Management-Business combination	Stock Return
Great Management – Great Business	**Potential multibagger**
Great Management – Bad Business	**Cyclical return**
Bad Management – Great Business	**Moderate return**
Bad Management – Bad Business	**Wealth Destroyer**

Chapter – 5

Valuation – It Matters Much

5.1 Why Valuation is an Important Consideration

An investment in Infosys during March 2000 generated negative return for the next six years! Investment in Larsen and Toubro (L&T) during December 2007 produced negative return till 2013! The software giant Infosys is one of the finest company having a consistent growth record with transparent and honest management. During 2000-2006, Infosys reported almost five times growth in revenue and nine times growth in the net profit while maintaining debt free status with superior return ratio. A company that has been maintaining high growth rate with the clean balance sheet and huge free cash flow for the last six years generated negative return! How can one explain this? It is hard to accept while the stock price is the reflection of the underlying business. It reflects that sometimes the world's finest company may not be the good investment option. During March-2000, Infosys was trading at Price to Earnings ratio of 100+. The stock price is not only the reflection of business fundamentals, but it also reflects the irrational behaviours of the market participants. Many times, excessive optimism pushes the stock price into an unsustainable range. It was during dot com bubble that pushed Infosys stock at P.E of 100+. If you purchase a quality product at an excessively high rate, do you find another buyer to take it even at a higher rate? Obviously, "No". Exactly, the same happened with Infosys. It is really important to justify the valuation of any stock; otherwise, you can't make money from your investment. The same logic is applicable on L&T. In spite of being the leading infrastructure company, L&T generated negative return during 2008-2013 period.

So, the world's best company may not be the good investment bet if you purchase it at a wrong price. Till now, we have learned how to analyse companies and its management. To become a successful investor, you have to buy a great company at an attractive price. Identifying great business is just the first step of successful investing. Finding out the attractive price completes the process. In this chapter, we will discover the ways for identifying attractive valuation of any company.

"Best managed companies may not be the good investment idea."

5.2 Common Valuation tools –

Price to Earnings ratio (P.E ratio)

Price to Earnings Ratio (P.E ratio) is one of the widely used and simple valuation ratios. It compares the current market price of the stock with its earnings per share.

So P.E ratio = Current market rate/ Earning per share (EPS)

The ratio is simple and easy to calculate. You can easily get the calculated P.E ratio at any financial website. There are two ways to calculate P.E ratio; trailing and forward. Trailing P.E ratio considers the EPS of past four quarters while forward P.E considers the analyst's estimation of the next year's EPS. Maximum financial websites report trailing P.E ratio whereas various brokerage houses present forward P.E in their research reports.

Price to Earnings ratio in isolation doesn't have any significance. Just by looking at a stock with low P.E (say 9), you can't declare it as undervalued. Various other factors should be accounted before reaching the final decision. Without analysing all other factors, it is impossible to say whether any stock is overvalued or undervalued. So, never follow P.E ratio in isolation. Combine P.E ratio with other factors to take a rational decision.

Best Usage of Price to Earnings ratio-

- **Compare with its historical average -** This is the best possible usage of P.E ratio. You can compare a stock's P.E with its last three years or five years historical P.E. If you find that a fundamentally strong stock is trading much below at its historical average, then it might be a worthy investment. Only make sure that the business model or the operating environment of the company hasn't changed much. If the low P.E is just because of market sentiment, then it can be a great opportunity for the bargain hunter. For example, during 2008 to 2013, Yes Bank was traded at an average P.E of roughly 14. By the end of 2011, it was available at the P.E of just 9 (Price was around Rs-250). Undoubtedly, that was a bargain rate that offered a great investment opportunity. No wonder, within the next one year; the stock generated almost 100% return!

- **Compare with its industry peers**- You can compare a stock's P.E with other stocks those are in the similar business. Normally, a stock that trades at a P.E below than their industry peers is valuation wise more attractive. However, don't rely much on this parameter. Simply, because within the same industry two companies might have different growth rate, different balance sheet strength and also different cash flow and all these factors alter P.E ratio. For example, L&T and IVRCL Infra are in the same industry. But L&T is well placed in managing future risk, debt level and growth than IVRCL Infra. So, it is obvious that L&T demands premium valuation than that of IVRCL Infra.
- **Compare with the broader market**- You can also compare a stock's P.E with the P.E of Sensex to get a rough idea of the valuation. It works well if the company is in part of Sensex. However, different stocks have different stories so you may not get a clear idea. Valuation also differs based on market capitalization. A large-cap Pharma stock that is trading at 30 Price to Earnings ratio may not be expensive whereas a small cap Pharma stock quoting at 20 P.E may be considered as expensive.

