

PUGET SOUND ENERGY

PROOF

If market price exceeds book value,
the market-to-book ratio is greater than 1.0,
and the earnings-price ratio understates the cost of capital.

MP = market price
BV = book value
i = cost of equity capital
r = earned return
E = earnings

1. At $MP = BV$, $i = r = \frac{E}{MP}$.
2. $E = rBV$.
3. Then, $\frac{E}{MP} = \frac{rBV}{MP}$.
4. When $BV < MP$, i.e., $\frac{BV}{MP} < 1$, then,
 - a. $\frac{E}{MP} < r$, since $\frac{E}{MP} = \frac{rBV}{MP} < r$, because $\frac{BV}{MP} < 1$;
 - b. $i < r$, since at $\frac{BV}{MP} = 1$, $i = \frac{E}{MP} = \frac{rBV}{MP}$, but if $\frac{BV}{MP} < 1$, then $i < r$; and
 - c. $\frac{E}{MP} < i$, since at $\frac{BV}{MP} = 1$, $i = \frac{E}{MP} = \frac{rBV}{MP}$, but if $\frac{BV}{MP} < 1$, then $\frac{E}{MP} < i$, because,
 - 1) $\frac{BV}{MP} < 1$, through MP increasing, and, if so, $\frac{E}{MP}$ decreases, therefore, $\frac{E}{MP} < i$, or
 - 2) $\frac{BV}{MP} < 1$, through BV decreasing, and, if so, given $E = rBV$, $\frac{E}{MP}$ decreases, therefore, $\frac{E}{MP} < i$.
5. Ergo, $\frac{E}{MP} < i < r$, the earnings-price ratio is lower than the cost of capital, which is lower than the earned return.