The Price to Earnings Growth (PEG) Ratio

Karl Siegling | 11 July 2014

Karl Siegling is a portfolio manager with Cadence Capital.

After having discussed the dangers of relying on a PE ratio and Dividend Yield, let's turn to a number of ratios we do use frequently and pay more attention to.

The first of these is the Price to Earnings Growth Ratio (or PEG ratio) which is a measure of the Price Earnings Multiple divided by the Earnings Per share growth rate of a particular share (PE divided by EPSG).

In practice the lower the PEG ratio the better or 'cheaper' a company's particular shares are. For example, a company growing its earnings per share by 20% per annum trading on a Price Earnings multiple of 10 times would have a PEG of 0.5. Conversely a company growing at 10% per annum trading on a price earnings multiple of 20 times would have a PEG of 2.0. In this example, on the face of it the company on a PEG of 0.5 would be significantly cheaper than a company on a PEG of 2.0. Another way of thinking about this ratio is that it measures the price you are paying for a particular level of growth.

What is really good about the PEG ratio is that it puts the PE multiple in a context of earnings growth rather than just earnings and forces the investor to think about the quality, security and consistency of earnings growth.

Just as we are getting comfortable with the science and the maths of valuation methodologies, we are once again being asked to form a **qualitative or subjective assessment** about earnings growth…..and ultimately earnings growth **relative** to a stock's current earnings multiple. It can be proven time and time again, and we can accept it almost as law, that should a company consistently fail to realise future expected earnings it will ultimately be worth less, and conversely, should a company consistently deliver strong earnings per share growth then it will be worth more.

What the PEG ratio does is allow the investor to evaluate a potential investment based on its earnings growth ***relative*** to its current PE valuation. The old adage is that it 'is all about earnings growth'…and in the long run this tends to be true….along with 'cash is king'…..but let's not get ahead of ourselves…..using operating and free cash flow for valuation purposes will be the topic of an up and coming article.

For the moment, let's focus in on the fact that knowing a company's valuation (or basic PE) relative to a company's earnings growth is far more valuable than just knowing the PE of a stock.

The PEG ratio gives the PE some context and a basic ability to evaluate companies with different levels of earnings growth against each other. For example, two stocks could have a PEG of 0.5. One could have EPSG of 20% per annum and a PE of 10, and another could have EPSG of 10% per annum and a PE of 5. Suddenly the assumption that a stock on a PE of 5 is cheaper than a stock on a PE of 10 is no longer true….from a PEG valuation perspective they have the same valuation. To determine which stock is ultimately worth more we would need to estimate how long the EPSG rates would last, and create a more detailed model of future year's earnings.

This is why analysts and portfolio managers, and investors in general, spend so much time trying to work out future earnings and future earnings growth for stocks. It is the future earnings and future earnings growth of a particular stock that ultimately determines whether the stock price will go up or down.

I have to confess that I spent my first few years in the investment industry looking for 'cheap' stocks….on a PE basis…..only to discover that just because a stock was 'cheap' on a PE basis did not mean it wasn't going to fall in price….especially if earnings growth was non-existent or negative!

I remain quite sentimentally attached to the PEG ratio. Once I fully understood the concept of being able to evaluate different types of companies relative to each other, the investment task became a lot easier.

The PEG ratio allows you to compare a high growth company with a low growth company and still find value in both, if it exists. The PEG ratio does not, for example, eliminate high growth or low growth companies in the way that the PE ratio sometimes does.

The PEG ratio combined with detailed cash flow analysis and cash flow valuation, has the capacity to keep most investors out of a lot of trouble, and avoid many companies that display poor investment characteristics.

In our next article we will focus on operating cash flow and free cash flow and how we evaluate whether a company is cheap or expensive from a cash flow perspective. The PEG ratio, combined with Cash flow analysis really forms the basis of most of our Fundamental Investment work.