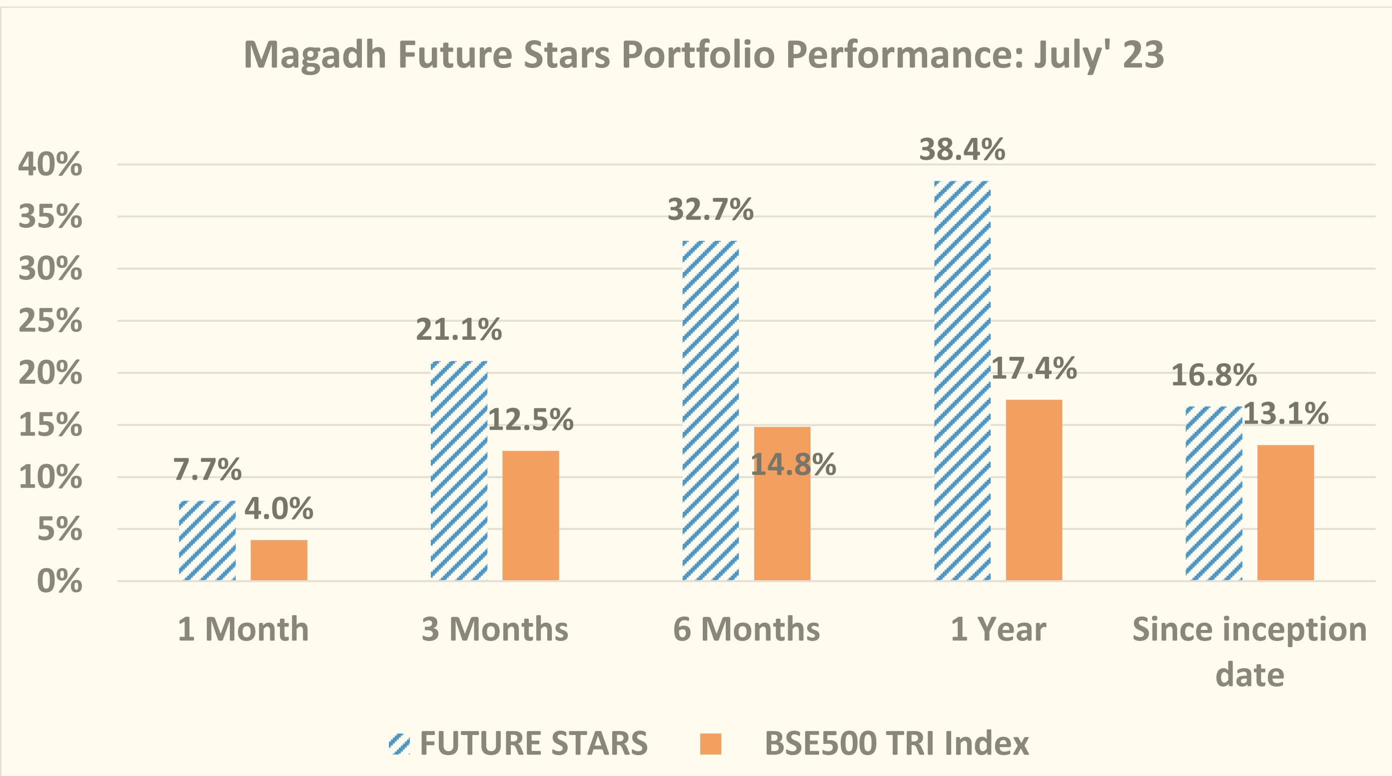
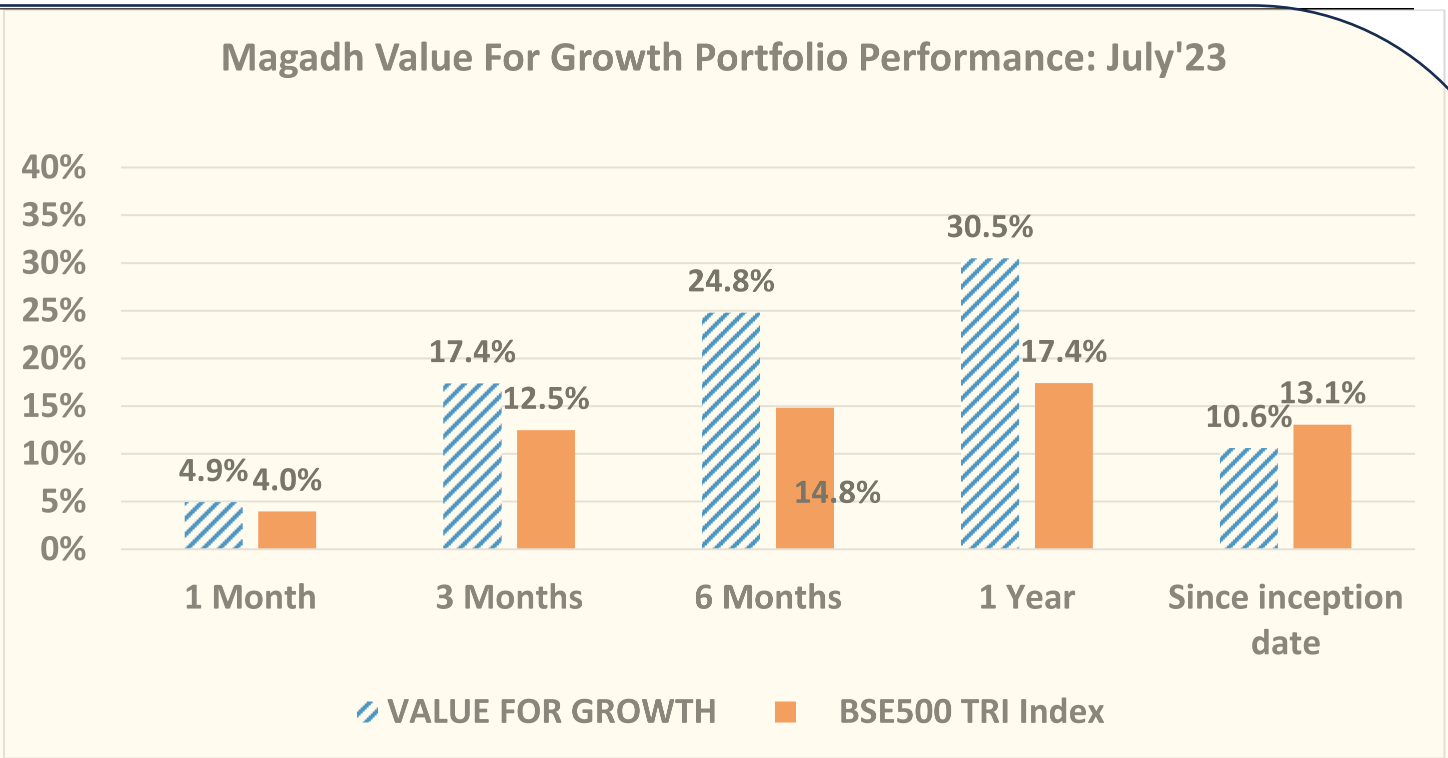
MAGADH CAPITAL

