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Price to Earnings Ratio

Introduction

Among the most familiar and widely used tools to value shares is the Price-to-Earnings Ratio (P/E).

The formula for calculating the P/E of a company is: $\frac{\text{Share Price}}{\text{Earnings per Share}}$

The idea behind P/E is that we need to evaluate a share price in relation to what it buys in terms of earnings and to help us judge whether a company is fairly valued, overvalued, or undervalued. The scaling of price per share to value per share also makes comparisons possible among different listed shares. For example, an investor pays more per unit of earnings for a share with a P/E of 20 than for another share with a P/E of 12. If the two companies are otherwise closely similar (if they have similar risk, profit margins, and growth prospects, for example), the investor may conclude that the shares of the second company are undervalued (or cheaper) relative to the first.

Determining Earnings

In calculating a P/E, the current share price for a listed company is generally easily obtained and unambiguous. Determining the earnings figure to be used in the denominator, however, is not straightforward. The following two issues must be considered:

- the time horizon over which earnings are measured, which results in two alternative definitions of the P/E
- adjustments to accounting earnings that may be required.

Alternative Definitions of P/E

There are two variations of the P/E: the current (or trailing) P/E and the forward (or leading) P/E. A share’s current P/E is based on trailing 12-month earnings and a forward P/E is based on analyst consensus forecasts of a company's average earnings per share during the coming 12 months. The advantage of using the current P/E is that it uses actual earnings data from the trailing 12-month period as opposed to potentially unreliable analyst projections. The disadvantage of using the current P/E is that it does not anticipate factors that could affect future earnings, such as a new product launch, recent acquisitions or industry changes.

Adjustments to Earnings

When calculating a P/E using earnings, care must be taken in determining the earnings per share (EPS) used in the denominator and consideration should be given to the following:

- nonrecurring components of earnings;
- transitory components earnings due to cyclicality; and
- potential dilution of EPS.

Normalising Earnings

Because of cyclical effects, the most recent 12-months of earnings may not accurately reflect the average or long-term earnings power of the business, particularly for cyclical businesses (businesses with high sensitivity to business- or industry-cycle influences). EPS for such businesses are often depressed or negative at the bottom of the cycle and unusually high at the top of the cycle. This problem is best addressed by normalising EPS, that is, calculating the level of EPS that the business could achieve currently under mid-cyclical conditions. There are several methods available to normalise EPS and the two most frequently used methods are:

- the method of historical average EPS whereby normal EPS is calculated as average EPS over the most recent full cycle
- the method of average return on equity whereby normal EPS is calculated as the average return on equity from the most recent full cycle, multiplied by current book value per share.

Conclusion

P/E is a useful investment tool but the determination of the appropriate earnings per share number is easier said than done and in most cases requires detailed analysis of a company's business outlook and financial history.

Investors should be careful about the conclusions drawn from the P/E. For example, a company trading on a low P/E is not necessarily cheap and therefore a sound investment. There may be a number of valid reasons for the low P/E such as poor management, uncompetitive products, low returns on shareholders' equity, low growth expectations for earnings and dividends, highly leveraged balance sheet etc.

The opposite may also be true. A higher P/E company is not necessarily a bad investment as there may be many reasons to justify a high P/E such as a dominant position of a company in its industry with a clear competitive advantage, high and sustainable growth rates in earnings and dividends, consistent high returns on shareholders' equity, quality of management etc. To quote Warren Buffett: "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

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