# Twitter Thread by swapnilkabra

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**Layman's explanation to PE Ratio and how it works.**
**A long thread! Do Bookmark this for patient reading.**

**#investing #investors #PEratio**

1/ PE (Price Earning) ratio is one of the most important metric used by investors to make decisions while picking up stocks.
But, more often than not, it is grossly misunderstood.
Let us decode this metric.

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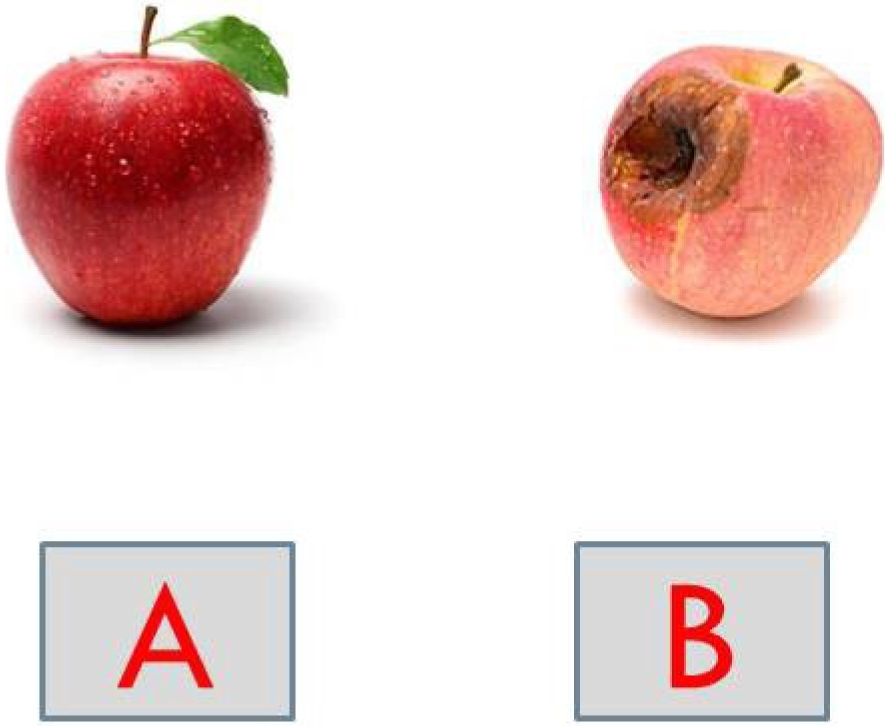
3/ How do you decide, what to buy?
Case A: Fresh Apple vs Stale Apple

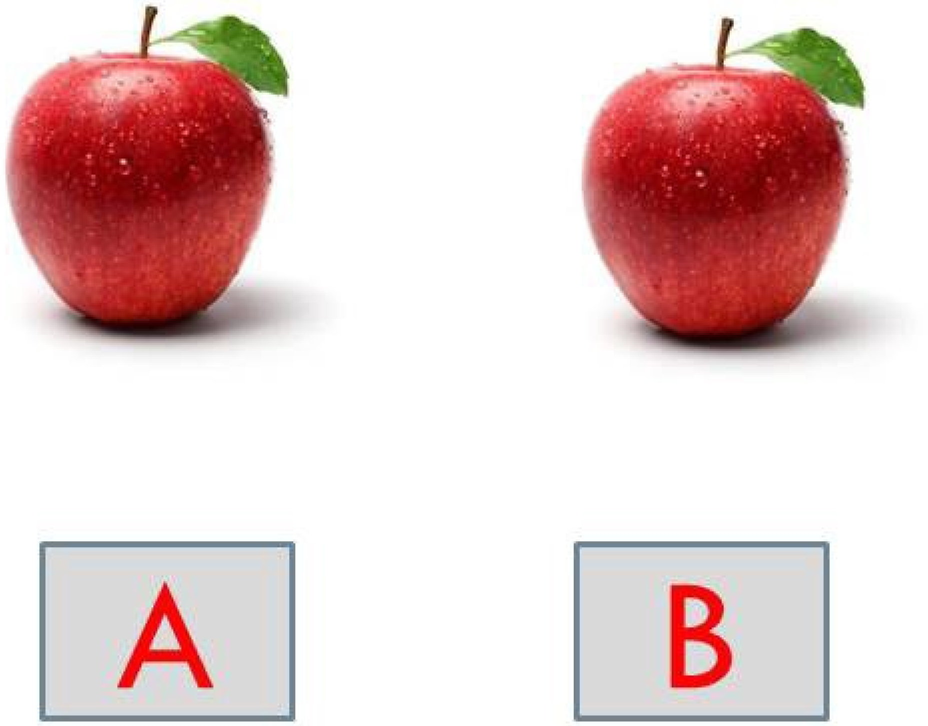



You go to a market and buy an apple. You have a choice to make.
Apple ‘A’ is fresh and juicy. Apple ‘B’ is clearly stale. Apple ‘A’ costs you ■.20 while Apple ‘B’ costs you only ■.10.

This clarifies the fact that a consumer will be paying more for Apple ‘A’ as it is better in taste and quality compared to Apple ‘B’.

This same thing happens in case of a stock. Hence, we can say that companies with better fundamentals will command more price as compared to companies with weaker fundamentals.

