Knowledge Series : P/E Multiple

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Introduction to the P/E Multiple

- The P/ E Multiple (or Ratio) is one of the most common indicators to judge the worth of a company’s shares
- Most people generally watch the movements of stock market indices like Sensex, Nifty etc. to understand if the market is falling or rising. However, the movement of only these numbers does not reveal the full story
- Investing in shares of a particular company requires investors to look at some numbers which give an indication of the true earnings prospects of the company
- The P/E multiple is one important measure to understand whether a rise or fall is justified by the earnings prospects of the company
- **The multiple basically tells investors what is the price to be paid per share for one rupee of earning generated by that company**

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What is the P/E Multiple

P/E multiple: (Price per share/ Earnings Per Share)

Price: Current Market Price of a single share of the company

EPS: $\frac{\text{Net Income of a company in the most recent 12 month period}}{\text{No. of shares outstanding}}$

- For eg: If the current share price of a particular company 'X' is 275, and the Net Earnings of the company Rs 10 lakh, with total outstanding shares numbering 1 lakh
- EPS= Rs 10,00,000/ 1,00,000 or Rs 10 per share
- **P/E multiple = 275/ 10 or 27.5**

Higher P/E ratio means that investors are paying more for each unit of income, indicating that the stock is more expensive compared to one with a lower P/E ratio all other parameters being equal

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What does this multiple mean?

- From our previous example, P/E multiple = 275/ 10 or 27.5
- This means for purchasing a share that earns Rs 10 every year, the share is available at a price which is 27.5 times the earnings of the company.
- **Purchaser of stock 'X' is paying Rs 27.5 for every Re of earning**
- One can study similar companies in the peer group of company 'X', to figure out how favorably the P/E of 27.5 compares against other companies.

- Stocks with higher forecast earnings growth will usually have a higher P/E, and those expected to have lower earnings growth will in most cases have a lower P/E.
- It is usually not enough to look at the P/E ratio of one company and determine its status. Usually, one should look at a company's P/E ratio compared to the industry the company is in, the sector the company is in, the indices it could be benchmarked against, as well as the overall market.

Application of the P/E Multiple

- Investors can use the P/E ratio to compare the value of stocks: **if stock 'X' has a P/E twice that of stock 'Y', all things being equal (especially the earnings growth rate), 'X' is less attractive than 'Y' as one has to pay double the amount to get the same Re 1 of earning.**
- By comparing price and earnings per share for a company, one can analyze the market's valuation of a company's future earnings potential.
- Companies are rarely equal, however, comparisons between industries, companies, and time periods may be misleading.
- Another way to look at this ratio is that, it indicates the number of years required to pay back the current purchase price of the shares (ignoring the time value of money)

Higher P/E Multiples <u>may</u> indicate overvaluation while Low P/E Multiples, undervaluation

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Example of P/E analysis

- **Normally, stocks with high earnings growth potential are traded at higher P/E**
- For example, lets assume share price of high growth stock 'Y' = Rs 300
  - Current EPS= Rs 10 per share
  - Hence P/E = 300/ 10; or 30.
- Next year's expected earnings per share= Rs 20 per share
  - Hence forward P/E= Rs 300/ 20; or 15
- **This means purchaser of this stock is paying lesser now than in the previous year, making the stock more attractive for purchase**

Conclusion

- The P/E multiple shows how much investors are willing to pay per rupee of earnings.
  - If a company were currently trading at a multiple (P/E) of 20, the interpretation is that an investor is willing to pay Rs 20 for Re 1 of current earnings.
- A higher P/E ratio suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. However, a higher P/E may also indicate overvaluation
- Hence, this multiple doesn't tell us the whole story by itself. It's usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E to come to a reasonable conclusion about the attractiveness of the stock.

Thank You