What drives P.E ratio?

Different companies have different historical P.E levels. Some stocks (mostly from Pharma and FMCG sector) always trade at a higher P.E while stocks from infrastructure or realty sector often trade at much lower P.E. So, let's have a look why it is so? What are the driving forces?

High growth commands higher PE : - High growth companies always demand a higher PE. If a company is consistently growing faster than its peers across the market cycle then most likely it will continue the trend. Therefore, investors are ready to pay the premium for its future growth. For example, HDFC Bank is consistently reporting 30%+ growth rate across the market cycle since the last ten years. So, it is quite obvious that the bank will demand higher P.E multiple than its peers. Among all private banking stocks, HDFC Bank always commands 20%-30% higher premium.

Business Model – Cash is the king. Companies those generate massive cash flow are less leveraged. Moreover, these companies can easily meet their working capital requirements quite comfortably. Naturally, these companies demand a higher premium that translates into higher P.E. FMCG major ITC is a good example. You will find that ITC always trades at P.E of around 30 or above. Have a look at their cash flow and debt level; you will get the answer. On the other side, follow the infrastructure major Larsen and Toubro (L&T). Their business model is capital intensive, so they have to take massive external debt to fund their day-to-day operations. Higher capital requirement translates low valuation. You will find Larsen & Toubro trade at lower valuation than that of ITC, despite the fact that both are established and fundamentally strong companies and also the market leader in their respective segments.

Drawbacks of P.E ratio

- **Accounting tricks -** In the P.E ratio,"E" stands for earning or simply reported profit. But the problem is that a company can easily distort their reported profit. There are several accounting tricks by which a company can inflate (or sometimes deflate) their earnings.
- **One time income/Charges**- If a company recently sold some of its assets or some other business then that income is recorded as "one-time gain/profit". These one-time income/expenses are mentioned in the footnotes of the income statement. One-time income can easily inflate earning/profit and thus lowers the P.E ratio. Similarly, the one-time expense can negatively affect the reported profit and thus translates into higher P.E. So, have a close look at the footnotes of the income statement to identify such things while evaluating a stock based on P.E ratio.
- **Cyclical Firms** - Companies that go through boom and bust cycle, requires close attention. Cyclical firms are those companies whose profit increases heavily during a particular period, then decreases after some time. Again increases and again decreases and the cycle continues. Such types of companies having fluctuating earnings are known as cyclical firms. Auto or Car manufacturing industry is one such example. Tata Motors, Maruti Suzuki, TVS Motors, etc. are cyclical companies. So, if you find a low trailing P.E of any such cyclical companies, don't get tempted. It may happen that in the near future, earnings may fall. Stock price always discounts the future.

Low P.E may be the indication of bleak future.

Despite being several drawbacks and limitations, P.E ratio is the most popular valuation tool due to its ease of calculation. You can get the calculated ratio at any financial portal. However, your purchase decision should not be based only on P.E ratio. If an asset-light business is growing faster than its peers and is generating huge cash flow with good return ratios then be prepared to accept higher P.E multiple.

Price to Sales Ratio (P.S ratio)

Price to Sales ratio is another basic valuation tool. It is the current price of the stock divided by the sales per share. You can calculate it by simply dividing market capitalization of a company by its reported total sales.

Advantages:

- The main advantage of this ratio is that the “S” portion or total revenue (sales) is not frequently manipulated. Companies that use accounting tricks are more focused on boosting net profit instead of sales. So, unlike P.E ratio, P.S ratio is not manipulated too often.
- Sales are less volatile than earnings. Cyclical companies may report volatile profit but not the sales to that extent. Moreover, one-time charges can boost profits but not the sales.

Disadvantages:-

- The main disadvantage of this ratio is that total sales can’t ensure profitability. A company might report loss with increasing sales. Even the loss might widen with the increasing sales!
- Net profit margin varies from company to company. P.S ratio would be significantly lower for the low margin business. Most retailers have low profit margin and resulting low P.S ratio. On the other hand, high margin business (software business) trades at high P.S ratio. So, while judging P.S ratio, check the industry in which the company is operating.

