The Top Quality Company Selection Handbook

Episode 6: Master Reference Guide

Building wealth in the stock market requires a "Filter First" approach. Before looking at the stock price, we must audit the company's "Medical Report" (Financial Ratios).

1. The 7-Step Quality Search Workflow

Before diving into ratios, follow this logical sequence to filter the 5,000+ listed companies:

1. **Macro Filter:** Is the country's GDP growing? (Episode 2)
2. **Sector Check:** Is the industry (e.g., EV 2-Wheelers) in an uptrend?
3. **Liquidity Audit:** Can they pay their bills today?
4. **Solvency Audit:** Is the debt a "Ladder" or a "Noose"?
5. **Efficiency Audit:** Are they collecting cash or just booking paper profits?
6. **Profitability Audit:** Is the return on capital better than a Bank FD?
7. **Valuation Check:** Am I paying for a Ferrari but getting a Cycle?

Pillar 1: Liquidity (The Survival Test)

Can the company survive the next 12 months without a crisis?

A. Current Ratio

Formula: `Current Assets / Current Liabilities`

- **The Logic:** It measures the "Margin of Safety." If a company has ₹2 in assets for every ₹1 it owes in the short term, it can survive a bad sales month.
- **Live Example: * Bajaj Auto:** Current Ratio ~1.55 (Healthy).
  - **Ola Electric:** Current Ratio ~1.95 (Highly liquid due to recent IPO funding, but needs to be watched for "Cash Burn").

Pillar 2: Solvency & Leverage (The Strength Test)

Is the company built on solid ground or a mountain of debt?

B. Debt-to-Equity (D/E) Ratio

Formula: `Total Borrowings / Total Equity`

- **The Logic:** This tells you who owns the company—the Shareholders or the Bank. High debt during high-interest-rate cycles can kill a company.
- **Mentor's Secret:** Always check the **Interest Coverage Ratio** alongside D/E. If a company has debt but its profits cover the interest 10 times over, it is safe.

- **Live Example:**
  - **Hero MotoCorp:** D/E of 0.02 (Virtually Debt-Free).
  - **TVS Motor:** D/E of ~0.85. **Note:** Higher than peers because it finances its own customers through TVS Credit.

C. Trade Receivables (The "Real Cash" Check)

- **The Logic:** If Trade Receivables are growing faster than Sales, the company is selling goods but not collecting cash. It's a "Paper Profit."
- **Red Flag:** High Trade Receivables + Low Cash Balance = High Risk of Bankruptcy.

Pillar 3: Profitability (The Efficiency Test)

Is the management using your money wisely?

D. Return on Capital Employed (ROCE)

Formula: `EBIT / (Total Assets - Current Liabilities)`

- **The Logic:** This is the ultimate "Report Card." If a company takes ₹100 from investors and lenders and generates only ₹5 profit (5% ROCE), you are better off keeping your money in a Savings Account.
- **Target:** Look for companies with **ROCE > 20%**.
- **Live Example:** * **Eicher Motors:** ROCE ~28%. This is why it is a market darling; it is a cash-generating machine.

Pillar 4: Valuation (The Price Test)

Am I overpaying for quality?

E. Price-to-Earnings (P/E) Ratio

Formula: `Market Price per Share / Earnings per Share (EPS)`

- **The Logic:** It tells you how many years of profits you are paying upfront. A P/E of 50 means you are paying for 50 years of current profits today.
- **Valuation Logic:** High Quality (High ROCE) + High Growth usually commands a High P/E. But beware of "Cyclical Highs."

⚡ Shortcuts: Extracting Data in 60 Seconds

Don't be a data entry operator. Can Use **Screener.in** to automate your Episode 6 assignment:

1. **The Query Trick:** Go to Screener > Screens > Create New Screen.
2. **The Code:** `Return on capital employed > 20% AND Debt to equity < 0.5 AND Current ratio > 1.5`
3. **The Result:** From 5,000 stocks, you will be left with the top 5% Quality companies in India instantly.

Conclusion: As DebtToEquity ratio is Important, Which Profitability Ratio is Most Important?

If you could only look at **one** number, look at **ROCE (Return on Capital Employed)**.

Why? Because a company with high ROCE can pay off its debt (Solvency), keep enough cash (Liquidity), and eventually, the market will reward it with a higher price (Valuation). ROCE is the "Heartbeat" of a Top Quality Company.

Assignment for Students: Pick 5 Industries. Create a table with these 5 ratios. Highlight the "Quality Leader" in Green and the "Risky Player" in Red based on the logic above.

Thankyou,
See in the Next Live Class