P/E ratio- what you need to know

The price-earnings ratio (P/E) is hands down the most popular ratio among investors. Value investors have long considered the price-earnings ratio a useful metric for evaluating the relative attractiveness of a company's stock price. Made popular by the late Benjamin Graham, who was dubbed the 'father of value investing' as well as Warren Buffett's mentor, Graham preached the virtues of this financial ratio as one of the quickest and easiest ways to determine if a stock is trading on an investment or speculative basis. When it comes to valuing stocks, the price/earnings ratio is one of the oldest and most frequently used metrics.
Although a simple indicator to calculate, the P/E is actually quite difficult to interpret. It can be extremely informative in some situations, while at other times it is next to meaningless. As a result, investors often misuse this term and place more value in the P/E than is warranted.

In this article, we'll introduce you to the P/E ratio and discuss how it can be used in security analysis and perhaps more importantly, how it should not be used.

P/E calculation

P/E is short for the ratio of a company's share price to its per-share earnings. As the name implies, to calculate the P/E, you simply take the current stock price of a company and divide it by its earnings per share (EPS):

If XYZ PLC is trading at Rs.60 a share, for instance, and earnings came in at Rs.3 a share, its P/E would be 20 (60/3). That means investors are paying Rs.20 for every Rs.1 of the company's earnings. If the P/E slips to 18, they're only willing to pay Rs.18 for that same Rs.1 profit. (This number is also known as a stock's 'multiple', as in XYZ PLC is trading at a multiple of 20 times earnings.)

Most of the time, the P/E is calculated using EPS from the last four quarters. This is also known as the 'trailing' P/E. However, occasionally the EPS figure comes from estimated earnings expected over the next four quarters. This is known as the 'projected' P/E or 'forward' P/E. A third variation that is also sometimes seen, uses the EPS of the past two quarters and estimates of the next two quarters.

There isn't a huge difference between these variations. But it is important to realize that in the first calculation, you are using actual historical data. The other two calculations are based on analyst estimates that are not always perfect or precise.

Which is better? The trailing P/E has the advantage that it deals in facts -- its denominator is the audited earnings number the company reported to the Colombo Stock Exchange. Its disadvantage is that those earnings will almost certainly change -- for better or worse -- in the future. By using an estimate of future earnings, a forward P/E takes expected growth into account. And though the estimate may turn out to be wrong, it at least helps investors anticipate the future the same way the market does when it prices a stock.

For example, suppose you have two stocks in the same industry – XYZ PLC and TTT PLC with identical trailing P/Es of 20. XYZ has a stock price of $60 and earnings of $3, while TTT has a stock price of $80 and earnings of $4. They may look like similar investments until you check out the forward P/E. The market is projecting that XYZ's earnings will grow to $3.75 a share, 25% growth -- while TTT's earnings are only expected to grow by 6% to $4.25. In that case, XYZ's forward P/E slips to 16, while TTT would be valued with a forward P/E of 18.8. Assuming the estimates bear out, XYZ would clearly be the better buy.

Companies that aren't profitable and consequently have a negative EPS, pose a challenge when it comes to calculating their P/E. Opinions vary on how to deal with this. Some say there is a negative P/E, others give a P/E of 0, while most just say the P/E doesn't exist.

Market P/E fluctuates significantly depending on economic conditions. The P/E can also vary widely between different companies and industries.

Growth of earnings

Although the EPS figure in the P/E is usually based on earnings from the last four quarters, the P/E is more than a measure of a company's past performance. It also takes into account market expectations for a company's growth.
Remember, stock prices reflect what investors think a company will be worth. Future growth is already accounted for in the stock price. As a result, a better way of interpreting the P/E ratio is as a reflection of the market's optimism concerning a company's growth prospects.
If a company has a P/E higher than the market or industry average, this means that the market is expecting big things over the next few months or years. A company with a high P/E ratio will eventually have to live up to the high rating by substantially increasing its earnings, or the stock price will need to drop.

Cheap or expensive?