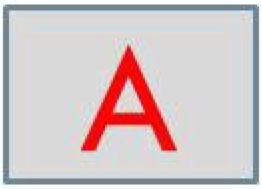
4/ How do you decide, what to buy?
Case B: Costlier Fresh Apple v/s Cheaper Fresh Apple

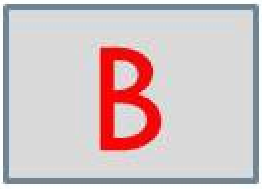



Suppose, you have to make a choice between Apple ‘A’ and Apple ‘B’. Both are fresh and juicy. However, Apple ‘A’ costs you ■.20, whereas Apple ‘B’ costs you only ■.15. Hence, you choose Apple ‘B’ over Apple ‘A’.

This again can be related to buying a stock. We can again say that companies which are undervalued and have good fundamentals must be bought compared to overvalued companies with good fundamentals.

5/ How do you decide, what to buy?
Case C: Apple vs Orange




Say, an apple in your neighborhood costs you ■.20 and an orange costs you ■.15. So, what would you buy?
The answer would clearly differ from person to person. This decision is subjective. Different things have different utilities.

Hence, two different things can not be compared on the basis of their market price. Apples and Oranges, you see!
This is so relatable in stock market. Companies making different products and belonging to different industries can not be compared.

6/ How to read PE ratio?
All the above cases so discussed can be linked to PE ratio.
PE ratio= Market Price/ Earnings Per Share (EPS)
In other words, it is nothing but the market price one is ready to pay for every rupee earned by the company per share every year.

On the face of it when an investor looks at the PE multiple, there can be conclusions like,

•If market price of a company is more but the EPS is less, the PE ratio is bound to be more. Hence, the investor is paying more for a company whose earnings are less. A sign that the stock is overvalued!

•If market price of a company is less but the EPS is more, the PE ratio is bound to be less. Hence, the investor is paying less for a company whose earnings are more. A sign that the stock is undervalued!

But, is investing this simple? Can we seriously compare companies on the basis of PE multiple?

Obviously, things are not as easy as they look. If that were the case, any ‘Average Joe’ would have been a buffet by simply comparing companies using PE multiple and value investing in stocks with lower PE multiple.

Companies which have been consistently delivering growth and have good fundamentals will command a higher PE compared to their peers which are struggling to make profits.

That is the reason we see companies like ‘Nestle’ and ‘HUL’ so richly valued compared to other ‘FMCG’ stocks. This is exactly what we saw in ‘Case A’ above. ‘Fresh’ apple will be valued more than ‘Stale’ apple.

The relevance of PE ratio is more in case of companies which are showing the same growth and clocking good profits consistently. That is where you must put money in a stock with lower PE multiple.

This is analogous to ‘Case B’ above. Go for ‘cheaper fresh apple’ than buying the ‘costlier fresh apple’.
A ‘Nestle’ must not be compared with an ‘Asian Paints’! The reason is what we discussed in ‘Case C’. ‘Apples’ and ‘Oranges’ are not comparable!

7/ How is PE ratio misunderstood?
Let us have a good look at this illustration.

| | EPS (₹) | | | Market Price (₹) | PE Multiple |
|---|---|---|---|---|---|
| **Company** | **Year 1** | **Year 2** | **Year 3** | | |
| **A** | 10 | 30 | 100 | 1000 | **10** |
| **B** | 40 | 60 | 100 | 500 | **5** |

Now, Company A is available at a PE multiple of 10 whereas its counterpart, Company B is trading at a PE multiple of 5.

If you observe, in the year 3, both these companies are clocking an EPS of ■.100. Hence, at market price of ■.1000 one may say that Company A is overvalued compared to Company B which is available at half the money.

But, before you go ahead and put your money in Company B, you must also observe the trend of EPS. Company A has shown tremendous growth from an EPS of ■.10 in year 1 to ■.100 in year 3.

Hence, if we assume the trend to continue, one would be better off to pay more money for a share of Company A, as in the coming years, if the same growth in earnings continue, the share would look cheap as the PE multiple would fall.

On the other hand, the Company B is not having a great jump in the EPS growth. Hence, investors are betting their money on Company A.

To conclude, a growth stock will always be richly valued. Because investors anticipate it to grow exponentially and hence in terms of future growth, it will be great to buy a costlier stock.

Lesson to learn here is, past earnings are not relevant but future potential surely is! This is what people misunderstand.

8/ When will PE not work?
Investors can be misled if they use this metric in case of cyclical or seasonal stocks.

There are companies whose earnings are unpredictable and are cyclical. Companies catering to real estate sector, sugar sector, etc belong to this category. One year there is great demand and the next year it may be lull!

Say, there is a sudden jump in earnings of a company due to a better cycle or a better season. Investors can be trapped because they feel the stock is clocking good numbers and there is jump in EPS and the PE multiple is low. Why not put the money here?

But, the future in these companies can not be predicted. There is no clear sign here as these are cyclical stocks. It may happen that the company is not consistent and next year due to bad cycle, the earnings are going downhill.

At that time, one would realize that the company was a bad pick as such companies do not justify a higher PE multiple.

9/ Investing is an art and everyone is clearly not a great artist. All a layman can do is understand the complexities of stock market and investing.
One thing at a time!
The End.