Analyzing the market value ratios

• P/E: How much investors are willing to pay for $1 of earnings.
• P/CF: How much investors are willing to pay for $1 of cash flow.
• M/B: How much investors are willing to pay for $1 of book value equity.
• For each ratio, the higher the number, the better.
• P/E and M/B are high if ROE is high and risk is low.
Example

Estimation of PER in case of a company with good prospect of business growing:

<table>
<thead>
<tr>
<th>Variables</th>
<th>Quick increase period</th>
<th>Sustainable increase period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected growth rate</td>
<td>15%</td>
<td>5%</td>
</tr>
<tr>
<td>Payout ratio</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Opportunity cost of capital</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Length of period</td>
<td>3 years</td>
<td>undetermined after 3dt year</td>
</tr>
</tbody>
</table>

Earning per Share = 0.0713 ron

\[
\text{PER} = \frac{0.5 \times (1.15) \times \left(1 - \frac{(1.15)^3}{(1.14)^3}\right)}{(0.14 - 0.15)} + \frac{0.5 \times (1.15)^3 \times (1.05)}{(0.14 - 0.05) (1.14)^3} = 7.52
\]
Potential problems and limitations of financial ratio analysis

- Comparison with industry averages is difficult for a conglomerate firm that operates in many different divisions.
- “Average” performance is not necessarily good, perhaps the firm should aim higher.
- Seasonal factors can distort ratios.
- “Window dressing” techniques can make statements and ratios look better.