Best Usage:-

- P.S ratio is of more use when you are analysing stocks that are in the cyclical industry (like- Auto, Cement, Steel, etc.) Companies having one-time profit/charge can also be valued through this ratio. P.S ratio comes handy for any turnaround companies.

Price to Book Ratio (P.B ratio)

Price to book ratio (P.B) is another important valuation tool. It compares the stock price with its book value per share (also refers to net worth).

Theoretically, book value per share indicates the amount that each shareholder should receive if the company liquidates completely.

Best Usage:-

- **Banking Stocks -** The ratio is very useful for Banking/NBFC stocks. Banks have huge liquid assets into their balance sheet. The best part is that most of the assets are mark-to-market, means those assets are frequently revalued. So, the book value of a bank is reasonably current and provides a better picture of the current net worth of that bank.
- **Capital Intensive Business -** Companies having huge tangible assets can be better evaluated by this ratio. However, a factory or a piece of land or any other tangible asset is recorded on the balance sheet at whatever value the firm paid for it which is often different from the current value of that asset. Thus, it can misguide the result.

Drawbacks:-

- **Service Sector-** P.B ratio has almost no significance for software companies. Consider the example of Infosys; they are creating wealth through intangible assets such as brand name, database, industry reputation, etc. Such intangible assets are not recorded in the balance sheet. So, software firms or the companies that generate most of their wealth through intangible assets should not be evaluated through book value.
- **Inaccurate Measure-** As discussed earlier, tangible assets may not be valued as per the current market rate. A factory or a piece of land is recorded on the balance sheet at the value that the firm paid for it

which is different from the current market value. Moreover each firm carries some intangible assets that are difficult to measure. Like, L&T has a strong brand name that makes it a dominant player in the sector. Now, you can't calculate the exact value of that the brand name.

Combining P.B ratio with ROE:-

Price to book value is tied with Return on Equity (ROE). Given the two companies that are equal elsewhere, the one with higher ROE will have higher P.B ratio. The reason is simple. The company that can return higher value on its equity should quickly compound its book value at a faster rate. Companies whose ROE and P.B ratio doesn't go hand in hand should be analysed with extra care.

Final Words:-

Like every ratio, the P.B ratio also has several advantages and disadvantages. This ratio is useful for analysing Banking/NBFC stocks and other capital intensive business but doesn't have much significance in the service sector or software firms. Lower the ratio better is the investment opportunity.

5.3 Misconception among Investors –

Misconception #1 - Low-priced stocks are cheap and high priced stocks are expensive.

During the last several years, I had interacted with thousands of investors and noticed one peculiar myth. Followings are the illustration-

During March 2013 I had suggested a stock that was priced at Rs. 1200. To my surprise, just after the suggestion, I started receiving comments like-

"How a stock, priced at ₹1200 can generate multi-fold return?"

"I don't want to invest in such high-priced stocks, provide me some low priced stocks."

"The stock is already at ₹1200, so where is the room for further price appreciation?"

Within one year from the suggestion, the stock touched its life-time high of Rs-2300. There are hundreds of examples where a “so-called high-priced” stock generated multi-fold return. Page Industries was trading around ₹1,000 during July 2010. By the end of 2014, the same is hovering around ₹7,000. Seven times return within four years! Consider the well-known tyre manufacturer, MRF. It was trading around ₹3,000-3,500 during January 2008 (peak of bull-run). By the end of 2015 the price jumped to ₹28,000 level! Yes, it is twenty-eight thousand, there’s no extra zero! 8 times return within seven years from a high-priced stock. The best part is that even from this level, the stock is poised to move in the upward direction.

Conversely, there are many low priced stocks (priced below ₹10) consistently underperforming the market. A well-known penny stock Shree Astavinayak Cine Vision was available around ₹7 during 2011. Within the next two years, the stock price came down to ₹0.70 (70 Paisa) - 90% loss within two years! By 2014, the stock is no more traded at the either exchange (NSE and BSE)! 3i Infotech, Rei Agro, Kingfisher Airlines – all are examples of low-priced, consistently underperforming stocks.

