MAGADH CAPITAL

Fair Value Estimation 101 At Magadh PMS

As a topsy turvy month brought the curtains over financial year 2023-24 we, as portfolio managers, look back at the year gone by to explore the learnings.

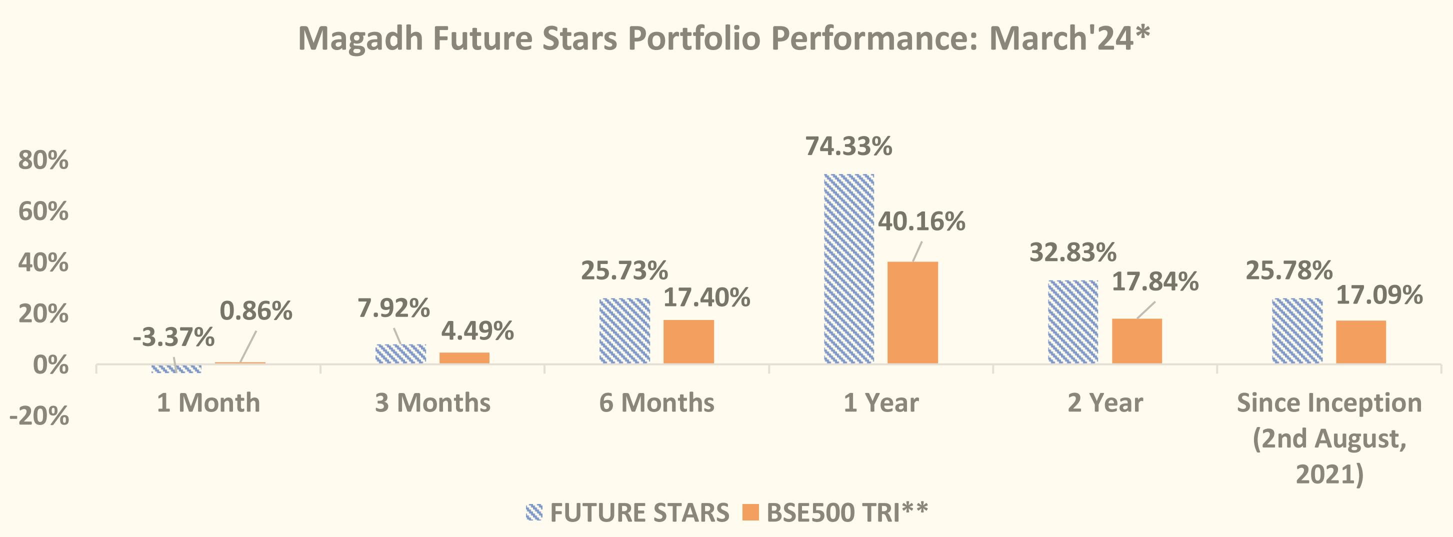
We performed well in FY2024. Our Future Stars (FS) and Value for Growth(VG) portfolios delivered 74.33% and 58.58% return – after all fees and expenses- in the year, versus benchmark (BSE 500 Total Return Index) return of 40.16%. Of course, a side effect of this solid performance during the year was the relatively sombre performance during the month of March, 2024. Performance fee – that is chargeable once annually- kicked in at the end of March, impacting the portfolio performance in March month even though the one year performance remained fairly robust.

