Adjusted Price-Earnings Ratio: The Case of Pharmaceutical Sector in India

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Abstract: **The Price-Earnings Ratio is a benchmark that provides a comparison in the selection of stocks. Stocks with low Price-earning ratio expected to bring higher returns in subsequent quarters and on the contrary. This paper makes an attempt to gauge for the P/E relative of the 15 stocks as a sample from period 2011-12 to 2015-16 belongs to pharmaceutical companies specifically rather than gauging for the P/E ratio of the Standard & Poor's Index. The computation of Price-Earning Relative is embedded in the stock's P/E ratio component of the equation, to the market's P/E ratio, which leads to an estimation of Adjusted P/E -ratio.**

Keywords: **Price-Earnings Ratio, Price-Earning Relative, Adjusted P/E ratio, Pharmaceutical Companies.**

I. INTRODUCTION

In order to generate return from the stock market, investors evaluate and employ various techniques either fundamental or technical. Valuations of scrip are sighted through the prism of earnings, corporate social responsibility, cash flows and capital structure. Moreover these attributes, much primary efficient tool used by the investors are the Price-Earnings (P/E) Ratio. Investors and scrip analysts have long used this multiple to discover if stocks are reasonably valued.

II. WHAT IS PRICE EARNING RATIO AND HOW IT IS AFFECTED?

Price-Earnings Ratio, also noted as 'Earnings Multiple is figured out by dividing current market price of a scrip with the company's earning per share of most recent 12 months.The P/E multiple of stock market index is gauge by weighted mean of all the sensitive stocks included in the index. The P/E multiple of a stock normally reveals the number of rupees the potential investor is minded to honor for a rupee out of the company's EPS.

While there is no equivocacy with the numerator, but there are two variations with the denominator. Trailing P/E's comes up from the announced EPS of the last four quarters and the Forward P/E's is estimated on the premise of estimated EPS usually of next four quarters.

III. P/E RATIO AND STOCK PERFORMANCE IN DIFFERENT TIME PERIOD

Stock Analysts and Fundamental investors have long used the P/E Ratio, in order to determine if the particular stocks are reasonable valued. From a very long time, the mutual fund managers have argued that mean P/E ratio for a stock market index such as S&P BSE SENSEX that works on the sensitiveness of top 30 market capitalization companies that can help predict long term changes in the index. Pursuant to the outlook, a low P/E ratio rebound to rapid growth in the subsequent years while a high P/E ratio tends to be followed by slow growth rate in following years. While in short term, high P/E ratio reflects high earnings to the investor. A high P/E ratio typically indicates that the market as a whole expects significant future earnings growth. Conversely the low P/E relative is absorbed in the prediction of low earnings growth of the stock in the subsequent years. Despite this rollercoaster of up and down markets, there seems to be a wide consensus about the fact that value strategies outperform growth strategies in both the India and in other countries.

IV. PREVIOUS STUDIES ON P/E RATIO

Loads of researches has been conducted in the field of market analysis by using different sample data in both developed and developing countries and found mixed evidence regarding the determinants of P/E ratio. Efforts in this area are categorized into three broad categories: 1) those screening for individual stocks by examining the P/E ratios which might help in highlighting firms that have fallen out of favor,2) those who are examining the long-term and short-term outlook for stock prices, based on the past relationship behavior to the P/E ratio,3) those who are comparing the performance of low P/E (value) and high P/E (growth) strategies.

Basana et al. (2012) findings reveal that there is a significance difference between low PE and high PE portfolio stock return in short term (holding period of six months) but there is no significance difference between both portfolio stock return if they are keep up for 1-4 years. This finding provides a signal for investors to invest in low PE stocks for short-term time horizon (six months) in order to realize higher capital appreciation(profit taking).

Bodie et al. (2008) stated that Stock with low PE ratio is perceived as having cheaper current price hence it is a good bargain and expected to generate higher return in subsequent period as the particular stock is mispriced.

Bajkowski .John(2000) Price-earnings relatives direct to establish ideal comparisons that can help identify firms that have deviated from their normal valuation level—with the stipulation that nothing has been changed significantly to fundamentals of the company, industry, or market.

