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:**

Variables	Quick increase period	Sustainable increase period
Expected growth rate	**15%**	**5%**
Payout ratio	**50%**	**50%**
Opportunity cost of capital	**14%**	**14%**
Length of period	**3 years**	**undetermined after 3dt year**

Earning per Share = 0.0713 ron

$$\mathrm{PER} = \frac{0.5 * (1,15) * \left(1 - \frac{(1.15)^3}{(1.14)^3}\right)}{(0.14 - 0.15)} + \frac{0.5 * (1,15)^3 * (1.05)}{(0.14 - 0.05)\,(1.14)^3} = 7.52$$

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.