WHAT IS PRICE TO EARNINGS RATIO (P/E) ?

AUM CAPITAL
YOUR TRUST IS OUR WEALTH

PRICE TO EARNINGS RATIO (P/E RATIO)

Price to earnings ratio (P/E) is one of the most important financial analysis ratios that is used by analysts to determine how the company is faring when compared to other companies in the same domain and how the company is faring when compared to the past performance of the company.

PE Ratio Formula = Price Per Share / Earnings Per Share

Example:-

If "Maruti Suzuki" price is at Rs. 5283.15 and its Earnings per share is Rs. 248.30. Therefore, **PE Ratio** *= (5283.15/248.30) =* **21.27.**

Note:-
Compare PE Ratio of the company with the other companies within the sector. The simple way to compare the other companies PE is by Industry PE Ratio.
Industry PE of Automobile = 17.78
Therefore, Maruti Suzuki's PE is greater than Industry PE.

EXAMPLE – AUTOMOBILE SECTOR

Particulars	Tata Motors	Mahindra & Mahindra	Maruti Suzuki	Bajaj Auto	Eicher Motors
Market Price	74.25	362.85	5283.15	2397.55	13400.55
EPS (Rs.)	5.94	40.29	248.30	161.60	753.37
P/E Ratio	12.50	9.01	21.27	14.83	17.79

If we compare above Scrips on PE Ratio basis with its Industry PE Ratio which is 17.78. Tata Motors, Mahindra & Mahindra, Bajaj Auto & Eicher Motors would be good buy as its PE Ratio is less than Industry PE.

Note:-
The above comparison cannot be the only way to select the scrips in the Sector.

TRAILING PE V/S FORWARD PE

Trailing PE uses earnings per share of the company over the period of the previous 12 months for calculating the price-earnings ratio whereas Forward PE uses the forecasted earnings per share of the company over the period of the next 12 months for calculating the price-earnings ratio.

Trailing PE Ratio Formula (TTM or Trailing Twelve Months) = Price Per Share / EPS over the previous 12 months (Ex:-April 2019 to March 2020).

Forward PE Ratio Formula = Price Per Share / Forecasted EPS over the next 12 months (Ex:-April 2020 to March 2021).

Note:-
The key difference between the two is the EPS used. For Trailing PE, we use the historical EPS, whereas, for Forward PE, we use EPS forecasts.

LIMITATIONS OF P/E RATIO

❑ Different debt to equity structure can have a significant effect on company's earnings.

❑ It cannot be used when earnings are negative.

❑ Earnings are subject to different accounting policies. It can be easily manipulated by management.

Particulars	AA	BB
Sales	1000	1000
COGS	(500)	(500)
Gross Profit	500	500
SG&A	(100)	(100)
EBITDA	400	400
D&A	(50)	(50)
EBIT	350	350
Interest	(100)	(200)
PBT	250	150
Tax (@30%)	(75)	(45)
PAT	175	105
Shares	100	100
EPS=PAT/shares	1.75	1.05
Trading Price	40	40
PE	22.86	38.10

Change in Interest or Debt payment changes PE Structure

Particulars	AA	BB
Sales	1000	1000
COGS	(500)	(500)
Gross Profit	500	500
SG&A	(100)	(100)
EBITDA	400	400
D&A	(50)	(150)
EBIT	350	250
Interest	(100)	(100)
PBT	250	150
Tax (@30%)	(75)	(45)
PAT	175	105
Shares	100	100
EPS	1.75	1.05
Trading Price	40	40
PE	22.86	38.10

Change in Depreciation Policy AA follow straight line while BB Accelerated Depreciation