Once an investor informed that he purchased few low priced stocks and considered them as “lottery ticket”. His thought process was like either those ₹3-4 stocks turned into money multiplier or remained on the same level. No wonder, his portfolio was showing 70% loss! Instead of purchasing thousand quantities of 3 rupees stock, had he bought a single quantity of MRF at ₹3,000, he would have earned multi-fold return.

One may think that a two rupees stock can easily generate multifold return even if the price reaches to ₹ 5 or 6. But at the same time people forget that if the same stock comes down to ₹1, they will be in 50% loss. Further, if the condition worsened, then the same will fall even more and get disappeared thus resulting in 100% loss. Many stocks used to trade around ₹1-2 few years back and currently they are no more traded in the stock market. So, don’t think that one rupee or two rupees stock can’t fall further!

Even today, I receive requests from new investors asking for ₹10-20 stocks. Their methodology includes investing more quantities in low-priced stocks. It is difficult to convince amateur investors that price is just a number, nothing else. A fundamentally sound thousand rupees stock has a better probability to double your money than a mediocre ten rupees stock. After all, at the end of the day only return matters, it doesn’t matter how many stocks you own!

“Low-priced stocks are cheap” – this single misconception caused severe loss. Thousands of amateur investors become a victim of this misconception. Always remember, the stock price is just a number and nothing else.

“A □2 stock can be costlier than the □2,000 stock.”

Misconception #2 – Investing in low P.E stocks is called value investing.

During my initial years of equity investing, I used to run for stocks with low Price to Earnings ratio, low Price to book ratio and high dividend yield. Finally, I ended up with below average return on my overall portfolio. Very soon I realised that Value investing is not about finding low P.E stocks.

Naive investors put too much focus on statistically cheap stocks and called this attribute as “Value investing”. My dear friends, you are committing a big mistake. Stocks with low P.E., low P.B., and high dividend yield look cheap statistically. It may seem like bargain hunting but the reality is that most of these stocks have a very low-quality business, or their future earnings growth is in a big question. Valuation is a direct function of future earnings growth. If a business can grow by 30% annually, then it should command the premium.

Quality justifies the premium pricing. Even in real life, we don’t hesitate to pay extra for a quality product from a reputed brand. You can’t compromise on price for the quality. So, why you should hesitate when it comes to equity investing?

5.4 Valuation techniques and their drawbacks –

Discounted Cash Flow method (DCF)-

In simple terms, discounted cash flow method attempts to find out the value of a company today, based on projections of how much money it's going to make in the future. DCF analysis says that a company is worth all of the cash that it could make available to investors in the future. It is described as "discounted" cash flow because cash in the future is of less worth than cash of today. If the value arrived through DCF analysis is higher than the current cost of investment, the opportunity is considered as good one.

Apart from DCF methods, there are few more common valuation methods like – asset-based valuation, Liquidation value method, reproduction cost method, etc.

I am not going to explain DCF in or any other method in detail because ***I believe, theoretically these methods are almost perfect, but practically they are of no use.***

DCF is merely a mechanical valuation tool. By this method, you are predicting the future cash flow of the company, based on either past performance or business model. Is it practically possible to assume future cash flow of any company for the next three/five years? The business world is dynamic. Changes in technology, government regulation or higher competition can completely derail your estimation. During 1998-2000, how many analysts predicted future cash flow from mobile telephony business? During 2005-2007, online education provider Educomp was in the limelight. Various analysts predicted huge growth potential that caused multi-fold return within a short period. However, post-2008; the stock suffered 90% crash in its price! How can you predict future cash flow of cement or steel or any other similar commodity business? How can you figure out the capacity expansion plan? Is there any confirmation that the entire new capacity will be fully utilised? Can you say that the higher competition won't grab their market share in future? Similarly, you can't predict future cash flow for FMCG or Pharmaceutical companies considering factors like regulatory environment, higher competition, user preference or demographic shift. In a nutshell, it is next to impossible predicting the future cash flow of any business for the next 5-10 years. Moreover, small changes in input can largely alter the intrinsic value. A marginal error in an assumption can cause a huge difference in the result. Due to such high complexities, DCF method has little to no practical significance. Following examples are sufficient enough to prove that traditional valuation techniques have almost no practical usage.

