**Price to Earnings Ratio**

A term you’ll see often is price to earnings ratio, or PE ratio for short. This is the stock’s current market price divided by its most recently reported earnings per share (EPS). You can sort of interpret the PE ratio as how much the company is valued compared to how much money it made. It’s important to be careful about how we interpret a high or low PE ratio, because we can’t say whether a PE ratio is good or bad by looking at it in isolation. Let’s first look at where the price comes from. This market price of a share is based on the collective estimates by investors of the company’s current equity plus its future earnings. The future earnings are based on estimates of future cash flow, which are then adjusted to their present-day value, or Present Value (PV). This is getting a bit outside the scope of what you’ll need to know for this course, but the point we want you to remember is that the market price of a stock is based on both its current assets minus liabilities, but also estimates of the company’s future performance.

Now coming back to the PE ratio. What does it mean to have a high PE ratio? A company may have low or negative earnings, but a high stock price. Why do you think that is? You may have heard of certain startups that are valued at billions of dollars, and yet have low earnings. This is because investors expect potential for high earnings growth, based on the trajectory of past earnings growth. This also means that investors are estimating that the high stock price relative to earnings will be justified by high future earnings. On the other hand, it’s also possible that investor optimism towards the company’s future never materializes, in which case the stock may be overpriced.

Note also that a low PE ratio can also be due to different underlying reasons. An example of a company with a low PE ratio may be one that has high and stable earnings, but less expectations for future growth. Since the company may decide that its investors are better off receiving earnings as dividends instead of reinvesting earnings into the business, the earnings will be distributed as cash to shareholders. This also means that the stock price itself represents the value of the company excluding the cash that was already distributed to these shareholders. Again, keep in mind that a low PE ratio can also be a sign of something else. If a company is expected to face pressure from competitors or government regulation that reduce their expectations for future earnings, then investors may pay a lower price for each share, and that could also result in a lower PE ratio.

In practice, you’ll want to see how a company’s PE ratio compares to other similar companies in the same industry and same geographic region.

You’ll see PE ratios again in later lessons, so for now, just remember that it’s one of many ways to take a snapshot of a company’s financial health.