How Much Should You Pay for a Stock?

Description

With stock prices going up and down all the time, how do you decide when to buy a stock? Specifically, how much should you pay for a stock?

Just like shopping at the local market, where quality merchandises tend to be more expensive, quality stocks tend to be priced at a premium as well.

At most, pay a fair price for quality stocks

One quick and simple way investors can identify quality stocks is by their A-grade ratings from credit-rating agencies. **Canadian National Railway** (TSX:CNR)(NYSE:CNI) has an S&P credit rating of A. Additionally, its earnings per share have increased over the long run (+20 years), which means the company is becoming consistently more profitable over time.

At the recent quotation of under $95 per share, Canadian National Railway trades at a price-to-earnings ratio (P/E) of ~18.8, while the analyst consensus at **Thomson Reuters** estimates the company will grow its earnings per share by 10.2% per share for the next three to five years.

Reuters has a mean 12-month price target of $109 for Canadian National Railway, which indicates the company is trading at a discount of ~13%. So, the stock is reasonably priced.

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Demand a bigger discount from B-rated stocks

Altagas Ltd. (TSX:ALA) has an S&P credit rating of BBB, which is one notch higher than the minimum rating to be considered investment grade. For B-rated stocks, investors should demand a bigger margin of safety before buying.

At the recent quotation of ~$24 per share, Altagas trades at a P/E of ~21.1, while the analyst consensus at Reuters estimates the company will grow its earnings per share by 15.8% per share for the next three to five years.

This seems like a pretty cheap stock. However, there's more to the story. Like most other North American energy infrastructure company stocks, Altagas is sensitive to interest rate hikes because of the debt-heavy nature of the business.

Moreover, the stock is currently weighed down by the WGL Holdings acquisition. To partly fund the huge acquisition, Altagas is considering +$2 billion of asset sales, which brings in uncertainty — can Altagas find buyers who will pay a good price for its assets?

Reuters has a mean 12-month price target of $28.80 for Altagas, which indicates Altagas is trading at a discount of ~16%. Value investors might demand a discount of 30-50% before considering the stock. This way, there's a bigger margin of safety to limit the downside.

Investor takeaway

Whether you're looking to buy an A-grade or B-grade company, the lower the valuation you pay, the more limited the downside is, because when the stock is trading at a cheaper price, some risks have already played out.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. TSX:ALA (AltaGas Ltd.)
3. TSX:CNR (Canadian National Railway Company)

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Date
2025/07/27
Date Created
2018/04/08
Author
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