Drawbacks with practical examples -

During June-2013 Astral Poly Technik (small cap stock from the Plastic sector) was traded around ₹230 with the P.E range of 35-40. If you had attempted to justify the valuation via DCF method (or any other method), you had concluded it as "highly overvalued". By August 2014, the stock price touched ₹800 level! More than three times return (250%) within one year from so-called "highly overvalued" stock and quoting at a P.E of 50+! Any valuation technique or any formula will again conclude it as "highly overvalued". Still, from that price range, the stock will most likely continue its upward journey.

The same phenomenon applies to dozens of stocks like Page Industries, Eicher Motors, HDFC Bank, etc. Throughout the year of 2014, Page Industries was quoting at 55+ P.E. Not a single valuation formula can prove it as "undervalued" or even "reasonably valued", still the stock is poised to generate an above-average return over the next 2-3 years. HDFC Bank, a well-known large cap bank also illustrates the same. Historically, HDFC bank always trades at a premium compared to its peers. Since the last ten years, many analysts have been coming up with their research reports mentioning "Cautionary" outlook on the valuation front. However, the stock has excellent track record of providing 25%+ CAGR return to its investors since the last 12 years.

Astral Poly Technik, Page Industries, Eicher Motors and HDFC Bank – are examples that conclude that not a single valuation technique or formula is sufficient enough to take an investment decision. Business school will teach you complex valuation methods like DCF, asset-based valuation, Liquidation value method, reproduction cost method, etc. If you remain highly dependent on these methods, you will miss many great money making opportunities.

Why Valuation Method Fails –

Valuation is an art, not a science. It is not like a numerical problem that can be solved using few formulas. The stock market is dynamic in nature. Today's winner can easily turn tomorrow's loser. Valuation is like predicting the future potential of a stock and assigning a value. Whenever you are predicting future, there come lots of "if and else". Manual intervention is must to handle such uncertainties. A single formula or a well formulated excel sheet is not sufficient enough to handle this. If you conduct Google search, you will get various ready-made Excel spreadsheet based on DCF valuation method. With the advent of technology, it is easy to find the software that can compute the valuation. Always remember, valuation is an art and software can't master the same. A single formula, any software or any well formulated excel spreadsheet can't help you. It is you who can find out the proper value by your own set of methodologies.

"Not a single formula or excel spread sheet is sufficient enough to judge valuation"

5.5 Easiest Way to Judge Valuation –

My attempt is to present complex subject into an easy-to-understand method. Anyone having basic understanding can implement the following methods. There are two components in my valuation method – First one is to compare with its historical average and the second one is to compare P.E with average growth rate. Let's find out how combining the both can do wonders with.

Comparing Valuation with its Own Historical Average

Comparing valuation with its own historical average provides a clear indication. During the last 20 years, average Sensex P.E remained around 18. Whenever it crossed 25, a market crash followed. (Sensex P.E is calculated by dividing the total market capitalization of Sensex stocks by the total net profit of all 30 Sensex stocks; i.e. market capitalization/total net profit). At the peak of the dot-com bubble (March 2000) and the peak of 2007-08 bull run – on the both occasion Sensex P.E crossed 25. On both the occasion, year-long market crash followed. So, it is quite easier to figure out the bubble and take precautions to make the most from a market crash.

Conversely, whenever Sensex P.E reaches below 15, it was followed by year-long bull-run. During early 1999, 2009 and December 2011 Sensex P.E dipped below 15. Those who invested during these periods ended up with a handsome return. Moreover, you won't find a single investor who suffered loss by investing during those periods. Considering the recent example, during December-2011, Sensex was at 15,500 (Sensex P.E dipped below 15). By August 2014 Sensex was hovering around 27,000, the return of around 75% within 3 and half years. So, even if you had invested in all Sensex companies during December-2011, you would be in 75% profit within 44 months. It doesn't require in-depth understanding or complex formula to earn big in the stock market. All it requires is discipline, hard work and basic understanding. Sensex P.E below 15 is a golden opportunity for investing in the stock market. You might find such occurrence once or twice in a decade. So, make sure to utilise any such future occurrence fully.