Damodaran (2006) states that other things held equal, higher growth firms would have higher PE ratios than lower growth firms. Other things held equal, higher risk firms will have lower PE ratios than lower risk firms and other things held equal, firms with lower reinvestment needs will have higher PE ratios than firms with higher reinvestment rates. However, he also reminds that other things are difficult to hold equal since high growth firms tend to have risk and high reinvestment rates.

Solanki.Ashwin (2014) the investors should invest in those companies, which have low P/E stocks because it gives the possibility to generate better returns. But most importantly here the proportion to keep P/E, as the sole base to invest does not works fully but up to significant extent it proved itself viable. Due to these change volatility increased in market and models don't able to prove the things.

V. PRICE-EARNINGS RELATIVE

The learning of Price-Earning Relative model, however, hypothesizes that long-term growth and risk figure of the firm has not fundamentally changed over time. The Price-Earnings relative average, which is above 1:00, depicts that a company's Price Earnings Ratio is by and large above then what the complete market is providing to the customer, at the same time when the price earnings relative average is less than 1:00, bring out signals that a company's price earnings ratio tends to be plunging than the market's earnings. Bajkowski.J (2000) explained that changes in the relative levels of P/E ratio may signal that the market, for whatever reason, is changing its expectations about the future earnings potential of a firm, or not paying attention and mispricing the security. It may also signal that a short-term change has already occurred or is expected to occur. Table 1 provides an illustration to determine the price-earnings relative model, which is exercised on Aurobindo pharma (4th highest market capitalization pharmaceuticals industry in India).

Price Earning Relative:Table 1

Years	Market P/E Ratio		AurobindoPharma 52-week Stock Price		EPS	Price-Earnings Ratio		P/E Relative To Market	
	High	Low	High	Low		High	Low	Low	High
2015-16	22.75	17.6	1541	582	33.9	45	17.17	1.99	0.97
2014-15	21.54	15.9	1280	509	54	23.70	9.42	1.10	0.59
2013-14	19.56	15.2	545	139	40	13.62	3.47	0.69	0.22
2012-13	19.21	14.97	205	100	10	20.5	10	1.06	0.66
2011-12	20.97	16.02	206	80	-4.2	-49	-19.04	-2.33	-1.18
5-year Average	20.81	15.94				11	4.20	0.50	0.25

Average Price-Earnings Relative Ratio

Five Year High = 0.50

Five Year Low = 0.25

Five Year Average = 0.38

Current Market P/E Ratio = 20.96

Adjusted P/E Ratio = 5-year average P/E relative x Current Market P/E Ratio
= 20.96 x 0.38
= 7.96

Source: The entire domestic stock market data within www.equitymaster.com was used to determine the average of the price-earnings ratio.

From the last 5 years Aurobindo pharma has averaged a price earnings ratio, which is outperforming the overall market, lasting to an average price-earning relative of 0.38, which is an indicator of the fundamental performance of Aurobindo pharma in highly volatile market. Multiplying the current market's price-earnings ratio with the Aurobindo pharma's price-earnings relative will provide an Adjusted Price-Earnings Ratio. The current market price-earnings ratio is 20.96 dated on 15th March 2016 (www.craytheon.com), heading to the adjusted price-earnings ratio to 7.96(20.96 x 0.38). The rationale of adjusted rice-earnings ratio is based on the premise that market is fairly priced and the company's correlation to the market has not yet reciprocated.

