

Investing in athletic shoes with Mac, Aisha, and Reggie Part 3: Understanding the price-to-earnings ratio

In Part 2, Aisha learned that a company's capital structure refers to the way it finances itself and its growth. Reggie told her that one reason a company's capital structure is important to investors is because it shows how much debt the company has.

Now, Aisha wonders why the capital structure includes the number of shares that are "outstanding" for each company.

Outstanding shares

Reggie explains that an "outstanding" share of stock is a share that an investor owns. The number of shares a company has outstanding equals the number of shares that all investors in that company, put together, are holding.

Aisha looks at the capital structure of Nike and Adidas and sees different amounts of shares outstanding. Nike recently had 505 million* shares outstanding—a lot more than Adidas' 203 million shares outstanding.

What outstanding shares mean to an investor

Wait a minute, they thought, the price of Adidas stock is more than the price of Nike's stock, and Nike has more than two times the number of shares in the stock markets as Adidas. How they should take these factors into account when trying to decide if they should invest in Nike or Adidas?

"The number of shares a company has outstanding generally has little to do with whether a company's stock is a good investment or not. Almost all publicly traded companies have millions of shares outstanding," explains Reggie.



Mac's research shows them that the price of a share of stock moves around a lot. So far during 2007, a share of Nike's stock has sold for as much as \$55.40 and as little as \$37.46. A share of Adidas has sold for as much as \$63.46 and as little as \$46.39. That day, the market price for Nike was \$54.72 per share and \$62.44 per share for Adidas.

He adds that in general, just because the price of a share of a company's stock is higher or lower than of one of its competitors, investors cannot assume either stock is better or worse than the other.

The price-to-earnings ratio

The price-to earnings (PE) ratio is a tool many investors use to evaluate companies.

Investors can predict the future with a PE ratio.

The PE ratio helps investors even if the companies they're looking at have different numbers of shares outstanding, and if their stock is trading at very different prices.

The PE ratio is simple to calculate. Just take the price of one share of a company's stock and divide it by the company's earnings per share over a 12-month period.

For example, use Nike's recent price of \$54.72 and its earnings for the past fiscal year of \$2.71 per share:

$$\frac{57.42}{2.71} = \text{a PE ratio of approximately } 20.20$$

Investors sometimes use different 12-month periods to calculate PE ratios. Some look at a company's reported earnings from the previous year—this gives the "trailing" PE ratio. Other analysts use the estimated earnings for the next 12 months in a company's future to calculate the "forward" PE ratio.

Each method has advantages and weaknesses. Last year's reported earnings are "on the books," so trailing PE ratios are accurate and not subject to change. A forward PE ratio is only an *estimate* and is

Company Name	Recent Price	Trailing Earnings	PE Ratio
Nike	\$57.72	\$2.71 per share*	20.20
Adidas	\$64.44	\$3.19 per share*	19.57
Timberland	\$26.66	\$1.67 per share*	15.96
<i>Data from reports ending 5-29-07</i>			

subject to change because actual company earnings are often different from analyst estimates.

But investors are usually forward-looking in the sense that they want to know how a company will do in the future, and that's why some investors use forward PE ratios. Just don't forget that forward PE ratios are based on forecasted earnings that may turn out to be very different than the earnings a company reports in real life!

Look at the table to see recent PE ratios for Nike and some of its competitors in the shoe and sports apparel industry.

As a company's stock price changes—and we've seen that stock prices can change quite a bit—the firm's PE ratio also changes.

The PE ratio also shows an investor how much he or she would pay today—remember that the "price" part of the PE ratio is just the stock's market price—for a dollar's worth of the company's earnings. Nike's PE ratio of 20.20 "tells" an investor that she's paying about \$20.20 for every \$1 of the company's earnings—its \$54.72 stock price is 20.2 times greater than Nike's earnings of \$2.71 per share.

Mac notices that these recent PE ratios are somewhat lower than ratios for the shoe industry as a whole in recent years. In 1999, the industry average PE ratio was 21.6; in 2000, it was 17.5; and in 2001, it was 18.1. He wonders why are some current PE ratios lower than PE ratios in the recent past?

"One reason probably has to do with the economy and the impact it has on shoe companies and the stock market as a

whole," suggests Reggie.

Aisha and Mac realize that as the economy has been slowing down in the past several years,

the prices of many stocks have dropped. This affects the PE ratio—if the "price" part of the equation drops more than the "earnings" part, the resulting ratio will be lower.

What can the PE ratio tell us?

