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SEO Title: Key Financial Ratios: Stock Value Analysis

SEO description: There are different ways to value a stock. Five of the key financial ratios are the price-to-earnings ratio, PEG ratio, price-to-sales ratio, price-to-book ratio, and debt-to-equity ratio.

5 Key Financial Ratios You Should Know

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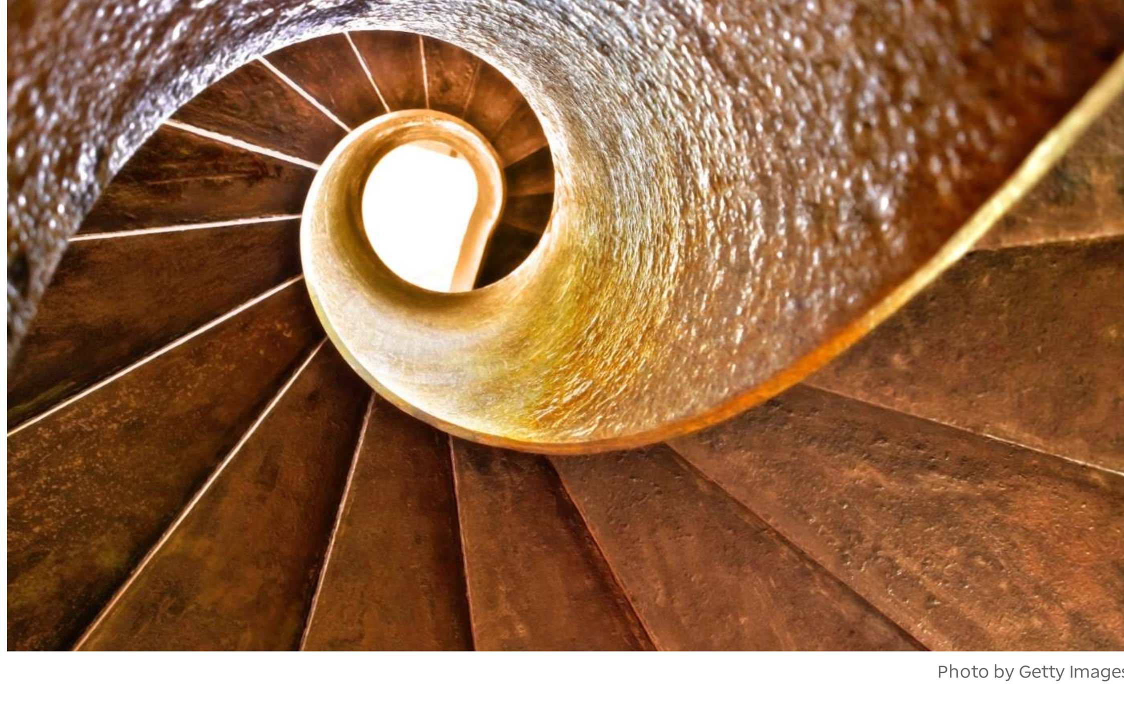

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Key Takeaways

- Knowing how to use key financial ratios provides the basic groundwork to get started
- No ratio or analysis tool can reliably stand alone as an indicator of a stock's current or future value
- Company fundamentals can change, which is why it's a good idea to periodically check the most important stock ratios

Figuring out the value of a stock can be as simple or as complex as you make it. It depends on how much depth of perspective you need. If you see *too much*, it's easy to miss the important points amid the complexity. If you see *too little*, you risk leaving a lot of important information unknown.

How much is just enough? It's really up to you. What you might want to do first is have all your basics down pat. And that's what we'll explore here.

Five Key Financial Ratios for Analyzing Stocks

There are several stock ratios, but these five are so fundamental to analyzing stocks that you really should know them like the back of your hand. If anything, they can help give you direction when trying to figure the "value" of a stock. You're probably asking yourself: Valuation *relative to what?* Well, that's the point.

You might want to view a stock's value from many different angles. But certainly you want to make sure you have all the basics covered. And that's what these five ratios are designed to do. So, let's get started.

Price-to-Earnings or P/E Ratio

Price-to-earnings (P/E) ratio is quite possibly the "most heavily used stock ratio in the world," said Michael Fairbourn, education coach at TD Ameritrade. The **P/E ratio** tells you how much investors are willing to pay for a stock above its per-share earnings.

For example, if a stock has a P/E ratio (also called the "multiple") of 20, it means investors are willing to pay up to 20 times its earnings per share to own it. But is that too much or too little? Expensive or cheap?

Ultimately, it can depend on what a company is capable of accomplishing in terms of future earnings. You can always compare a stock's P/E to that of the S&P 500 historical average, which, according to Fairbourn, is currently near 15. Besides that, the P/E ratio can't really tell you much beyond what investors are willing to pay *now*.

