The Price to Earnings or PE ratio is a widely used valuation ratio. You would quite often hear people saying for instance, that ABC stock is cheap because it is at 10 x PE or XYZ stock is expensive as it is quoting at 20 x PE. But can someone, by just looking at the PE ratio, determine whether a stock is cheap or expensive?

Let's look at a real-life example. In March 2003, Stock A was quoting at ~7 x PE while Stock B was quoting at ~21 x PE. Today, Stock A is down 85% from its March 2003 price, while Stock B is up by more than 20 x (~21% CAGR).

Stock A in the example above is MTNL while Stock B is Nestle India. While, obviously, the stocks selected are with significant hindsight bias, the point is – a stock may not be cheap at 7 x PE and at the same time a stock may not be expensive at 20 x PE. There is a lot of information in a PE ratio that the market is trying to convey.

The value of a business is the discounted value of all the free cash flow that the business can generate in the future. Let's say, when XYZ stock is quoting at 20 x PE vs. 10 x PE for the company ABC, essentially you would be paying more for the future of XYZ than of ABC. When the stock is quoting at a given PE valuation, the market is inherently making certain assumptions about the future of the business.

What Is the Market Thinking or Indicating Through the Pricing of the Stock?

For a stock quoting at a low PE ratio, the market is concerned about <u>one</u> of the following:

Low growth industry, limited scalability: If the business has limited growth potential or the industry in which it operates does not offer enough scalability, the future might not hold significant value.
No competitive advantage and at the mercy of the competition: If the company does not have a competitive advantage, the future visibility in terms of scalability and profitability of the business is clouded. As competition can severely impact future earning potential.
Corporate governance issue: As an investor, we are minority shareholders in a business. If history shows that the majority/promoter shareholder is not being fair to the minority shareholders by – siphoning out money from the business through related party transactions or other means, then even though the future of the business might have great value, but the same might not flow down equally to the minority shareholders. Also, if the past track record

of the management shows frequent poor capital allocation through unwarranted diversification or expensive acquisitions, there would be difficulty in assigning value to future cash flows, as you would not know how the money would be deployed.
Technology or regulatory change: If there is a technology or regulatory change that is likely to affect the future of the business, the current low PE could in effect be reflecting this future structural change. Such businesses available at attractive PEs are the biggest value traps. E.g. MTNL in India, Kodak in the US.
For a stock quoting at a high PE ratio, the market is indicating all of the following (These are mostly reverse of above):

High growth or very long visibility of growth: The earnings are expected to grow rapidly or there is very high long term visibility of reasonable growth. The overall market opportunity could be big which could provide scalability potential.
Competitive advantage: The company has a competitive advantage which should help it sustain its scale and profitability and grow with or above industry rate.
No doubts on capital allocation and corporate governance: The majority/promoter shareholder is fair with the minority and there has been no past record of poor capital allocation, which raises concerns about future capital allocation.
The market does not perceive any technology or regulatory threat to scalability or profitability of the business.
Note the words underscored in the above points. For a low PE, the stock market might be concerned about any one of the points, while for a high PE the stock market is essentially indicating that it is confident about all the points mentioned.

If we disagree with the market's assessment on the above points, we have an opportunity. If as an investor, we are able to find a low PE stock which does not have any of the concerns mentioned above, it could be a mispriced stock and could provide an opportunity.

At the same time, if a high PE stock has any issues with the above points, it should raise red flags for an investor. The PE ratio is an indicator that gives us information about the market's perception of the business. We need to dig deeper to assess before agreeing or disagreeing with the market's perception of value, rather than just looking at a headline PE ratio to say if the stock is cheap or expensive.

While above blog focused on what the market is assuming about an individual stock based on its PE ratio, we have discussed how overall market valuation affects returns for an investor in this blog recently.

Note: There could be points beyond the ones discussed above which could lead to market pricing stocks at Low/High PE. For example – earnings could be suppressed or extraordinarily high due to the cyclicality of the business, extraordinary expenses/income. But if you would look beyond the cyclicality factor by looking at normalised earnings and after excluding the extraordinary items, the above points should hold. Sometimes, the market is not looking at earnings or the future earning potential of the business but it's assigning value to assets that the business is holding. In such cases, the PE at which the stock is quoting might not suggest anything.