PEG RATIO

PEG RATIO

- The PEG Ratio or 'Price Earnings to Growth' Ratio determines a stock's value while taking into account future earnings growth
- Like the P/E Ratio, the PEG Ratio is used to get a better understanding of whether or not a company's stock is overpriced, under priced or just right (fairly priced)
- The PEG Ratio uses the P/E Ratio of a company and compares it with that company's annual growth rate
- If a company's stock is fairly priced, then its P/E Ratio should equal its annual growth rate.

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PEG RATIO

PEG Ratio is calculated as = PE Ratio / Expected Earnings Growth (%)

$$\text{PEG Ratio} = \frac{\text{PE Ratio}}{\text{Expected Earnings Growth (\%)}}$$

- The P/E Ratio is the ‘Price to Earnings’ Ratio’ (discussed last week)
- The expected earnings growth will be in percentage form and is available from a company’s annual report
- A PEG ratio of 1 suggests equilibrium between market value of stock and anticipated earnings
- It means that the stock is fairly priced and current market price (numerator) justifies the anticipated growth rate (denominator)

PEG RATIO

For Example: A company stock has a P/E of 20. Analysts feel that the stock has an anticipated earnings growth of 12% over the next five years

PEG Ratio = 20 / 12 = 1.66

- **Here, stock price is higher than its earnings growth**
- **This means that market price is higher compared to anticipated earnings growth**
- **This can be attributed to ‘hype’ or undue enthusiasm in the market for that stock**
- **To keep up with the market hype, the company will now have to grow faster**
- **This means that if the company doesn’t grow at a faster rate, the stock price will decrease (stock price correction will occur as hype will die down)**

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Another example…

- **Another company stock has a <u>P/E of 30</u>. Analysts feel that the stock has an anticipated <u>earnings growth of 40%</u> over the next five years**

PEG Ratio = 30 / 40 = 0.75

- **Here, stock price is lower than its earnings growth**
- **This means that market price is lower compared to anticipated earnings growth.**
- **This tells us that the company's stock is undervalued**
- **The stock is trading in line with the growth rate and the stock price has potential to increase in future**

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PEG RATIO

Some thumb rules…

- **PEG Ratio <u>greater</u> than I means:-**
  - **The market's expectation of growth is higher than analysts' estimates**
  - **The stock is currently overvalued due to heightened demand for shares (investor hype)**
- **PEG Ratio less than I means:-**
  - **Markets are under-estimating the projected growth and the stock is thus undervalued (a possible contra pick)**
  - **Analysts' estimates of future earnings growth are currently set too high**

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Advantages of PEG Ratio…

- Investors prefer PEG because it puts a definite value in relation to the expected growth in earnings of a company
- PEG ratio can offer a suggestion of whether a company's high P/E ratio reflects an excessively high stock price or is a reflection of promising growth prospects for the company

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Disadvantages of PEG Ratio…

- **Less appropriate for measuring companies without high growth. Large well-established companies, for instance, may offer dependable dividend income but little opportunity for growth**

- **A company's growth rate is an estimate and is subject to limitations of projecting future events i.e. in this case estimated growth rate is only an estimate based on past trends**

PEG RATIO

Hope you have now understood the concept of PEG Ratio.

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Thinking of Investment

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