

P/E RATIO



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P/E RATIO

- The P/E Ratio or 'Price to Earnings' Ratio looks at the relationship between a stock price and company's earnings
- It is a valuation ratio of a company's current share price to its per share earnings
- It is sometimes also referred to as 'Price Multiple' or 'Earnings Multiple'
- The P/E Ratio is the most popular metric of stock analysis, though not the only one



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PE is calculated as...

$$\text{PE} = \frac{\text{Market Value per share}}{\text{Annual earnings per share}}$$

- The market value per share (numerator) is the current market price of a single share
- The annual earnings per share (denominator) is the net income of the company for the most recent 12 months period divided by number of outstanding shares of the company

So, annual Earning Per Share (EPS) = $\frac{\text{Net Income}}{\text{No. of shares}}$



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For Example: A company having share price of Rs. 40 and Earning Per share (EPS) of Rs. 8 would have a P/E ratio of Rs. 5

$$\text{P/E Ratio} = \text{Rs. } 40 / \text{Rs. } 8 = \text{Rs. } 5$$

But what does this P/E ratio tell you?

Essentially, the P/E Ratio gives you an idea of what the market is willing to pay for the company's earnings



How come?



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Some thumb rules:

- A higher P/E Ratio shows willingness of market to pay more for the company's earnings
- Some investors read a high P/E as an over-priced stock, which may be the case sometimes
- However, it can also indicate that the market has high hopes for the share's future and has bid up the price
- Considering our previous example where P/E ratio is 5
- Since this is a ratio of market value to annual earnings depicted as 5:1, this means that the market is prepared to pay Rs. 5 now for every single rupee of earning from a particular stock



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Conversely...

- A low P/E Ratio may indicate 'vote of no-confidence' by the market which means that the investors have undervalued the stock due to lack of confidence in its future growth
- However, it could also mean that this is a stock which has been overlooked by the market and does possess strong future growth potential (a possible contra pick)
- If this is the case, they are considered value stocks and investors sometimes make their fortunes spotting these 'diamonds' before the rest of the market discovers their true value



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So what is the right P/E?...

- There is no correct answer to this question because part of the answer depends on your willingness to pay for earnings
- The more you are willing to pay (high P/E) means that you believe that the company has good long term prospects over and above its current position
- So, for some investors, a P/E of 5 would be a great deal while for some others a P/E of 5 for a particular stock is high
- So, a P/E ratio also depicts the perceived value of a particular stock



Types of P/E



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- **Trailing P/E:** - In the example earlier, we have considered annual earnings per share (EPS), which is the sum of earnings for the last 12 months. This gives 'trailing P/E' or actual P/E based on known earnings figures
- **Forward P/E:-** In the P/E ratio formula, you can use expected earnings per share (next 12 months) in place of previous annual earnings per share. This will give an idea of what could be the best price to pay for a particular share for its anticipated earnings
 - If earnings are expected to grow in the future the estimated P/E will be lower than the current P/E.
 - If the estimated EPS is Rs. 10 and current market price is Rs. 40, then the P/E would be 4 (Rs. 40 / Rs. 10)
 - This P/E is lower than the P/E given in earlier example, where the EPS was lower

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Factors affecting P/E Ratio...

- **Growth** – Better the growth prospects of the company, the more willing people are, to be a part of that company by paying more per rupee of earning
- **Risk** – The higher the risk, the lesser inclination people would have; to invest in equity shares thus affecting share price to an extent
- **Past Track Record** – Track record is a major factor that determines consumer trust and willingness to invest in a particular company
- **Government Vision** – Government's approach and vision for a particular industry and company affects the P/E Ratio. Government restrictions on certain industries affects business of a company and hence its share price
- **Performance of Economy** – General effects on economy; for e.g. monsoon etc. impacts company performance. A good monsoon leads to higher productivity, growth in economy and will reflect on the stock's P/E



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Hope you have now understood
the concept of P/E Ratio.



Thinking of Investment

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