator to determine a stock's current value and future price movement. The idea here is that if price breaks out from the 52-week range, in either direction, the momentum may continue in the same direction.

20-Day Average Volume (Shares): The average number of shares of a company traded in a day over the last 20 days. It is a direct indication of a security's overall liquidity. The higher the average daily trading volume, the easier it is to enter or exit the stock at a desired price with more buyers and sellers being available.

Daily Price Change: This is the percentage difference between a trading day's closing price and the prior trading day's closing price. This item is updated at 9 p.m. EST each day.

1-Week Price Change: This is the percentage change in a stock's closing price over the last 5 trading days. This change reflects the collective buying and selling sentiment over the 1-week period.

A strong weekly price increase for the stock, especially when accompanied by increased volume, is an indication of it gaining momentum.

4-Week Price Change: This is the percentage change in a stock's closing price over the last 20 trading days or past 4 weeks. This is a medium-term price change metric and an indication of the stock gaining momentum.

12-Week Price Change: This is the percentage change of a stock's closing price over the last 60 trading days or past 12 weeks. Similar to 4-week price change, this is a medium-term price change metric. It shows whether a stock has been enjoying strong investor demand, or if it has been in consolidation, or distress over this period.

52-Week Price Change: This is the percentage change in a stock's closing price over the last 260 trading days or past 52 weeks. This long-term price change metric is a good reference point for investors. Some investors seek stocks with the best percentage price change over the last 52 weeks, expecting the momentum to continue.

Market Cap: The number of outstanding common shares of a company times its latest price per share. This figure represents a company's size, which indicates various characteristics, including price stability and risk, in which investors could be interested.

Year-To-Date Price Change: Change in a stock's daily closing price in the period of time beginning the first day of the current calendar year through to the previous trading day.

of Analysts: Number of EPS estimates used in calculating the current-quarter consensus. These estimates come from the brokerage analysts tracking this stock. However, the number of such analysts tracking this stock may not match the number of estimates, as all brokerage analysts may not come up with an estimate or provide it to us.

Beta: A measure of risk commonly used to compare the volatility of a stock to the overall market. The S&P 500 Index is the base for calculating beta and carries a value of 1. A stock with beta below 1 is less risky than the market as a whole. And a stock with beta above 1 is riskier.

Dividend: The portion of earnings a company is expected to distribute to its common shareholders in the next 12 months for each share they own. Dividends are usually paid quarterly. Dividend payments reflect positively on a company and help maintain investors' trust. Investors typically find dividend-paying stocks appealing because the dividend adds to any market price appreciation to result in higher return on investment (ROI). Moreover, a steady or increasing dividend payment provides investors a cushion in a down market.

Dividend Yield: The ratio of a company's annual dividend to its share price. The annual dividend used in the ratio is calculated based on the most recent dividend paid by the company. Dividend yield is an estimate of the dividend-only return from a stock in the next 12 months. Since dividend itself doesn't change frequently, dividend yield usually changes with a stock's price movement. As a result, often an unusually high dividend yield is a result of weak stock price.

S&P 500 Index: The Standard & Poor's 500 (S&P 500) Index is an unmanaged group of securities considered to be representative of the stock market in general. It is a market-capitalization-weighted index of stocks of the 500 largest U.S. companies. Each stock's weight in the index is proportionate to its market value.

Industry: One of the 250+ groups that Zacks classifies all stocks into based on the nature of business. These groups are termed as expanded (aka "X") industries and map to their respective (economic) sectors; Zacks has 16 sectors.

Zacks Industry Rank: The Zacks Industry Rank is determined by calculating the average Zacks Rank for all stocks in the industry and then assigning an ordinal rank to it. For example, an industry with an average Zacks Rank of 1.6 is better than an industry with an average Zacks Rank of 2.3. So, the industry with the better average Zacks Rank would get a better Zacks Industry Rank. If an industry has the best average Zacks Rank, it would be considered the top industry (1 out of 250+), which would place it at the top 1% of Zacks-ranked industries. Studies have shown that roughly half of a stock's price movement can be attributed to the industry group it belongs to. In fact, the top 50% of Zacks-ranked industries outperforms the bottom 50% by a factor of more than 2 to 1.

Last EPS Surprise: The percentage deviation of a company's last reported earnings per share from the Zacks Consensus Estimate. Companies with a positive earnings surprise are more likely to surprise again in the future (or miss again if they recently missed).

Last Sales Surprise: The percentage deviation of a company's last reported sales from the Zacks Consensus Estimate.

Expected Report Date: This is an estimated date of a company's next earnings release. The information originated or gathered by Zacks Investment Research from its information providers or publicly available sources is the basis of this estimate.