Table 2 showing adj. Price-Earning Ratio of Pharmaceutical Companies

Company (Ticker)	Price as on (15/03/2016)	Trailing EPS	Current P/E ratio	5-year average p/e relative	Adjusted P/E ratio
Sunpharma (SUNP)	843.15	19.6	43.02	1.78	37.30
Lupin (LUPL)	1,726.60	50.4	34.26	1.33	27.81
Dr. Reddy's Lab (REDY)	3,138.65	126.1	24.90	1.19	24.86
Aurobindo Pharma (AUBD)	709.75	33.9	20.94	0.38	7.96
Cipla (CIPL)	524.70	18.7	28.05	1.45	30.5
Cadila's Health (CADIL)	338.65	15	22.58	1.31	27.5
Divi's Lab (DIVI)	960.40	42	22.86	1.33	27.86
Piramal Enterprise (NCHP)	937.85	55.1	17.02	0.23	4.78
Torrent Pharma (TORR)	1279.10	101.8	12.56	0.82	17.2
Glenmark Pharma (GLPH)	813.60	24.9	32.67	1.60	33.35
Glaxosmithkline (GLXO)	3265.55	44.3	73.71	2.66	55.77
Alkem Labs (ALKE)	1353.75	60.79	22.25	N.A	N.A.
Biocon (BICN)	475.85	44.8	10.62	0.83	17.37
Ajanta Pharma (AJPH)	1404.35	45.2	31.07	0.78	16.38
Alembic Pharma	612.60	38.2	16.03	0.75	15.84

VI. ADJUSTED PRICE-EARNINGS RELATIVE SCREEN

Table 2, however communicates the outcome of the sequence of the Nifty Pharmaceuticals top 15 on the ground of their market capitalization in decreasing order so that the firms under the company could be easily comparable.

The next set of filters that made was the inculcation of the last 5 years data in order to make it more honest, however the 5 years data of Alkem labs was not available as the company was listed on December 23, 2015.

Ad Interim drops in earnings of the companies due to incidents like penalties, special charges, violating the CSR norms, extraordinary events such as USFDA (United States Food and Drug Administration) intervention especially in the cases of Pharmaceutical companies may push the price-Earnings Ratio to a new high. So long as the market digest the earning's fall off as short-lived, the stock price-earnings ratio will be high, as the stock price may not plunge as very as the earnings.But there are some incidents whose effects are cited in the share prices. In our Aurobindo Pharma example, the company had a bloodbath in earnings in 2011 making it a negative price-earnings ratio because of the USFDA alert on one Unit VI Cephalosporin unit located at Chitkul village in Hyderabad and muted demand in Europe (http://articles.economictimes.indiatimes.com/2012-02-13/news/31055257_1_ramprasad-reddy-net-profit-q3).

The year is not excluded from the example in Table 1. Calculating the average Price-earnings average of first 3 years results in Aurobindo is -2.51, which found significantly lower comparing with the original calculation of 7.96.

Table 2 reveals a peer comparison of the top 15 pharmaceutical companies in India, which could help the investors before adding one or two pharmaceutical stock into their portfolio to make it an efficient portfolio. The companies that are much higher in their adjusted price-earning ratio are Glaxosmithkline, Sunpharma, Glenmark Pharma respectively could be the flavor of the short-term investors while the companies which are having low price-earning ratio such as Aurobindo Pharma, Piramal Enterprises, Ajanta Pharma would be the demand of the long term potential investors.

Usually investors look for the news to help attract consideration to a company and to boost its stock price. Low adjusted price-earning relative stocks could be languish and might not come into the consideration of the potential investor until the investors find a reason to re-consider the stock. Surge in earnings revisions, higher revenue guidance and positive earnings surprises are events that push investors to consider the stock. When these factors are revised on the money, market favors the stock to come out with above-average performance.

VII. CONCLUSION

Filtering the stocks to add in the portfolio on the basis of their price-earning relative never go out of favor. Price-earning relative can help highlighting firms that could be a multi-bagger in the coming years.

Price-earning relatives acts as a yardstick which provides a comparative tool to figure out that the firms which have deviated from their accustomed valuation can be priced normal or perform better in the subsequent periods with the stipulation that fundamentals of the company are rock solid. While engineering the selection criteria of low price-earning relative stocks one can include various items such as forward earnings and financial strength of the company and revenue guidance by the company while disclosing their audited and unaudited financial statements as investing funds in low price-earning relative stocks could be outperformer, but caution is appropriate. The current study is finite to the analysis of Price-Earnings Relative and Adjusted Price-Earnings Ratio in Pharmaceutical sector only; forthcoming analysiscould be possible in exploring determinants of Price-Earning relative for Infrastructure sector of Indian stock market.

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