Understanding the Market

By Garry Crole,
Investment Committee, InterPrac Financial Planning

10 July 2017

Fair Value and the Forward PE Ratio

I am often talking about the Fair Value of a company, and in doing that, one major factor to take into consideration is the likelihood companies can grow earnings, and the effect this has on a company's true valuation over the long term.

In my case, I want to see earnings and equity grow and use the return on that growing equity to calculate Fair Value. We have a table we use that applies a set multiple to equity to determine Fair Value, based on the actual ROE percentage and the amount of equity a company is reinvesting.

A different method to calculate a Fair Value that many use, and we often compare to our Fair Value, is by using a forward PE ratio as a method to determine Fair Value.

PE is the price to earnings per share, calculated by dividing the earnings per share (EPS) and the share price. For example, if the share price is $1.20 and the earnings per share were 10 cents, the PE is 12.

If this company never grew earnings and paid out 70% of its profit in dividends, it would take 17 years to have a zero cost base. We all know many companies who do not grow earnings do not survive 17 years so a PE of 12 on this company is HIGH.

However, if the same company grew earnings by just 5%, the next example shows the importance of selecting companies who can grow earnings.

In this equation, let us assume that this company can grow its earnings at a compounded rate of 5% p.a. for the next three years; the earnings per share would be $0.116.

Assuming the PE remained at 12 times earnings, the subsequent share price would be $1.39 at the end of year three and the payback period of dividends at 70% of EPS would actually reduce to about 10 years.

Because earnings and dividends are growing, the market might even apply a larger multiple of say 16 times earnings compared to the original 12 times earnings at the end of year three. This causes a significant share price re-rating from $1.39 to $1.86.

The three-year per annum return profile with no change in PE would be 5.07% compared to 15.65% with an increase in PE to 16 times earnings.

The key variable from the equation to see if the PE did rise from 12 to 16 is all about how quick can a company grow earnings. Whilst 5% is quite low, there are many growing at

25%+, and this is what those who use PE rates as a valuation tool look for, and is part of the reason we saw stocks like Blackmores, Dominoes valued at such high PE ratios.

The risk is sustainability of the growth. If the party stops, the market can punish stocks priced for growth over 10 years, when a shorter timeframe is more valid.

Despite that warning, it is clear that most of the leverage in a company's valuation is within the multiple that an investor is willing to pay for a company's earnings stream at a point of time in the future.

A company's PE can be dependent upon a range of subjective factors, such as industry backdrop, reputation of management, consistency of earnings and industry consolidation, along with many others.

Rather than PE, I tend to use return on equity as my prime calculation to determine Fair Value, because there is for me far less personal opinion and variables. However, many others use the price to earnings (PE) multiple as a valuation tool.

What investors who use the PE calculation are looking for is to find companies who can grow earnings but have an under-priced current PE ratio compared to their peers or their historical PE ratios.

If you look at relative predictability, the Big 4 banks tend to have had a relatively consistent PE expectation, which is worth exploring in looking at this discussion.

I would argue CBA is the best run of the Big 4 banks, so deserves the highest PE multiple, ANZ and WBC would be second and NAB not too far behind them in 4th place.

With interest rates at record lows, I think bank PE multiples should be discounted from their 5 year historical multiple, to reflect lower growth in the economy and the slowing of their earnings growth.

Presently NAB is actually trading at the highest PE of the Big 4 banks on 2016 earnings at a 17.2 PE ratio, whilst CBA is at 14.8, and WBC and ANZ are just below 14.

NAB will reduce this PE, as its 2016 earnings had some abnormal financials, with the EPS at $1.73, yet the dividend was $1.98. If you look at what the board would have looked at, and reverse the dividend number using a traditional payout of 70%, the normalised earnings number is closer to $2.48 and the current multiple of NAB would come down to 12.2.

I think a PE on 1-year forward earnings of 14 for CBA, 13.5 for WBC and ANZ, 12.5 for NAB is a fair multiple.

Our CBA Fair Value based on another method of calculation currently has CBA at $81.60, with an expectation to increase by 4% each 6 months as it grows its equity per share and results tabled, so come the 2017 result we expect to have CBA Fair Value at about $83.

If you look at the PE method, and divide $83 by 14, that suggests we expect earnings per share for CBA to move to $5.93 per share, up from $5.52 in 2016, for it to see the PE method of valuation match our current Fair Value based on return on equity.

In Westpac's case we have Fair Value at $30.60, divide this by 13.5 and a match would see EPS of $2.27, ANZ we are looking for $2.04, whilst NAB we are looking for $2.32.

For those who want another method, Warren Buffett has not exactly published his formula for what he calls the intrinsic value of a company, but he has dropped a number of hints. He apparently multiplies estimated future earnings by a confidence margin between zero and a hundred percent (a bird in the bush being worth 0.5 birds in the hand, and all that; bush birds are the earnings you hope for, and hand birds are the earnings you're confident will materialise). He then compares these probable earnings with something he has total confidence in, by using a U.S. treasury yield as his discount rate. In calculator form it is very much like our return on equity formula where we use 5% plus the bond rate as the basis of our 1 times multiple of equity as Fair Value. If you want to read about the Buffett formula this Wikipedia version is one that is almost understandable http://www.investopedia.com/articles/01/071801.asp.