Earnings ESP: The Zacks Earnings ESP compares the Most Accurate Estimate to the Zacks Consensus Estimate for the yet-to-be reported quarter. The Most Accurate Estimate is the most recent version of the Zacks Consensus EPS Estimate. The idea here is that analysts revising their estimates closer to an earnings release have the latest information, which could potentially be more accurate than what they and others contributing to the consensus had predicted earlier. Thus, a positive or negative Earnings ESP reading theoretically indicates the likely deviation of the actual earnings from the consensus estimate. However, the model's predictive power is significant for positive ESP readings only. A positive Earnings ESP is a strong predictor of an earnings beat, particularly when combined with a Zacks Rank #1 (Strong Buy), #2 (Buy) or #3 (Hold). Our research shows that stocks with this combination produce a positive surprise nearly 70% of the time.

Periods:

TTM: Trailing 12 months. Using TTM figures is an effective way of analyzing the most-recent financial data in an annualized format that helps neutralize the effects of seasonality and other quarter-to-quarter variation.

F1: Current fiscal year. This period is used to analyze the estimates for the ongoing full fiscal year.

F2: Next fiscal year. This period is used to analyze the estimates for the next full fiscal year.

F12M: Forward 12 months. Using F12M figures is an effective way of analyzing the near-term (the following four unreported quarters) estimates in an annualized manner. Instead of typically representing estimates for the full fiscal year, which may not represent the nitty-gritty of each quarter, F12M figures suggest an all-inclusive annualized estimate for the following four quarters. The annualization helps neutralize the potential effects of seasonality and other quarter-to-quarter variations.

P/E Ratio: The price-to-earnings ratio measures a company's current market price per share relative to its earnings per share (EPS). Usually, the trailing-12-month (TTM) EPS, current-fiscal-year (F1) EPS estimate, or forward-12-month (F12M) EPS estimate is used as the denominator. In essence, this ratio shows what the market is willing to pay today for each dollar of EPS. In other words, this ratio gives a sense of what the relative value of the company is at the already reported level of earnings or at a future level of earnings.

It is one of the most widely-used multiples for determining the value of a company and helps comparing its valuation with that of a competitor, the industry group or a benchmark.

PEG Ratio: The price/earnings to growth ratio is a stock's P/E ratio using current fiscal year (F1) EPS estimate divided by its expected EPS growth rate over the coming 3 to 5 years. This ratio essentially determines a stock's value by factoring in the company's expected earnings growth and is thus believed to provide a more complete picture than just the P/E ratio, particularly for faster-growing companies.

P/S Ratio: The price-to-sales ratio is calculated as a company's current price per share divided by trailing 12 months (TTM) sales or revenues per share. This ratio shows what the market is willing to pay today for each dollar of TTM sales per share. The P/S ratio is at times the only valuation metric when the company has yet to become profitable.

Cash/Price Ratio: The cash-to-price ratio or Cash Yield is calculated as cash and marketable securities per share divided by the company's current share price. Like the earnings yield, which shows the anticipated yield (or return) on a stock from earnings for each dollar invested, the cash yield does the same, with cash being the source of return instead of earnings. For example, a cash/price ratio of 0.08 suggests a return of 8% or 8 cents for every \$1 investment.

EV/EBITDA Ratio: The EV/EBITDA ratio, also known as Enterprise Multiple, is calculated as a company's enterprise value (market capitalization + value of total long-term debt + book value of preferred shares - cash and marketable securities) divided by EBITDA (earnings before interest, taxes, depreciation and amortization). Usually, trailing-12-month (TTM) or forward-12-month (F12M) EBITDA is used as the denominator.

EV/Sales Ratio: The enterprise value-to-sales ratio is calculated as a company's enterprise value (market capitalization + value of total long-term debt + book value of preferred shares - cash and marketable securities) divided by annual sales. It is an expansion of the P/S valuation, which uses market value instead of enterprise value. The EV/Sales ratio is perceived as more accurate than P/S, in part, because the market capitalization does not take a company's debt into account when valuing it.

EV/CF Ratio: The enterprise value-to-cash flow ratio is calculated as a company's enterprise value (market capitalization + value of total long-term debt + book value of preferred shares - cash and marketable securities) divided by the trailing-12-month (TTM) operating cash flow. It's a measure of how long it would take to buy the entire business if you were able to use all the company's operating cash flow.

The EV/CF ratio is perceived as more accurate than the P/CF ratio, in part, because the market price does not take a company's debt into account when valuing it.

EV/FCF Ratio: The enterprise value-to-free cash flow metric compares a company's enterprise value to its trailing-12-month (TTM) free cash flow (FCF). This metric is very similar to the EV/CF ratio, but is considered a more exact measure owing to the fact that it uses free cash flow, which subtracts capital expenditures (CAPEX) from a company's total operating cash flow, thereby reflecting the actual cash flow available for funding growth activities and payments to shareholders.