Now, let’s have a look at the another part of our valuation method -

Comparing P.E with Average Growth Rate-

I have already discussed P.E ratio in detail. Now let’s find out the last three years average profit growth rate. It is better to consider EPS (Earning per share) growth rate because at the end of the day it is the EPS that matters the most for shareholders and many times, profit growth doesn’t translate into EPS growth. In the case of equity dilution, EPS growth rate will differ from profit growth. *However, for the ease of understanding, I am going to discuss this method with profit growth rate*. Suppose a company is growing at 10% annually, then what would be the fair price multiple? The answer will vary based on the risk appetite of investors. From my experience, one should not pay more than 20 price multiple for the company growing at 10%. In other words, make sure that the current P.E is not more than two times of the last three years average growth rate.

It is almost similar to the concept of Price to Earnings Growth (PEG) ratio that is calculated by dividing P.E ratio with the earnings growth rate. So,

PEG Ratio = Price to Earnings ratio/ Earnings Growth rate.

The only modification is that I am considering the last three years average EPS growth rate. It can be concluded as –

1. PEG ratio less than 0.5 indicates that the stock is undervalued and can be a great investment bet.
2. PEG ratio greater than 0.5 but less than 1 indicates that the stock is either undervalued or reasonably valued, based on other parameters it can be a good investment bet.
3. PEG ratio greater than 1 but less than 2 indicates that the stock is reasonably valued. To take any investment decision, make sure to check other parameters.
4. PEG ratio greater than 2 indicates that the stock is overvalued.

PEG ratio combined with historical valuation will provide better insight on the valuation.

Historical P.E analysis of Sensex has been described earlier. Now, let’s focus on individual stocks. Moving back to the comparison of historical valuation, first of all, find out the average P.E ratio for the past five years. Suppose, in the last five years, a stock is traded in the P.E range of 5 to 25. So the average P.E comes at 15. Now let's consider the following conditions-

1. P.E at 8-12 (20%-40% discount than average) – Considering the current P.E, which is less than the last three years average growth rate, the range of 8-12 is considered as "undervalued" and may offer an attractive entry opportunity.
2. P.E at 12-18 (near average) – In this range, the stock is "reasonably valued". It can be a good entry opportunity if future prospects of the company remain intact.
3. P.E at 20-30+ – In this range, the stock is "overvalued". If at the same time, P.E ratio is greater than twice of the last three year's average profit growth rate then avoid the stock.
4. P.E at 5-8 or below 5 – In this case, it requires serious attention. We can't mark it as "undervalued" without having an in-depth study. Such low valuation may be because of recent serious damage in the fundamental of the company.

Detailed Example-

For further clarification, let's consider the example of Yes Bank. During 2010-2014, Yes Bank has a consistent average growth rate of around 38%. During the same period, the stock mostly traded in the P.E band of 6-22.Thus, average P.E becomes 14. With the average earnings growth rate of 38%, PEG ratio will remain below 0.5.

PEG = P.E/ Average earnings growth rate

PEG = 19/38 =0.5

So, our first consideration of undervaluation will perfectly hold anywhere below the P.E of 19. Don't take investment decision based on only one criterion. Now, considering the historical P.E band of 6-22, average historical P.E comes at 14. It will translate the followings –

1. 20%-40% discount than average – P.E band 8-11 (Best investment opportunity)
2. Near average – P.E band 12-17 (Mediocre investment opportunity)
3. Upper range – P.E band 17-22 (Don't make fresh investment. You

can sell your existing holdings)

4. More than 50% discount than average – P.E band 6-8 (Requires serious attention)

So, as per the formula, the stock will offer the best investment opportunity in the P.E band of 8 to 11. From 2010-2014, Yes Bank was found trading in this valuation zone twice –during December 2011 and during August 2013.

During December- 2011 and early January-2012 P.E was hovering around 10 and the stock price was around ₹240. As per the valuation method, this is a great investment opportunity. No wonder, by December 2012 the stock price generated around 95% return (quoted around ₹470). At the price of ₹470, P.E ratio was around 18 i.e. upper band of the average. Thus, indicating Exit/Profit booking signal.

Yes Bank Valuation analysis with entry and exit point				
Average P.E 14, Attractive Buy Zone – P.E 8-11				
	Dec,2011	Dec,2012	Stock Return	Sensex return
P.E ratio	10	18		
Stock Price	240	470	95%	25%

Similarly, during August-2013, P.E was hovering around 10 and the stock price was around ₹280. For a short duration, the stock price reached below ₹250 and P.E touched 6. The aim is not to find out the exact bottom. Successful investing does not require finding out the exact top and bottom. It is next to impossible to buy at the exact bottom and sell at the exact top. As per the valuation method, ₹280 was a great investment opportunity. No wonder, within one year the stock price generated 100%+ return. By August 2014 the stock price was hovering around ₹600.

