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Price/Earnings and Enterprise Value

Price to earnings, P/E. What does it mean? It is mainly used as a gauge for price premium relative to peer companies. If P/E is 10x, then it would mean it takes 10 years of aggregated earnings to repay the price paid for equity. The reciprocal, or E/P, reveals the yield on the equity investment. The two interpretations are sensible, but both P and E are not representative of the value nor the earnings power of the core operations of the entity.

Equity has no meaning in and of itself. Equity is not a comprehensive value of the company. It represents the price of ownership, but excludes a key component of the financing mechanism, which is debt. **Equity is the residual value remaining after paying back the par value of the debt from the enterprise value (EV).**

The better indicator of a company's worth, is EV, or the value of the entire company, excluding the cash on hand. EV, from a book value perspective, is Stock holder's equity (assets – liability, or net assets) + debt – cash. The floor EV can be current assets excluding cash + fixed assets + interest bearing debt. Typically, EV is calculated as 6-7x FCF.

The problem with calculating EV is that the two components, equity and debt, are valued by the market. The debt price is fairly easy to calculate, since the value is capped at the nominal debt value, so we could run a bear scenario with the nominal debt value. However, equity is the residual value of EV minus debt, so it is circular logic to calculate Equity from EV, and vice versa.

So the conventional, fair practice is to slap a multiple on FCF and call that the Enterprise Value of a company. Yet, this method, is difficult to substantiate, with respect to intrinsic value, although it is reasonable to compare against market transactions. So we looked into bond valuation, to see if there was a logical method to calculate the value of an entity. Bond valuation is simple since on the maturity date, the realized principal recovery will be par value. However, with equity valuation, we don't know what the recovery on investment will be if we model a disposition. We could be conservative and assume a transaction value at P/Net tangible book at 1x, P/E at 10x, and P/FCF at 5x. So far, we feel this is the best method available, which is replicable for a large dataset of companies.

We feel the equity price in the market is fine when the market price of debt is 90+. However, once the debt piece of the co. is trading at lower than 20, we have to assume the market is pricing in a lower EV than the par value of the debt, which would leave zero residual value for equity. However, even when bond prices are lower than 20, oftentimes equity is not trading at zero.

P/E would never, ever consider the debt piece and EV, but it is a commonly used and taught ratio. Ultimately, it blindsides investors of leverage, insolvency and liquidity risk.

Earnings, or net income, includes the interest expense on debt, so people assume net income is fully equity's ownership. In a conventional sense, this is true, but we are looking at net income with respect to ownership related to value. Let's assume the co. doesn't have any debt, but it is owned by 2 parties – Party A and Party B. Party A owns preferred shares while Party B owns the common shares. Party B can't assume full entitlement to the net income; it must be shared with Party A.

But people will explain, debt is different; debt is only entitled to what is listed in the loan covenant. However, if the market is pricing a lower EV than debt, then the cash flow should no longer flow to the equity holder. Rather, the debt holders, more specifically the fulcrum security, will be owners of the cash flow, in the case of insolvency. Therefore, net income is not purely the "equity pieces" money, which is what P/E implies. A co. could have negative EV, but price could still be higher than $1/share and as long as earnings can be manipulated to be positive as well, it will make it seem like P/E is meaningful.

How is P/E misleading? Net income is influenced by the capital structure, i.e. interest expense from the debt, as well as non-core operating cash flow. So Earnings will be distorted by the non-operating pieces in the GAAP formula.