Price-Book Ratio

Another metric used to value a company is the Price/Book Ratio (P/B Ratio). This ratio measures the company's market value to its book value and can give investors an idea of how expensive a company is trading compared to the assets they hold on the balance sheet.

First, let's figure out how to calculate book value for a company and what it tells you. To calculate a company's book value, you subtract the preferred stock from the shareholder's equity that the company currently has and divide that by the number of outstanding shares. All of this information can be found in the balance sheet section of the company's financial statements. The reason that preferred stock is subtracted is that they have priority over common shareholders in receiving dividends and any assets if the company were to go bankrupt. Book value shows how much the company would be worth if all of the assets were liquidated and liabilities were paid out. This can give an idea of whether the company is overvalued/undervalued when compared to the current market price.

Price/Book Value is the amount of money an investor is paying for $1 of book value in the business. This is similar to the P/E ratio, as it is the amount an investor is paying for $1 of earnings in the company. For example, if the P/B is 8, an investor is spending $8 for every $1 they would get back if the company's assets were liquidated today and distributed to common shareholders (assuming the liquidation would happen orderly and that book value approximates liquidation value).

Now let's give an example with JP Morgan ($JPM):

These numbers are pulled directly from the 10-Q report for the period ending 3/31/2022 and given in Millions of dollars.

Total Shareholder Equity: $285,899

Total common shares outstanding: 2,937.05

Book Value/Share= 285,899/2,937.05= $97.34

Now, let's use $JPM current stock price at $115 per share:

Price/Book Value= 115/97.34= 1.18

This shows that common shareholders are paying $1.18 for every $1 in assets that JPM currently holds.

Although JPM is trading above its book value, it is not by a significant amount. Investors can use P/B ratios to potentially find undervalued companies in the market if they are trading below book value and continue to have strong earnings moving forward.
If book value is accurate and you buy close to book value, then there is likely good downside protection with your investment. This is especially true if the business is profitable, and will continue to be profitable, because book value will grow over time. And even more true if you're buying close to tangible book value (i.e. not counting goodwill and other intangibles on the book value calculation).

The P/B Ratio is more relevant for companies, such as banks and insurance companies, that require a lot of capital to run their business and generate profits. It's less relevant for other companies, such as competitively advantaged, capital-light technology companies, because those businesses require few assets to generate their profits, and so usually deserve to trade at decent premiums to book value.

So the capital intensity and quality of business is a big determinant in how useful the P/B Ration can be in the investing process. For more, we suggest reading the section of Warren Buffett's 2007 Letter to Shareholders with the heading "Businesses – The Great, the Good and the Gruesome."