



Module 2

The Language and Tools of Financial Analysis

Profitability Measures 2 (When is really good, good enough?)

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Introducing market value of equity

Two of the most often quoted and related financial ratios are the Earnings Per Share (EPS) and P/E measure

$$\text{EPS} = \frac{\text{Net Income}}{\text{Average outstanding number of shares}}$$

$$\text{P/E Ratio} = \frac{\text{Market Capitalization}}{\text{Net Income}} = \frac{\text{Share Price}}{\text{Earnings per Share}} = \frac{\text{P}}{\text{EPS}}$$



A multiple

$$\text{EPS(Kellogg's, 2014)} = \frac{632}{358} = \$1.77$$

$$\begin{aligned}\text{P/E Ratio(Kellogg's, 2014)} &= \frac{\text{Share Price}}{\text{Earnings per Share}} \\ &= \frac{\$65.58}{\$1.77} = 37.15\end{aligned}$$

The P/E ratio is also known as a multiple....

which is then used to forecast the share price.

Forecasting the share price

A popular 'fast-track' analyst P/E forecast depends crucially on the stability of the P/E ratio

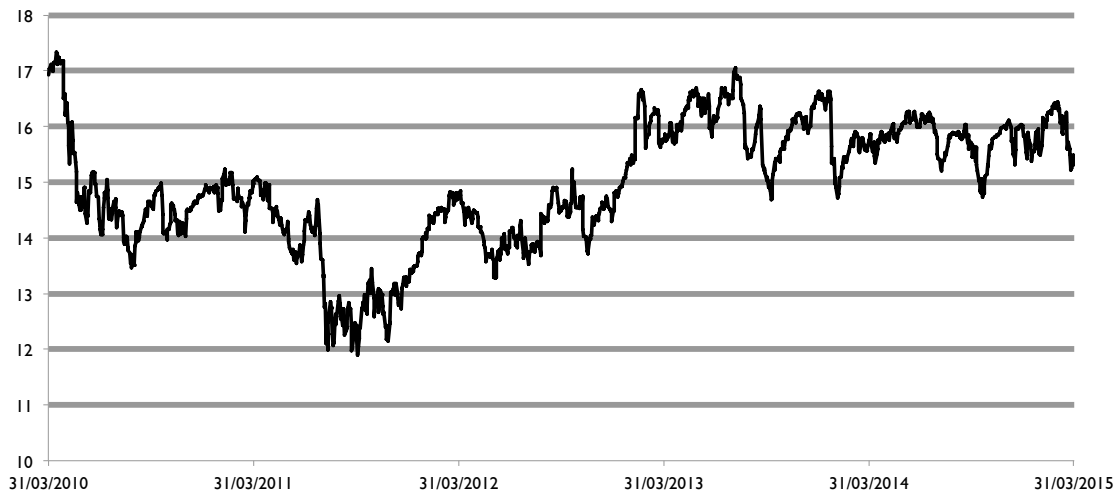
$$\text{Forecast P}(2015) = \text{Forecast EPS}(2015) \times \frac{\text{P}(2014)}{\text{EPS}(2014)}$$

How stable are P/E ratios?



Market-wide P/E ratios – forward looking

Trailing PE - Dow Jones Industrials (5 Yr)



Comparison

	KELLOGG'S		KRAFT	
	2014	2013	2014	2013
EPS	\$1.77	\$4.98	\$1.74	\$4.55
P/E	37.15x	11.65x	36.84x	11.81x
P	\$65.58	\$57.98	\$63.93	\$53.71



Source list

- Slide 5: PE Ratios – Dow Jones Industrials © the University of Melbourne, created by Thomas Szoka. Data sourced from Datastream.
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