NICO Asset Managers

"INVEST today for tomorrow "

INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

5 April 2019

Topic 305: How to Value Shares

In the next coming weeks, we will be looking into the ways in which investors can value their shares. There are several methods that an investor can use to value shares. Some of these methods include the Price Earnings (P/E) ratio, the Price to Book value (P/BV) ratio and the Earnings yield. This week, we are going to look at P/E ratio.

The P/E ratio

This is a comparative ratio based on the share price and profitability of a company. The P/E ratio is calculated as the current market share price divided by the earnings per year on the share. This ratio is used by investors to compare which shares in a given industry are cheaper relative to others. If a company has a higher P/E ratio than a rival in the same industry, assuming all things are the same, it is translated that investing in this company could be a risky value for the investor and hence less attractive. This is because a higher P/E ratio will translate to the investor paying a higher price for each income generated by the company. However, the higher P/E ratios can also be associated with higher expected rates of growth in earnings for that company.

Advantages and disadvantages of using the P/E ratio

The main advantage of using the P/E ratio is that it is easy to compute and easy to understand. In addition, in Malawi for example, all the companies that are listed on the MSE must provide their information to the public by publishing financial statements in the newspapers. As a result, there is readily available information for these companies for the investors to use to compute the P/E ratio and hence make investment decisions.

The disadvantage of using the P/E ratio is that it uses historical information. For example, the current P/E ratios on the MSE are based on the company's financial performance for 2018. As a result, the ratio can be of little help to the investor during a period where economic conditions have changed significantly in a short period of time. In addition, it has several interpretations. For example, holding all things the same, when comparing two companies A and B operating in the same industry, a higher P/E ratio for A than for B would translate company A as being less attractive to the investor because it is overvalued, that is, the investor will be paying a higher price per earning than would have been in B. However, the same higher ratio can also be translated as a high growth expectation in earnings for that counter. Furthermore, the P/E ratio does not account for the level of debt the company has. The companies with more debt are of a higher risk, but the P/E ratio only considers the share price and earnings irrespective of the debt that the company has that could affect the performance.

The Malawi stock exchange (MSE) generates reports that have the necessary ratios that investors can use for analysis in the counters. For example, we have four counters that are in the banking industry; NBM, FMBCH, NBS and Standard Bank. From the daily MSE reports, the necessary information in terms of each of these counters' respective P/E ratio is offered. As at 3rd April 2019, the P/E ratio for FMBCH, NBS, NBM and Standard Bank were 8.28, 7.68, (26.38) and 10.98 respectively.

Head Office
19 Glyn Jones Road
Chibisa House
P.O. Box 3173
Blantyre
Tel No: 01 832 085/086 Fax: 01 821 617

Lilongwe Branch
Corner Kenyatta Drive
NICO Centre
P. O Box 30729
Lilongwe 3
Tel no: 01 757 086 Fax: 01 751 617

invest@nicoassetmanagers.com | www.nicoassetmanagers.com

INVESTMENT MANAGEMENT | CORPORATE FINANCE | INVESTOR SERVICES