



Trading and Investing for Beginners

What is the price to book ratio?

By Eric LeRiche

How much is a company worth and does the stock price reflect that value?

There are many ways to define a company's worth. One way is the market cap or how much money would you need to buy every single share of stock at the current price per share.

Another way to determine the value is with the balance statement, looking at the Book Value. The book value of an entire company is its shareholder's equity, i.e. the company's assets minus its liabilities. If a company's shareholders' equity is \$200,000, the book value of the company is \$200,000. If the company has 1,000 shares outstanding, each share has a book value of \$200

Book Value = Assets - Liabilities

In other words, if you wanted to closed shop, how much would be left after you settled all the outstanding obligations and sold off all the assets.

A growing business will always be worth more than its book value for its ability to generate earnings and growth.

Book value is especially interesting for value investors who look at the relationship to the stock's price by using the Price to Book ratio.

The calculation can be performed in two ways, but the result should be the same either way. The first way, the company's market cap can be divided by the company's total book value from its balance sheet. The second way, using per-share values, is to divide the company's current share price by the book value per share (i.e. its book value divided by the number of outstanding shares).

Investors looking for hot stocks aren't the only ones researching the markets. Folks called value investors go about their business looking for companies that the market has passed by.

Some of these investors become quite wealthy finding sleepers, holding on to them for the long term as the companies go about their business without much attention from the market, until one day they pop up on the screen, and some analyst "discovers" them and bids up the stock. Meanwhile, the value investor pockets a hefty profit.

As with most ratios, it varies a fair amount by industry.

Industries that require more infrastructure capital (for each dollar of profit) will usually trade at P/B ratios much lower than of, for example, consulting firms. P/B ratios are commonly used to compare banks, because most assets and liabilities of banks are constantly valued at market values. A higher P/B ratio implies that investors expect management to create more value from a given set of assets, all else equal (and/or that the market value of the firm's assets is significantly higher than their accounting value). P/B ratios do not, however, directly provide any information on the ability of the firm to generate profits or cash for shareholders.

This ratio also gives some idea of whether an investor is paying too much for what would be left if the company went bankrupt immediately. For companies in distress, the book value is usually calculated without the intangible assets that would have no resale value. In such cases, P/B should also be calculated on a "diluted" basis, because stock options may well vest on sale of the company or change of control or firing of management.

It is also known as the market-to-book ratio and the price-to-equity ratio (which should not be confused with the price-to-earnings ratio).

That's it for this week, next time we'll talk about - Dividends.

See you then and in the mean time, don't forget to protect your capital!

Yours truly,

Eric LeRiche

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