

Forecasting High and Low PEs

Some Rules of Thumb

[SSG, part 4]

High PE

Seldom should it be more than 20-25

Seldom should it be higher than historical average

Another option is to make it no more than $1\frac{1}{2}$ times forecast EPS growth rate

The forecasted growth rate earnings per share [from SSG graph, part 1] for the company on the graphic on the next page was 18% annually. Therefore, using the 3 rules above for forecasting high PE, the possible figures are

20—25 [first rule]

36 [second rule: historical high average]

27 [that is, EPS growth rate of 18% * $1\frac{1}{2}$ = 27]

The way to not get overly optimistic is to select the most conservative answer [ie, first rule, 20-25]

3 PRICE-EARNINGS HISTORY as an indicator of the future
This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

		PRESENT PRICE		HIGH THIS YEAR		LOW THIS YEAR			
		43.250		105.000		37.000			
Year		PRICE		C Earnings Per Share	D Price Earnings Ratio		F Dividend Per Share	G % Payout F ÷ C × 100	H % High Yield F ÷ B × 100
		A HIGH	B LOW		D HIGH A ÷ C	E LOW B ÷ C			
1	1995	25.8	18.4	0.89	29.0	20.7	0.050	5.6	0.3
2	1996	39.0	23.3	1.10	35.5	21.2	0.050	4.5	0.2
3	1997	52.5	34.3	1.35	38.9	25.4	0.060	4.4	0.2
4	1998	76.4	46.5	1.69	45.2	27.5	0.070	4.1	0.2
5	1999	83.3	37.0	2.06	40.4	18.0	0.100	4.9	0.3
6	TOTAL		159.5		143.8	85.3		23.5	
7	AVERAGE		31.9		36.0	21.3		4.7	
8	AVERAGE PRICE EARNINGS RATIO	28.6		CURRENT PRICE EARNINGS RATIO		19.9			

4 Proj. P/E [16.89] Based on Next 4 qtr. EPS [2.56] Current P/E Based on Last 4 qtr. EPS [2.17]
4 EVALUATING RISK and REWARD over the next 5 years
Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell. The upside/downside ratio is the key to evaluating risk and reward.

A HIGH PRICE -- NEXT 5 YEARS
 Avg. High P/E **36.0** × Estimate High Earnings/Share **4.71** = Forecast High Price \$ **117.8**

B LOW PRICE -- NEXT 5 YEARS
 (a) Avg. Low P/E **21.3** × Estimated Low Earnings/Share **2.06** = \$ **37.1**
 (b) Avg. Low Price of Last 5 Years = **31.9**
 (c) Recent Severe Market Low Price = **37.0**
 (d) Price Dividend Will Support Present Divd. = **0.100** = **36.8**
 High Yield (H) **0.003**

[Red arrows and ovals above shows how Toolkit “defaults” the historical high and low PEs into parts 4a and 4b, respectively. These figures should not stand if unrealistically high, as in the case above.]

Low PE

Seldom should it be higher than the historical average.

Another option is to make it no more than the forecast EPS growth rate. [Note: 18 in this case, from SSG, part 1]

Therefore, using the 2 rules above for forecasting low PE, the possible figures are

21 [first rule—the historical figure]

18 [second rule—using the forecast EPS growth rate.]

Again, select the lower figure, that is, 18.