The PE ratio tells investors quite a bit about a company because it shows whether the company's stock is expensive (investors consider stock having a "high" PE ratio to be expensive) and how much investors think the company will grow in the future. What's a high PE ratio? It depends.

First, there is an "industry effect" which means the PE ratios of some types of companies (like software manufacturers and firms in other high-tech fields) are all generally higher than PE ratios for companies in other industries (like auto manufacturers and other low-tech fields).

This seems to be because companies in the same industry share some basic characteristics. Investors evaluate these characteristics the same way, so they tend to reach the same conclusions about firms that have those characteristics.

So, what's considered a high ratio for a low-tech company could be considered a low ratio for a high-tech company. "Remember that PEs change constantly as company stock prices fluctuate. But generally speaking, a PE ratio in the 30s or higher is thought to be fairly high and a PE in the mid-teens is thought to be low," Reggie advises.

Stocks with high PE ratios are generally considered expensive. Stocks with low PE ratios are generally considered inexpensive. How does this work?

Remember that the PE ratio tells us how much an investor is willing to pay today for a dollar's worth of the company's earnings. Investors focus on corporate earnings because when a company increases its earnings consistently over time, its stock price generally increases. For a company with a "high" PE ratio—say one over 30—an investor is paying *more* for a dollar of earnings than for a company with a "low" PE ratio—say under 10.

Why would someone pay \$30 for one company's dollar of earnings when she could pay \$10 for another company's dollar of earnings? The answer lies in way the investor thinks the company will grow in the future.

Investor expectations

Let's look at an example of a company that investors expect to grow very quickly and one that investors expect to grow slowly.

Let's say that XYZ Computer Corp. has a stock price of \$50 but has reported earnings of only \$1 per share. It has a PE ratio of 50, meaning an investor would pay \$50 to get that \$1 of earnings.

Fifty is a "high" PE ratio—why would an investor pay this much for a share of XYZ stock?

First of all, Reggie tells his friends that some investors won't pay that much. "Many investors follow the "value" theory of investing, which says that you shouldn't invest in stocks with high PE ratios," he says.

Investors consider many factors, including PE ratio, when selecting Nike or Adidas.

But some people believe it's OK to invest in stocks with high PE ratios. Why? Most of the time, it's because the investor expects the company to report much higher earnings in the next few years, resulting in a higher stock price. If XYZ Computer Corp. eventually reports earnings of \$10 per share—up from \$1 per share—while still keeping a 50 PE ratio, the company's stock price would have jumped to \$500!

Of course, these are very important "ifs"—XYZ would have to show tremendous growth to raise its earnings from \$1 per share to \$10 and its PE ratio would have to stay at 50 for this to happen.

Other companies have very low PE ratios. This suggests that investors don't think those companies are going to increase their earnings very much and don't expect the price of the company's stock to rise.

Consider the hypothetical OldLine Manufacturing Co., which makes machine tools used in the automotive and textile industries. Investors see no signs that the company is changing or expanding into new lines of business. Oldline's management seems content to continue to operate the way it always has.

OldLine also reports \$1 per share in earnings, but its market price is only \$7 per share.

OldLine's PE ratio would be 7 (share price of \$7 divided by earnings of \$1). Investors in this stock are willing to pay only \$7 for that \$1 in OldLine's earnings. They think the firm's earnings and stock price won't increase very much.

Using the PE ratio to compare stocks

Looking again at our PE table, Aisha notes that Nike's PE is slightly higher than Adidas' PE. The difference indicates that investors expect Nike to grow more quickly than Adidas and Nike's stock price to increase more quickly. But the PEs are close enough that an investor could conclude the chances of making money on Nike stock and Adidas stock are fairly similar.

What about Timberland, another shoe company? Its PE ratio of 15.96 is a lot lower than Nike's 20.20 PE. For some reason, or a number of reasons, investors don't think Timberland's earnings will grow as quickly as Nike's.

They're only willing to pay \$15.96 for a dollar of Timberland earnings, while they're willing to pay \$20.20 for a dollar of Nike's earnings. Timberland's PE ratio, when compared with Nike's, tells us that investors don't think Timberland's earnings will increase at the same pace as Nike's earnings. They also don't think the price of Timberland's stock will increase as much or as quickly as the price of Nike's stock.

Stocks in the same industry, such as Nike and Adidas, generally have similar PE ratios. If the ratios aren't similar, that's a clue to potential investors to look into the situation more closely.

For more information, see:

Part 1: How to find information about stocks

Part 2: What dividends and capital tell you about a company

Part 4: How debt ratio and industry structure help you pick stocks

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