Yes Bank Valuation analysis with entry and exit point				
Average P.E 14, Attractive Buy Zone – P.E 8-11				
Time Period	Aug,2013	Aug,2014	Return	Sensex return
P.E ratio	10	15		
Stock Price	280	600	114%	46%

We can summarise the above illustration as follows-

- If current valuation (P.E and P.B ratio) is less than the last five years average and the current P.E is less than half of the last three years average profit growth (PEG ratio < 0.5), then we can conclude that the company is undervalued and can become a great investment bet.
- If current valuation (P.E and P.B ratio) hovers around the average of the last five years valuation and current P.E is less than or equal to last three years average profit growth (PEG <= 1), then we can conclude that the company is reasonably valued.
- If the current valuation is either in the lowest or highest range of last five years range, then it requires serious attention.
- If current P.E is double of the last three years average profit growth rate (PEG >2) and the current valuation is in the highest band of last five years average, then the stock is overvalued. It is always better to avoid such stocks.
- You can get a better result if you replace profit growth rate with EPS (Earning per share) growth as it is the Earning per share that matters the most. Moreover, profit growth doesn’t always ensure EPS growth. After equity dilution, profit growth rate and EPS growth rate varies.
- To judge any cyclical business, you can alter the consideration period. Instead of 3 years or 5 years average value, you can consider any period based upon the circumstances.

Limitations – The above method won’t work for loss-making companies as we are relying upon profit growth rate. So, it won’t provide a clear picture of turnaround cyclical business or loss-making business having good future prospects. However out of 10 loss-making companies only 2-3 successfully turns around. Further, it might take longer than expected for the turnaround. For example, Suzlon started reporting loss since FY2009. Many analysts anticipated turnaround during 2012-2013, but it didn’t turn into reality. Thousands of investors are still stuck on Suzlon. Similarly, Bajaj Electrical took longer than anticipated to turn around its loss-making business. Thus many investors were stuck on that stock for a prolonged period. Staying away from such stories is a prudent move unless you have enough conviction and in-depth understanding on the business. So, it is better to stay away from any loss making business. You can earn better result by simply avoiding loss-making business. What's the necessity of following such business while hundreds of quality businesses are there?

Advantages of Our Valuation Method –

Unlike DCF method or asset based valuation method or any other valuation method, the above-mentioned method is easier to implement. No need to use any Excel sheet, no need to make any difficult assumption. You don't have to predict future cash flow and discounted rate. It will take huge resources if you are going to predict future cash flow based on the current business model because in such situation you have to study entire industry dynamics and peers analysis. The chances of errors are also higher while predicting future. A single small error has a multiplying effect that can alter the result by a huge margin. In any other conventional valuation method, the input data itself is based on assumption. Thus, the higher chances of wrong output. However, in our method, the past numbers are using as an input. Thus the input data can't be wrong. As there are no chances of mistake in input data so the result would mostly become correct. Only if you can work hard, dedicate time and have the burning desire to master the art, you are ready to go.

Final Words –

As I have mentioned in the beginning, valuation is an art, so don't think that you can master the subject from the day one. To master any art, it requires discipline, practice and desire to learn. Same goes here. You need to dedicate time and energy. Your MBA degree or any certificate won't help much for mastering valuation. Thus investors having no professional qualification can also master the art of making money in the stock market. No need to memorise any complex formula. No need to prepare well formulated excel sheet. Just implement the above stated simple method again and again. It will surely serve your purpose. With your growing experience, you can master the art better.

POINTS TO REMEMBER

- World’s best company may become the worst investment bet if you purchased it at wrong price.
- Investing in low P.E and low P.B stocks is not called value investing. Statistically cheap may prove as “value trap”.
- A ₹2 stock can be costlier than the ₹2000 stock. Price is just a number it has no relation with the valuation.
- Valuation is not a science, it is an art. No single valuation formula or complex excel sheet can conclude whether a stock is undervalued or not.
- To master any art, it requires time. You can’t master the art called “valuation” from day one by memorizing some formula. Huge amount of time, dedication with the burning desire of learning can only help you to master the subject.