P/EBITDA Ratio: The P/EBITDA ratio is calculated as a company's per share market value divided by EBITDA (earnings before interest, taxes, depreciation, and amortization). This metric is very similar to the EV/EBITDA ratio, but is considered a little less exact measure as it uses market price, which does not take a company's debt into account. However, since EBITDA is often considered a proxy for cash income, the metric is used as a measure of what the market is willing to pay today for each dollar of the company's cash profitability in the trailing 12 months (TTM) or forward 12 months (F12M).

P/B Ratio: The price-to-book ratio is calculated as a company's current price per share divided by its book value (total assets – liabilities – preferred stocks) per share. In short, the book value is how much a company is worth. In other words, it reflects the total value of a company's assets that its common shareholders would receive if it were to be liquidated. So, the P/B ratio indicates whether you're paying higher or lower than what would remain if the company went bankrupt immediately. Investors typically use this metric to determine how a company's stock price stacks up to its intrinsic value.

P/TB Ratio: The price-to-tangible-book value ratio is calculated as a the per share market value of a company divided by the value of its tangible assets (total assets – liabilities – preferred stocks – intangible assets) per share. Tangible book value is the same thing as book value except it excludes the value of intangible assets to get a step closer to the baseline value of the company.

P/CF Ratio: The price-to-cash flow ratio measures a company's per share market price relative to its trailing-12-month (TTM) operating cash flow per share. This metric is used to determine whether a company is undervalued or overvalued relative to another stock, industry or sector. And like the P/E ratio, a lower number is typically considered better from the value perspective.

One of the reasons why P/CF ratio is often preferred over P/E ratio is the fact that operating cash flow adds back non-cash expenses such as depreciation and amortization to net income. This feature helps valuing stocks that have positive cash flow but are not profitable because of large noncash charges.

P/FCF Ratio: The price-to-free cash flow ratio is an extension of P/CF ratio, which uses trailing-12-month (TTM) free cash flow per share instead of operating cash flow per share. This metric is considered a more exact measure than P/CF ratio, as free cash flow subtracts capital expenditures (CAPEX) from a company's total operating cash flow, thereby reflecting the actual cash flow available for funding activities that generate additional revenues.

Earnings Yield: The earnings yield is calculated as current fiscal year (F1) EPS estimate divided by the company's current share price. The ratio, which is the inverse of the P/E ratio, measures the anticipated yield (or return) from earnings for each dollar invested in a stock today.

For example, earnings yield for a stock, which is trading at \$35 and expected to earn \$3 per share in the current fiscal year (F1), would be 0.0857 ($3/35 = 0.0857$) or 8.57%. In other words, for \$1 invested in the stock today, the yield from earnings is anticipated to be 8.57 cents.

Investors most commonly compare the earnings yield of a stock to that of a broad market index (such as the S&P 500) and prevailing interest rates, such as the current 10-year Treasury yield. Since bonds and stocks compete for investors' dollars, stock investors typically demand a higher yield for the extra risk they assume compared to investors of U.S. Treasury-backed securities that offer virtually risk-free returns. This additional return is referred to as the risk premium.

Debt/Equity Ratio: The debt-to-equity ratio is calculated as a company's total liabilities divided by its shareholder equity. This metric is used to gauge a company's financial leverage. In other words, it is a measure of the degree to which a company is financing its operations through debt versus its own funds. The higher the ratio, the higher the risk for shareholders.

However, this ratio is difficult to compare across industry groups where ideal amounts of debt vary. Some businesses are more capital intensive than others and typically require higher debt to finance their operations. So, a company's debt-to-equity ratio should be compared with other companies in the same industry.

Cash Flow (\$/share): Cash flow per share is calculated as operating cash flow (after-tax earnings + depreciation + other non-cash charges) divided by common shares outstanding. It is used by many investors as a measure of a company's financial strength. Since cash flow per share takes into consideration a company's ability to generate cash by adding back non-cash expenses, it is regarded by some as a more accurate measure of a company's financial situation than earnings per share, which could be artificially deflated.

Current Ratio: The current ratio or liquidity ratio is a company's current assets divided by its current liabilities. It measures a company's ability to pay short-term obligations. A current ratio that is in line with the industry average or slightly higher is generally considered acceptable. A current ratio that is lower than the industry average would indicate a higher risk of distress or default. A higher number is usually better. However, a very high current ratio compared to the industry average could be an indication of inefficient use of assets by management.

Debt/Capital Ratio: Debt-to-capital ratio is a company's total debt (interest-bearing debt + both short- and long-term liabilities) divided its total capital (interest-bearing debt + shareholders' equity). It is a measure of a company's financial leverage. All else being equal, the higher the debt-to-capital ratio, the riskier the stock.

