This Company's P/E Is Meaningless

Description

This is something many of us mutter when a stock that we own, like, say, **Apple**, with a supposedly low P/E multiple, takes a dive. What's going on here?

How not to use a multiple

It's very easy for a pundit to stand in front of a crowd and sound smart and informed by proclaiming that Apple has a floor under it because its P/E multiple is 10. However, this is essentially meaningless information, when delivered in this fashion.

Multiples are completely useless in isolation and especially when trying to predict short term moves in stock prices. The following table conveys just how little predictive power an earnings multiple can have over a short period of time. We're using a selection of well-known U.S. based companies to help demonstrate this point.

Company	P/E LTM	YTD
Facebook (NASDAQ:FB)	n/a	11.6%
Amazon (NASDAQ:AMZN)	n/a	6.0%
Google (NASDAQ:GOOG)	23.2	4.2%
Qualcomm (NASDAQ:QCOM)	19.0	-1.9%
Apple (NASDAQ:APPL)	10.4	-16.8%

Source: Capital IQ

The “cheapest” company of the group, Apple, has had the worst year to date return and the two companies that don’t even have positive earnings have had the best.

In their simplest form, multiples are easy – that’s why you hear so much about them. In a world that is straining for its next sound bite, multiples are a perfect fit. It doesn’t take much to look at the table and point to the fact that Google is more richly valued than Apple because it trades at a higher earnings multiple. Under “classic” value investing theory, cheap stocks rise and expensive stocks fall, therefore buy Apple. People, not Fools, operate like this!

No shortcuts

To appropriately use a multiple you need to put it into context, and then let time takeover. There are two ways to give a multiple some meaning – a) compare against the company’s historical range, and b) compare to a group of similar companies. In addition, don’t just focus on one metric. Look at the price/earnings as well as the price/book, price/free cash flow, and price/sales on a historical and peer comparison basis. If they are all pointing towards the same conclusion, there’s a good chance a believable valuation message is being conveyed.

Again, to simply say Apple’s P/E is 10 therefore it’s a buy is poor logic. However, if that 10 P/E is framed against a 5 year average of 21 and a peer group that trades at 13…..now you’re starting to build a case.

Although the group provided above is somewhat tricky given the rapid change that occurs in the technology space, this historical and peer compare work can be done to some extent for Google, Apple, and Qualcomm. Relevant information exists for all three.

Sorry to say

For some companies multiples just don’t work. I would put Amazon and Facebook into this category.

Neither fits very well with criteria a) or b) from above. Yes, Amazon has been around for a while, but the company is evolving so rapidly that a multiple from two years ago really has no relevance on today, or tomorrow's valuation. Facebook has no history. And neither really has a solid peer group to compare against.

To illustrate how nonsensical multiples can be for companies like Amazon and Facebook, the table below outlines what the analyst community has established as the average one year target price for each, and how that compares to the projected consensus earnings.

Company	Target	EPS	Fwd P/E
Amazon	$310.25	$1.79	173.3
Facebook	$32.96	$0.66	49.9

Source: Capital IQ

Boss – "What's your target on Amazon?"

Analyst – "$310.25"

Boss – "How'd you get there?"

Analyst – "I reckon they're going to earn $1.79 next year and then I just slapped a multiple of 173 on that. Done."

Boss – "Good work."

When an analyst is given the outrageous task of affixing a one year "value" to a company like Amazon or Facebook, outrageous results are sure to follow.

The Foolish Bottom Line

All five of the companies included in this post are leaders in their field and arguably "great" businesses. If you think you've found a great one, don't schluff off the other important part of the investing equation. Determining a reasonable price. Do the work, think long term, use history, use comparables, and use common sense!

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Fool contributor Iain Butler does not own any of the companies mentioned in this post at this time. David Gardner owns shares of Apple, Amazon.com, Google, and Facebook. Tom Gardner owns shares of Google. The Motley Fool owns shares of Amazon.com, Apple, Facebook, Google, and Qualcomm.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NASDAQ:AAPL (Apple Inc.)

Category

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Date
2025/08/27
Date Created
2013/01/31
Author
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