



Trading and Investing for Beginners

What is the price to sales ratio?

By Eric LeRiche

You have a number of tools available to you when it comes to evaluating companies with earnings. The first three articles of this series deal with earnings directly. You can add the last two of the series i.e. the one on dividends and the one on return on equity to the list as specific to companies that are or have made money in the past.

Does that mean companies that don't have any earnings are bad investments? Not necessarily, but you should approach companies with no history of actually making money with caution since it becomes about speculations and projections.

The Internet boom of the 90s was a classic example of companies with no history of earning; some didn't even have products!

Thus we need some way to measure young companies with no earnings, yet worthy of consideration.

After all, every single success story companies had no earnings at one point in their corporate lives.

One ratio you can use is Price-to-sales ratio, P/S ratio, or PSR. It is calculated by dividing the company's market capitalization (the number of shares multiplied by the share price) by the company's revenue in the most recent fiscal year (or the most recent four fiscal quarters); or, equivalently, divide the per-share stock price by the per-share revenue.

$$P/S = \text{Market Cap} / \text{Revenues} \text{ or } P/S = \text{Stock Price} / \text{Sales Price Per Share}$$

The metric can be used to determine the value of a stock relative to its past performance. It may also be used to determine relative valuation of a sector or the market as a whole.

PSRs vary greatly from sector to sector, so they are most useful in comparing similar stocks within a sector or sub-sector. Also, since sales are less easy to manipulate as compared to earnings, price-sales ratios are more indicative of performance as compared to price-earnings ratios.

Much like P/E, the P/S number reflects the value placed on sales by the market. The lower the P/S, the better the value, at least that's the conventional wisdom. However, this is definitely not a number you want to use in isolation. When dealing with a young company, there are many questions to answer and the P/S supplies just one answer.

How should you use the P/S

Let's look at how to evaluate a firm not making money in the past year. Unless it is going out of business, the price-to-sales ratio will show if the firm's shares are valued at a discount against others in its sector. Say the company has a price-to-sales ratio of 0.8 while its peers have higher ratios of, say, 2.1. If the company can turn things around, its price per share will rise significantly as the price-to-sales ratio gets back in synch with its peers. Meanwhile, a company posts negative earnings may also lose its dividend yield. In this case, price-to-sales represents one of the last way to measure the value of the business. Generally speaking, a low price-to-sales ratio is good news for investors, and a very high price-to-sales ratio can be a "red flag".

When comparing companies sales you need to add some variables to the equation. Examination of sales must be coupled with a careful look at profit margins and their trends, as well as with sector-specific margins.

Debt easy to evaluate and adds very valuable information to the table

A firm with very little or no debt and a low price-to-sales metric is a more attractive investment than a firm with high debt and the same price-to-sales ratio. Eventually, the debt will need to be paid off, so the company might issue additional equity and these new shares will expand the market capitalization thus driving up the price-to-sales ratio.

Companies on the verge of bankruptcy, however, can have a very low price-to-sales ratios.

This is because their sales have not suffered a drop while their share price and capitalization collapses.

So how can investors tell the difference?

There is a way that helps differentiate between "cheap" sales and less healthy, debt-burdened ones: use Enterprise Value/sales rather than market capitalization/sales. By adding the company's long-term debt to the company's market capitalization and subtracting any cash, you get the company's enterprise value (EV).

Think of EV as the total cost of buying the company, including its debt and leftover cash, which would offset the cost. EV shows how much more investors pay for the debt. This approach also helps eliminate the problem of comparing two very different types of companies:

- 1) The kind that gets into debts to enhance its sales
and
- 2) The one that has lower sales but does not have debt

To conclude, as with all valuation tools, sales-based approaches are just the beginning. The worst thing that you can do is buying without looking at underlying fundamentals. Low P/S ratios can indicate unrecognized value potential - so long as other criteria like high profit margins, low debt levels and growth prospects are in place. In other cases, price- to-sales can be a classic value trap (A stock that has experienced a large price depreciation and is mistaken to be a value stock).

That's it for this week, next time we'll talk about the Price to Book ratio – P/B.

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

Yours truly,

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