The P/E ratio is a much better indicator of the value of a stock than the market price alone. For example, all things being equal, a Rs.10 stock with a P/E of 75 is much more 'expensive' than a Rs.100 stock with a P/E of 20. That being said, there are limits to this form of analysis - you can't just compare the P/Es of two different companies to determine which is a better value.

It's difficult to determine whether a particular P/E is high or low without taking into account two main factors:

1. Company growth rates - How fast has the company been growing in the past and are these rates expected to increase, or at least continue, in the future? Something isn't right if a company has only grown at 5% in the past and still has a stratospheric P/E. If projected growth rates don't justify the P/E, then a stock might be overpriced. In this situation, all you have to do is calculate the P/E using projected EPS.
2. Industry - It is only useful to compare companies if they are in the same industry. For example, some sectors typically have low multiples because they are low growth, stable industries. In contrast, some sectors are characterized by phenomenal growth rates and constant change. Comparing those is useless. You should only compare high-growth companies to others in the same industry, or to the industry average.

So far we've learned that in the right circumstances, the P/E ratio can help us determine whether a company is over or undervalued. But P/E analysis is only valid in certain circumstances and it has its pitfalls. Some factors that can undermine the usefulness of the P/E ratio include:

Accounting

Earnings is an accounting figure that includes non-cash items. Furthermore, the guidelines for determining earnings are governed by accounting rules that change over time and are different in each country. To complicate matters, EPS can be twisted, prodded and squeezed into various numbers depending on how you do the books. The result is that we often don't know whether we are comparing the same figures, or apples to oranges.

Inflation

In times of high inflation, inventory and depreciation costs tend to be understated because the replacement costs of goods and equipment rise with the general level of prices. Thus, P/E ratios tend to be lower during times of high inflation because the market sees earnings as artificially distorted upwards. As with all ratios, it's more valuable to look at the P/E over time in order to determine the trend. Inflation makes this difficult, as past information is less useful today.

Many interpretations

A low P/E ratio does not necessarily mean that a company is undervalued. Rather, it could mean that the market believes the company is headed for trouble in the near future. Stocks that go down usually do so for a reason. It may be that a company has warned that earnings will come in lower than expected. This wouldn't be reflected in a trailing P/E ratio until earnings are actually released, during which time the company might look undervalued.

If a company is in the growth phase of their business cycle, the P/E ratio is probably high. This means that their earnings are still relatively low or even negative since they are new in the marketplace and just getting started. Their stock price may be high since investors are trading on the potential of the firm. A price-earnings ratio that is too high, however, often means the company carriers a lot of risk.

Security analysis requires a great deal more than understanding a few ratios. While the P/E is one part of the puzzle, it's definitely not a crystal ball.
What have we learned about the P/E ratio? Although the P/E often doesn't tell us much, it can be useful to compare the P/E of one company to another in the same industry, to the market in general, or to the company's own historical P/E ratios.

What strategy should you employ?

Investors panic in a sluggish market. Anyone can make money in a bull market but you require a strategy to stay afloat in a market slump. The theory of 'circle of competence' is the key to financial success, according to Warren Buffett. Here, an investor should choose one particular area or 'circle of competence' to focus his efforts. This should be an area where he has honed his skills and experience.

A software engineer, for instance, has insight into the working and growth prospects of technology companies. A doctor, on the other hand, may have an understanding of the pharmaceutical sector. An investor develops his 'circle of competence' by his past work experience or personal interests.

Some points to remember:

- The P/E ratio is the current stock price of a company divided by its earnings per share (EPS).
- Variations exist using trailing EPS, forward EPS or an average of the two.
- Theoretically, a stock's P/E tells us how much investors are willing to pay per rupee of earnings.
- A better interpretation of the P/E ratio is to see it as a reflection of the market's optimism concerning a firm's growth prospects.
- The P/E ratio is a much better indicator of a stock's value than the market price alone.

- In general, it’s difficult to say whether a particular P/E is high or low without taking into account growth rates and the industry.
- Changes in accounting rules as well as differing EPS calculations can make analysis difficult.
- P/E ratios are generally lower during times of high inflation.
- There are many explanations as to why a company has a low P/E.
- Don’t base any buy or sell decision on the multiple alone.

(Source: Investopedia, The Economic Times)