Price –to-Earning Ratio

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Price-To-Earnings Ratio is one of the simplest and most popular method of valuation which measures the price paid for a single share in comparison to its earnings per share. It is calculated by using the following formula:

$$\frac{\text{Market Value Per Share}}{\text{Earnings Per Share (EPS)}}$$

P/E ratio can be either on trailing or forward basis. Trailing P/E is a historical approach in which the earnings of past 12 months are considered. Forward P/E is a futuristic approach in which projected earnings for next 12 months are taken into account for valuation. If some major shift is revenue pattern is expected in future, then it is recommended to use Forward P/E instead of Trailing P/E. Given the fact that stock prices of listed companies are usually volatile, their P/E will also be changing very frequently.

> Higher P/E ratio usually means that investors are willing to pay more for each unit of net income.
> A lower P/E ratio doesn't necessarily mean that it is undervalued. It may also mean that the company's earning could be subject to flat / negative growth due to financial trouble.

Comparison of P/E ratios with other companies in the same sector, or to the capital markets in general, or against the company's own historical P/E ratios is done to identify better alternatives. A higher P/E ratio usually means that investors are willing to pay more for each unit of net income, so the stock is more expensive in comparison to one with lower P/E ratio.

However, it must be understood that even if a company has a low P/E ratio, it doesn't necessarily mean that it is undervalued. In fact it may also mean that the company's earning could be subject to flat / negative growth due to financial trouble.

Index	As on 6/02/2010	Market Cap (Rs. Cr)	P/E Ratio
SENSEX	16429.55	2473984	**20.15**
MIDCAP	6397.82	943298	**17.67**
SMLCAP	8067.40	306883	**14.01**
AUTO	7170.99	220653	**17.80**
BANKEX	9828.68	514025	**13.27**
CONSUMER DURABLES	4001.78	19659	**16.52**
CAPITAL GOODS	13474.86	343585	**27.83**
FMCG	2662.05	236170	**26.22**
HEALTHCARE	4912.98	180690	**35.64**
IT	5173.99	484703	**23.95**
METAL	16401.52	613127	**24.61**
OIL & GAS	9596.24	799913	**14.45**
POWER	2961.56	618852	**27.48**
PSU	9414.28	1716820	**15.33**
REALTY	3236.69	106601	**40.14**

P/E can be calculated for a particular industry or even for the entire stock market. Please see the box for the valuation matrix for Sensex as well as some other key sectoral indices consisting of India's largest and most reputed companies across diverse sectors as on February 26, 2010

Given the fact that Sensex is valued at a P/E of 20, we can generally assume that the sectors which are currently valued at P/E less than 20 are either undervalued or have lower growth potential as compared to Sensex. This is evident from the fact that PSU index is valued at a P/E of 15.33 despite having huge assets. In recent budget, there were some negative news for Automobile as well as Oil & Gas Companies in the form of higher indirect tax levy, etc. which will have negative impact on their future performance and hence, their P/E is also comparatively lower. However, it would not be a good idea to assume that Realty companies will essentially have high growth potential due to their high P/E; perhaps, it may be a time for correction.

In general, the P/E ratio is higher for a company with a soaring growth rate. Thus, using just the P/E ratio as a valuation tool can make high-growth companies overvalued than their peers.

If the P/E ratio is divided by the earnings growth rate, the resulting ratio called as Price/Earning to Growth Ration (PEG) can be a better alternative for comparing companies with different growth rates. Lower PEG is better option and vice-versa.

Though P/E is a very handy method of valuation, one need to understand that it does not cover the outstanding liabilities of the organization and hence, the investors need to carefully review the balance sheet before making any investment commitments.