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THE PER FALLACY

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The Price Earnings Ratio (PER) is this ratio everyone knows about which even salmon pink newspapers devote space to and the entire financial community pays homage to. At the end of the day the ratio is easy to compute and indicates, almost intuitively, whether a stock is cheap or expensive. That's the theory. The truth is the PER is a very poor multiple as to the valuation of a company. Let me explain: neither a high PER means a company is expensive, nor a low PER means it is cheap.

The net profit of a company is only the accounting opinion of its managers as to profits and losses of a period, obviously established in accordance with generally accepted accounting principles and, of course, audited by a Big Four to embolden it. But what everyone betting a penny on the stock market should ask is: how much of the net accounting profit actually translates into cash? Or, rather: if I total cashed sales and subtract costs paid, interest on debt, investments needed to keep the business up, and whatever is taken away by the main partner, none other than the Treasury, what is left in cash? In many cases, even though the profit and loss statement looks very healthy, the company "burns cash" to the point it has to refinance its debt maturities, with the aggravating circumstance it keeps dividends up, which are usually linked to a percentage of net profit, the equally famous payout.

Let us see why a high PER may not signal a company is expensive. Imagine a company that has invested heavily in recent years, for instance to increase its production capacity (not to inflate its EBITDA through acquisitions, we will talk about that another day). In following years it will face higher amortizations, which will lower its profit before tax and increase its PER, but which will make, as they are not a cash outflow, 100% of net profit—or more—become available in cash to repay debt and remunerate shareholders. Now imagine a different situation. Take a low-PER company, where net profit margin on sales is good, but turns out to cash invoices late and incorrectly, to be fully involved in investment processes and, moreover, to face extraordinary expenditure in the short term, hopefully provisioned. Outcome: the conversion of net profit into cash is so poor the company must finance the deficit with more debt or with a capital increase. Of course, dividend is sacred, because payout is payout.

All this serves to explain that the PER, simple formula as it is, must incorporate many additional factors, such as working capital, maintenance investments, provisions, depreciation, and taxes and interest actually paid, in order to be useful. The goal is to isolate the free cash flow or, in other words, the cash that the company actually generates with its ordinary business. If the figure is significant in relation to the company's market value, it may be a purchase; if it is low, it may be a sale. And what is that significant figure in relation to the market value? Here come into play brainy equations but, out of common sense, it should exceed the rate of 10-year bonds in the company's country, plus a risk premium—say 5%—because shareholders are the last to recover their money in case of liquidation. Even the Oracle of Omaha himself uses such an approach.

At Fimarge we want companies whose yield is at least 7%, recurrent, barely indebted, and focused on staple consumer sectors. And we have them. Why? Because the volatility of a share is a function of its balance sheet and the predictability of its cash flows and, in the current situation, the name of the game is not winning big money but defending money already won. Volatility is for traders, not for us who earn our living by reading balance sheets with a long-term view.

Therefore the PER should not be an essential feature in the valuation of companies. It must be put into context, adjusted, and combined with many indicators and ratios. To take an extreme case: Pescanova traded at 8.0x PER just before filing for bankruptcy, but the cash from a six-months-old capital increase was gone. In this extreme case, and honestly acknowledging the convenience of analysis in retrospect, one realizes something was wrong with cash conversion. The statement of cash flows, possibly together with the statement of changes in equity, is the financial statement that receives less attention. But it deserves a lot more. If buying low-PER companies were a guarantee of success, it would be all too easy.