PRICE-TO-BOOK RATIO

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PRICE-TO-BOOK RATIO

- **Simply speaking, the Price-to-book ratio (i.e. P/B ratio) is the ratio of Price of a stock to that of the value of its tangible assets and is used to compare a stock's market value to its book value.**

- **Book value is an accounting term denoting the tangible value of the company. It is the total tangible value made up of the assets of the company. Intangibles like “brand” name and “goodwill” are not a part of the book value.**

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It is calculated as:

$$\text{P/B Ratio} = \frac{\text{Stock Price}}{\text{Total Assets – Intangible Assets and Liabilities}}$$

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Therefore…

- **What this means is that the lower the P/B, the better the value.**
- **A lower P/B ratio could mean the price that the market is quoting does not justify the current value of the assets of the company that it presently holds.**
- **One must remember that people pay a price of a stock not only based on its current assets but also based on future prospects of the company / industry in which it operates.**

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Secondly…

- **The value of intangibles such as goodwill, brand name, management team etc can be considerable and stock buyers pay quite a premium for such intangibles.**

- **Hence, if the intangibles are valuable or if people believe that the company has good prospects in the future, they normally would be willing to pay a much higher price as compared with the value of its current assets.**

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Hence…

- **Despite positive outlook for the industry, if the P/B of the company is quoting low, it calls for more introspection about the company.**
- **Something could be fundamentally wrong in the company for the market to be quoting a low price.**
- **Perhaps the management is unstable or there is a leadership problem or there could be underlying labour problems in the company or any other factor that perhaps cannot be easily determined**

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But how is it useful to you & me?

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- **This ratio guards you against paying a very high price for a company because it compares the price to what you could recover if the company were to suddenly close down.**
- **Hence, while paying a price for a stock one should keep in mind its tangible and intangible assets on one hand and the prospects of both the company as well as the industry on the other hand.**
- **As with most ratios, it varies a fair amount by industry.**

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For example…

- **In the telecom sector, this ratio can be expected to be high in keeping with the bright prospects of the industry.**

- **Further to this, if the company is a leader in the industry, like Airtel, the market will be able to sustain a high P/B ratio.**

- **This is one reason why the stock price of companies like Airtel is high as compared to its book value.**

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Therefore…

- **A higher P/B ratio implies that investors expect management to create more value from a given set of assets, all else being equal.**
- **P/B ratios do not, however, directly provide any information on the ability of the firm to generate profits or cash for shareholders.**

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To Sum Up

- **What: The Price-to-book ratio (i.e. P/B ratio) is used to compare a stock's market value to its book value.**

- **How: It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.**

- **Why: This ratio guards you against paying a very high price for a company because it compares the price to what you could recover if the company were to suddenly close down.**

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Hope you have now understood

he concept of Price-to-book Ratio

Thinking of Investment

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