



The Valuation Conundrum: P/E Ratio vs. P/S Ratio

Description

“Price is what you pay; value is what you get.” It’s a lesson Warren Buffett learned from Ben Graham. But there is more to this sentence than you think. Most often, new investors confuse value stocks with those whose stock prices have fallen significantly or are oversold. While these measures help shortlist value stocks, price-to-earnings ([P/E](#)) and price-to-sales (P/S) ratios are other parameters to identify undervalued stocks.

In this article, I will solve the valuation conundrum of the P/E or P/S.

The valuation conundrum

As an equity shareholder, look at a stock like a business owner, and everything will fall into place. As a business owner, if you were to earn \$1 million in profit, you could

- Either sell 5,000 products for a net profit of \$200/product; or
- Sell 200 products for a net profit of \$5,000/product.

When does the P/S valuation matter?

The first point above is the business of volume, where sales matter more than profit. In that business, you need to look at the P/S ratio. Some volume-driven businesses are retailers like **Loblaw** and software-as-a-service companies like **Lightspeed Commerce** ([TSX:LSPD](#))([NYSE:LSPD](#)).

Loblaw and Lightspeed have P/S ratios of 0.71 and 5.72, respectively. The huge difference is because of their size. Loblaw is already a market leader in grocery and has a revenue growth rate of around 2%. Lightspeed is a fast-growing omnichannel commerce platform with a revenue-growth rate of over 100%. Excluding acquisitions, it had average organic revenue growth of 51%, and it expects this rate to slow to 35% in the next five years. A 5.72 P/S ratio is cheap for a 35% revenue growth rate company. It is also below **Shopify’s** P/S ratio of 8.6.

As these companies become market leaders, their P/S ratio falls, and their P/E ratio grows. Because once these companies achieve the sales threshold, they tend to become profitable. I will elaborate. In the first scenario, the company aims to earn \$1 million by focusing on the 5,000 sales volume. The secondary focus is profit. The company aims to increase profit per sale to \$200 or more.

Lightspeed Commerce and Shopify are value stocks based on the P/S ratio. These stocks are not capital-intensive and don't have a huge debt burden, allowing them to scale. Their P/E ratios matter when they become large-cap stocks with market share and limited revenue growth.

When does the P/E valuation matter?

The second scenario focuses on reaching the \$1 million target through higher profits. That is where the P/E ratio matters the most. For instance, **Descartes Systems** ([TSX:DSG](#))([NASDAQ:DSGX](#)) and **Magna International** ([TSX:MG](#))([NYSE:MGA](#)) have large companies, as their clients and securing these clients take longer. But once these clients come on board, they sign long-term contracts and generate significant profit. Hence, their net income grows faster than revenue.

Descartes and Magna have trailing P/E ratios of 58.3 and 13.5, respectively. Descartes's net income surged 26%, while its sales surged 18% in the [first quarter](#). Magna's EPS fell 40%, while its sales fell 5% in the first quarter. This growth is reflected in the ratio. Descartes's ratio states that for \$80 per share price, you are getting the value of 1/58th the current EPS. This value will reflect in the long term, as you get access to all future EPS and dividends the company pays till you sell the stock.

Still, the two stocks are undervalued as their sales growth slowed. If sales grow, their EPS will grow faster, making the current stock price look like a bargain. Descartes's valuation looks like a bargain compared to its peer **Kinaxis's** P/E ratio of 212.

Beyond the P/E and P/S ratios

When determining which stock to buy, you should look at other factors, like the news, the company's business, the growth outlook, and the macro environment. The P/E and P/S ratios only tell you if the stock price is inflated or cheap depending on current fundamentals.

CATEGORY

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1. NASDAQ:DSGX (Descartes Systems Group)
2. NYSE:LSPD (Lightspeed Commerce)
3. NYSE:MGA (Magna International Inc.)
4. TSX:DSG (The Descartes Systems Group Inc)
5. TSX:LSPD (Lightspeed Commerce)
6. TSX:MG (Magna International Inc.)

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