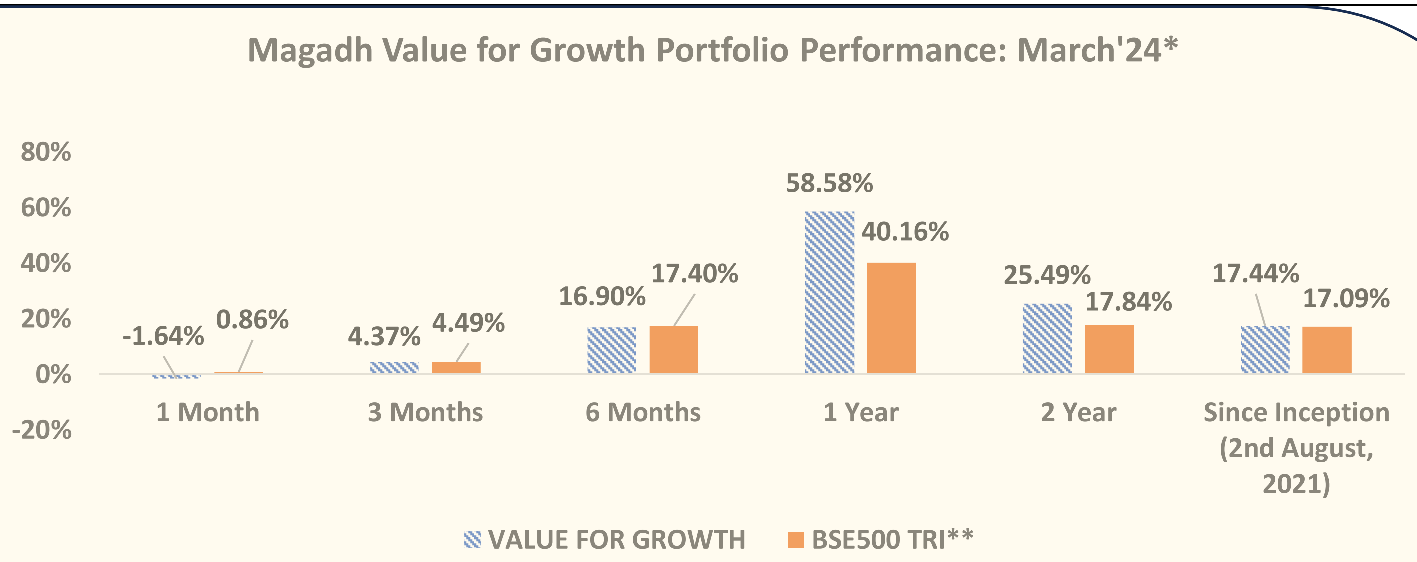
To us it is satisfying is that we stuck to our investment philosophy and process without getting tempted by short term opportunities and followed our standard risk management practices with full focus. As we have moved into a fresh year our approach and strategy remain the same. We do not attempt to time the markets nor do we chase hot stocks in hot sectors. As we help our investors in their pursuit of wealth creation, our risk management process aids our efforts towards capital protection. Behavioural finance provides guard rails to our investment framework helping us reduce the number and intensity of mistakes. Fundamental research is the basic building block of our investment process. For us fundamental research is centred around the exercise to estimate a stock's fair value. This exercise understandably requires a lot of effort. Eventually a fair value derived with a probabilistic approach helps us asses the margin of safety and, if the stock offers a favourable bet.

Here it would not be out of place to quote Joel Greenblatt, the famous American investor – " It's a very small fraction of people that can value businesses- and if you can't do that, I don't think you should be investing on your own. How can you invest intelligently if you can't figure out what something is worth." In our view poor investment outcomes are almost always rooted in either lack of control over emotions, or mistakes in (or reluctance to perform) fair value estimation.

Below we explain briefly the three methods we apply to estimate the fair value of the stock -

1) Multiples method – This is often the easiest method of evaluating a stock. This method looks





**Date is for the period Aug 02, 2021 till March 31, 2024. Performance is as TWRR - Time Weighted Rate of Return. Data for more than one year has been annualized. Past performance is no guarentee of future returns. Performance data provided herein is not verified by SEBI. **TRI - Total Return Index.*

to estimate the relative value of a company by comparing it to price of comparable companies. Multiples like P/E (price to earnings), P/BV (price to book/value) , EV/EBITDA (enterprise value/ earnings before interest tax depreciation and amortization) etc are derived for the company and compared to peer group or to historical trends of the company itself.

2) DCF (discounted cash flow) analysis to estimate the intrinsic value of the stock – This is the first principle – and typically the best, method of valuation. We use this as the bed rock of our valuation exercise since we find this to be the most robust and all-encompassing approach to estimate fair value of a stock. The concept in practice here is that the value of a company is equal to net present value of all the future cash flows. Handled properly this analysis is an excellent tool to analyze a company's prospects. By delving over the assumptions to be plugged into the DCF model one raises, explores and addresses a lot of questions regarding the company's business model, competitive advantages, sustainability, and probability to do well.

3) Replacement cost method – For many companies especially those in some old economy sectors with high capital requirement this method works well in extreme circumstances. This method provides a good idea in case of excessively high or depressingly low stock price of a company. This method works to estimate the price that a potential acquirer of a company will pay, or that company's assets will fetch upon liquidation.

Given that our investment process is heavily oriented towards bottom-up fundamental research, the above summarized valuation methods provide the core to our investment framework. As the new financial year has begun we are confident in our ability to deliver healthy portfolio performance by sticking to our investment philosophy and process.