Valuation

What's a Fair Price to Pay? — Lesson Explainer

The Concept

Share price alone tells you nothing - what matters is price relative to something, usually earnings. P/E ratio (price / EPS) tells you how many dollars investors pay today for each dollar of current annual profit.

PEG ratio (P/E / expected annual earnings growth) adjusts P/E for growth. Around 1.0 suggests price roughly matches growth; well below 1.0 can suggest a bargain; well above 2.0 often suggests price has run ahead of growth.

No ratio works in isolation - always compare against the company's own historical range and against direct industry peers.

Illustrative Example: Same P/E, Very Different Growth

Metric	Company A	Company B
Share Price	$75.00	$75.00
Earnings Per Share	$3.00	$3.00
P/E Ratio	**25.0**	**25.0**
Expected Annual Earnings Growth	30%	10%
PEG Ratio	**0.83**	**2.50**

Both companies trade at an identical P/E of 25 - equally 'expensive' on that number alone. But Company A grows 3x faster, giving it a much lower, more attractive PEG of 0.83 vs Company B's 2.50.

5 Things to Know About Valuation

1. Share price alone tells you nothing about value - always look at a ratio like P/E.

2. A high P/E isn't automatically bad, a low P/E isn't automatically good - context matters.

3. PEG adjusts P/E for growth - identical P/E ratios can hide very different PEG ratios.

4. Valuation only means something in comparison - to history and to industry peers.

5. A 'cheap' valuation can be cheap for a reason - declining businesses trade at low multiples too.

4 Things to Check Before Trusting a Valuation

• Compare to industry peers - a P/E of 30 means different things in different industries.

• Compare to the company's own history - rich or cheap vs its own average?

• Sanity-check growth assumptions - a low PEG on an unrealistic forecast isn't really cheap.

• Combine with everything else in this track - margins, debt, and cash flow all matter too.

Worth knowing:
no single valuation metric tells the whole story - a low P/E can mean a bargain or a business in decline. Always read valuation ratios together with the income statement, balance sheet, and cash flow picture from earlier in this track.

Quiz — Answer the questions, then check the key on the next page

1. What does the P/E ratio measure?

A. The company's total debt
B. The company's dividend yield
C. How many dollars investors pay today for each dollar of current annual profit
D. The number of shares outstanding

2. What does the PEG ratio add on top of the plain P/E ratio?

A. A measure of trading volume
B. The company's dividend history
C. Nothing, they're identical
D. It adjusts P/E for the company's expected earnings growth rate

3. Why did Company A and Company B have different PEGs despite an identical P/E of 25?

A. Because their share prices were different
B. Because their expected earnings growth rates were very different (30% vs 10%)
C. Because one company paid a dividend
D. PEG ratios are always identical when P/E is identical

4. Why can a 'cheap' low P/E stock actually be a warning sign?

A. Declining businesses often trade at low multiples because the market expects trouble
B. Low P/E stocks are always fraudulent
C. P/E has no relationship to how the market views a company
D. Low P/E only happens to companies with no earnings at all

5. Why is comparing a valuation ratio to industry peers important?

A. It isn't important, one number works for every industry
B. Peers only matter for dividend stocks
C. A given P/E can be normal in one industry and expensive in another
D. Industry comparisons are illegal under securities law

Answer Key

1. What does the P/E ratio measure?

Correct answer: C. How many dollars investors pay today for each dollar of current annual profit

P/E = share price divided by earnings per share.

2. What does the PEG ratio add on top of the plain P/E ratio?

Correct answer: D. It adjusts P/E for the company's expected earnings growth rate

PEG divides P/E by the expected growth rate, letting you compare on a growth-adjusted basis.

3. Why did Company A and Company B have different PEGs despite an identical P/E of 25?

Correct answer: B. Because their expected earnings growth rates were very different (30% vs 10%)

Company A's much faster growth gave it a lower, more attractive PEG.

4. Why can a 'cheap' low P/E stock actually be a warning sign?

Correct answer: A. Declining businesses often trade at low multiples because the market expects trouble

A low multiple can reflect the market pricing in real risk or decline.

5. Why is comparing a valuation ratio to industry peers important?

Correct answer: C. A given P/E can be normal in one industry and expensive in another

A P/E of 30 is unremarkable in software, expensive in banking - comparisons need context.