"If a company with a 35 P/E has a higher growth rate than a company with a 10 P/E, then the company on the higher end of the ratio might actually be 'cheaper,'" Fairbourn explained. And this brings us to the next ratio.

Price/Earnings-to-Growth or PEG Ratio

Not as popular as its P/E relative, the price/earnings-to-growth (PEG) ratio may provide an even more comprehensive and clear picture of a stock's future growth prospects.

You may know a stock's P/E ratio, but how does such a number stand relative to its projected growth rate? A company's price-to-earnings may be "cheap," but if the company can't seem to grow, what's the point of holding on to a stock with a low P/E?

"In this ratio, you're comparing the P/E to the analyst consensus estimate of *projected earnings*, which typically project as early as quarterly to as long as five years," mentioned Fairbourn. So, how might you read this? Fairbourn suggested that if the PEG ratio is less than one, investors will generally consider it undervalued.

Why is the growth component so important? "You don't want to buy something that will forever be a bargain," Fairbourn said. "Investors will often want to see a history of growth in combination with projected growth. This could help to validate an undervalued PEG ratio."

Price-to-Sales or P/S Ratio

Some companies might have strong quarterly revenue (another word for "sales") but weak earnings, perhaps because they ended up spending a good portion of their revenue. Some investors are willing to forego profits now for potentially stronger returns in the future. They understand that certain companies may need to spend their cash and quarterly sales profits to build a bigger and better company for the future. The important thing here is sales.

The price-to-sales (P/S) ratio shows how much investors are willing to pay above a company's "revenues" (not "earnings"—revenue minus liabilities—but gross revenues).

Revenue may not be as "solid" a figure as earnings, but as Fairbourn pointed out, there's something cool about using revenue as a basis for valuation. "Sales are generally subject to less manipulation by management in comparison to earnings," he said. In other words, sales are sales, period. Although earnings can be affected by various expenses, what a company makes in sales is quite straightforward.

"The P/S helps us to understand the relationship between the current stock price and the annual sales of a company. So, if a ratio gives us a reading of, say, .53, then the ratio is telling us that we are paying 53 cents *per share for every dollar the company makes in sales*," Fairbourn explained. Does that sound like a bargain, or does that sound like a bargain?

Price-to-Book or P/B Ratio

How much is a company's stock worth relative to its net asset value (book value)? That's what the **price-to-book** (P/B) ratio attempts to show us.

On the surface, it's an effective metric that can compare a company's stock market cap to "what it *owns* versus what it *owes*," said Fairbourn.

But he also pointed out a big caveat: "Depending on the industry, many companies' asset costs are priced not according to market value but value carried at the time of acquisition." For example, if a company that's been around purchased real estate decades ago, the book value of that property may be decades old, not marked-to-market. So, to find the real book value of a company, you might have to dig a lot deeper, beyond the books.

Debt-to-Equity or D/E Ratio

Similar to a company's book value, we reverse the term for this last ratio, seeking to find out what a company *owes* relative to what it owns. The calculation is pretty simple.

Generally, investors prefer the debt-to-equity (D/E) ratio to be less than one. A reading of two or higher might be interpreted as carrying more risk. But it also depends on the industry. According to Fairbourn, "Some companies, like big industrial energy and mining companies, tend to carry more debt than businesses in other industries."

So, if you find an industry that typically carries a higher debt load, it may offer greater return, but at that expense of more risk.

How to Calculate Financial Ratios

- **P/E Ratio Formula:** P/E Ratio = Share Price ÷ Earnings per Share
- **PEG Ratio Formula:** PEG Ratio = P/E Ratio ÷ EPS Growth
- **P/S Ratio Formula:** P/S Ratio = Stock Price ÷ Sales per Share
- **P/B Ratio Formula:** P/B Ratio = Stock Price ÷ Book Value per Share
- **D/E Ratio Formula:** D/E Ratio = Total Liabilities ÷ Total Shareholders' Equity

Finding Your Way

Analyzing the value of a stock may not be all that simple. Calculations won't give you a clear answer, but if you treat them as coordinates on a map, they might point you in the right direction. As with every map, you can't always see the road or weather conditions. That's where you'll have to make your own adjustments and decide whether an opportunity is favorable or too risky. These five key financial ratios should help you get started. Remember, although they can't reveal everything that's important about a company, it helps to see just enough of the road ahead to decide where to go and whether to speed up or slow down.

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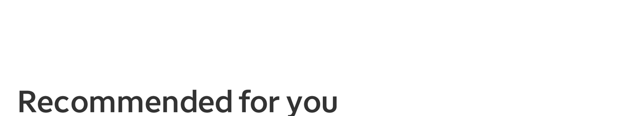

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