New Investors: Here’s How to Put a Value on Stocks Before You Buy

Description

New investors often don’t understand how stocks are valued and what makes them rise or fall in price. However, stocks are generally pretty easy to value. This is a crucial step to take before you ever buy stocks, because if you can’t put a value on it, how will you determine that it’s undervalued and worth an investment?

Learning how to value stocks both by metrics and in comparison to industry peers is one of the first and most important things to learn.

Therefore, if you’re new to investing and want to learn how to value stocks before you buy them, here are a few different methods to consider.

Before you buy stocks, you’ll want to value them by earnings

For most businesses, especially well-established companies that regularly earn a net income, one of the most popular and best ways to value stocks you want to buy is to base it on their earnings.

The whole point of buying businesses is to make money. Therefore, if you can value stocks by their current earnings and future earnings potential, you can get a good idea of what a stock’s worth, what you’re willing to pay, and how much value it offers.

For example, a stock like **Corus Entertainment** (TSX:CJR.B) is expected to earn a net income per share (earnings per share) of $0.80 this year after earning roughly the same amount last year. The stock is trading at a price-to-earnings (P/E) ratio of 5.6 times.

This means that at the current rate of the stock’s earnings, it will take you a little over five years for the stock to earn you back the same amount of money you paid to buy the stock.

If a 5.6 times P/E ratio seems extremely low, it is. Often, stocks that the market deems to be risky will trade at a discount and have lower valuations due to the higher chance that they don't meet these expectations.

On the flip side, high-quality stocks that have proven to grow earnings consistently will have a premium value if you want to buy. For example, **Dollarama**, one of the top long-term growth stocks in Canada, currently trades at a P/E ratio of 33.8 times.

What if stocks aren't reporting positive earnings?

The P/E ratio is only one metric to use. In order to paint a full picture, you'll have to look at other ratios as well. Not only that, but sometimes stocks aren't profitable yet, or, after running into trouble (as many stocks did with the pandemic), they're now temporarily not earning a profit. How would you value these stocks before you buy them?

There are several other important metrics to use. For example, with some companies and in some specific industries, you'll want to know how much debt the company has in addition to its market cap, which is essentially the stock's enterprise value (EV).

Then investors will often compare this to a company's EBITDA or its operating earnings to see how profitable the core business is. A popular ratio is the EV-to-EBITDA ratio.

A few years ago, Corus got into trouble for its debt load; this is a company you might want to use the EV/EBITDA ratio for. The P/E could be low, because its market cap is low due to the stock having so much debt.

However, in Corus's case, we can see a considerably low EV/EBITDA ratio of just 4.8 times, proving the stock is ultra-cheap.

In addition to the EV-to-EBITDA ratio, you can even look at the value that early-stage tech stocks offer before you buy, using the price-to-sales (P/S) ratio. Early tech companies are all about growth — growing revenue and the user base and sometimes spending billions on research and development.

While these companies are growing, they are usually valued with a P/S ratio. Then, eventually, as they start to become profitable, the market will evaluate these stocks with other metrics.

Bottom line

Whether you're a new investor or one with years of experience, understanding how to value stocks is one of the most important factors of investing and really the only way confirm that stocks are undervalued before you buy.

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2. Stocks for Beginners

TICKERS GLOBAL

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