However, this ratio can vary widely from industry to industry, the ideal amount of required debt being different. Some businesses are more capital intensive than others and typically require higher debt to finance their operations. So, a company's debt-to-capital ratio should be compared with the same for its industry.

Net Margin: Net margin is calculated as net income divided by sales. It shows how much of each dollar in sales generated by a company translates into profit. For example, if a company's net margin is 15%, its net income is 15 cents for every \$1 of sales it makes.

A change in margin can reflect either a change in business conditions, or a company's cost controls, or both. If a company's expenses are growing faster than sales, its net margin will decline. However, different net margin rates are considered good for different industries, so it's better to compare net margin rates of companies in the same industry group.

Return on Equity: Return on equity (ROE) is calculated as trailing-12-month net income divided by trailing-12-month average shareholder equity (including reinvested earnings). This metric is considered a measure of how effectively management is using a company's assets to generate profits. For example, if a company's ROE is 10%, it creates 10 cents profits for every \$1 shareholder equity, which is basically the company's assets minus debt. A company's ROE deemed good or bad depends on what's normal for its peers or industry group.

Sales/Assets Ratio: The sales-to-assets ratio or asset utilization ratio or asset turnover ratio is calculated as a company's annual sales divided by average assets (average of assets at the beginning of the year and at the year's end). This metric helps investors understand how effectively a company is using its assets to generate sales. For example, a sales-to-assets ratio of 2.5 indicates that the company generated \$2.50 in sales for every \$1 of assets on its books.

The higher the sales-to-assets ratio, the better the company is performing. However, similar to many other ratios, the asset turnover ratio tends to be higher for companies in certain industries/sectors than in others. So, a company's sales-to-assets ratio should be compared with the same for its industry/sector.

Historical EPS Growth (3-5 Years): This is the average annual (trailing-12-month) EPS growth rate over the last 3-5 years. This metric helps investors see how a company's EPS has grown from a long-term perspective.

Note: There are many factors that can influence short-term numbers — a recession will reduce this number, while a recovery will inflate it. The longterm perspective helps smooth out short-term events.

Projected EPS Growth (F1/F0): This is the estimated EPS growth rate for the current financial year. It is calculated as the consensus estimate for the current fiscal year (F1) divided by the reported EPS for the last completed fiscal year (F0).

Current Cash Flow Growth: It measures the latest year-over-year change in operating cash flow. Cash flow growth tells an investor how quickly a company is generating inflows of cash from operations. A positive change in the cash flow is desired and shows that more 'cash' is coming in than going out.

Historical Cash Flow Growth (3-5 Years): This is the annualized change in cash flow over the last 3-5 years. The change in a longer period helps put the current reading into proper perspective. By looking at the rate, rather than the actual dollar value, the comparison across the industry and peers becomes easier.

Projected Sales Growth (F1/F0): This metric looks at the estimated sales growth for the current year. It is calculated as sales estimate for the current fiscal year (F1) divided by the reported sales for the last completed fiscal year (F0).

Like EPS growth, a higher rate is better for sales growth. A look at a company's projected sales growth instantly tells you what the outlook is for their products and services. However, different sales growth rates are considered good for different industries, so it's better to compare sales growth rates of companies in the same industry group.

EPS F1 Estimate 1-Week Change: The percentage change in the Zacks Consensus EPS estimate for the current fiscal year over the past week. The change in a company's consensus EPS estimate (or earnings estimate revision) has proven to be strongly correlated with the near-term price movement of its shares. It is an integral part of the Zacks Rank.

If a stock's consensus EPS estimate is \$1.10 now versus \$1.00 a week ago, that will be reflected as a 10% upward revision. If, on the other hand, it went from \$1.00 to 90 cents, that would be a 10% downward revision.

EPS F1 Estimate 4-Week Change: The percentage change in the Zacks Consensus EPS estimate for the current fiscal year over the past four weeks.

A stock's earnings estimate revision in a 1-week period is important. But it's more meaningful to look at the longer-term revision. And, of course, the 4-week change helps put the 1-week change into proper perspective.

EPS F1 Estimate 12-Week Change: The percentage change in the Zacks Consensus EPS estimate for the current fiscal year over the past 12 weeks.

This metric essentially shows how the consensus EPS estimate has changed over a period longer than 1 week or 4 weeks.

EPS Q1 Estimate Monthly Change: The percentage change in the Zacks Consensus EPS estimate for the current fiscal quarter over the past four weeks.

While the revision in consensus EPS estimate for the current fiscal year is strongly correlated with the near-term price movement of its shares, the estimate revision for the current fiscal quarter is an important metric as well, especially over the short term, and particularly as a stock approaches its earnings date. If a stock's Q1 EPS estimate decreases ahead of its earnings release, it's usually a negative sign, whereas an increase is a positive sign.