Valuations, And Our Bias For DCF Method

Equity markets are eventually witnessing regression to mean. Nifty 50 performance has been muted in last 4-5 weeks. FII investments in Indian equities too have tapered down. In a way this should provide some joy to long term investors by suggesting that whatever froth was there in the markets is settling down. From a fundamental perspective we find it difficult not to be optimistic on Indian equities' 3-5 years prospects.
In last one year, as on 31st July 2023, Nifty 50 was up by 15.1%. Our Future Stars, and Value for Growth portfolios were up by 38.8% and 30.5% over one year as on 31st July while our benchmark BSE 500 TRI index rose by 17.4% in the period.

In the recently concluded result season, 1QFY24 results for large parts of our portfolio were healthy and the companies in our portfolios seem set on a healthy and profitable growth path with generally rising return ratios. Out of the combined total of 36 companies in our two approaches , Value for Growth and Future Stars, only two companies witnessed a YoY (year on year)decline in net profits. 8 companies had revenue growth lower than 10% YoY while 20 companies delivered revenue growth of more than 20%. Similarly, 20 companies registered PAT growth of 30% YoY or more.





Data is for the period Aug 02, 2021 till July 31, 2023. Performance is as TWRR - Time Weighted Rate of Return.Data for more than one year has been annualized .Past performance is no guarantee of future returns. Performance data provided herein is not verified by SEBI.

Our bias for DCF

Why do we use DCF, i.e. the discounted cash flow, methodology as the bedrock of our valuation exercise? We use multiples method too almost invariably, and replacement cost method occassionallly but DCF is a must do exercise in our decision making process in most instances. (Fair) Value of a company by definition and in practice lies in the company's future cash flows. Take the present value of future cash flows of the company and deduct the net debt and you get the fair equity value of the company. Of course there are lots of twists, turns, uncertainties, and minefields along the way since this can not be an exact science. This is about the future. It can't be predicted with certainty but if we get a reasonable range of outcomes and think in probabilistic terms we can get a decent level of confidence in our stock calls.

How does DCF model help in analysing and evaluating a stock –

1. Bridges narratives to numbers - Stories pertaining to a stock are easy to weave and to understand, while numbers provide substance to the stock call. Stories if not backed up by numbers can end up being pipe dreams. If they can't be explained by stories then numbers end up being far from from reality. Now, a DCF model is as good as the assumptions plugged in there. As one thinks about the assumptions one gets a better

picture of the company. These assumptions must stay true to the narrative around the stock. Thus, if a company has tailwind strong enough to provide a boost to its revenue growth over next 4-5 years then this should show up in the DCF as revenue growth assumption of say, 25% per annum between FY23 and FY28. Similarly, the tone of the story should draw from the numbers being suggested by the model.

2. Helps in understanding the business model of a company- The more one works with the discounted cash flow (DCF) model, along with the earnings model of the company, the better the grasp that one attains over key business drivers of the company. Crucially, one also senses which are the deceptively important drivers that should be ignored, to instead focus on the more relevant metrics. Take the example of a recent development in ITC , one of our portfolio holdings in the Value for Growth approach. There was a lot of excitement in the investment community regarding the announcement by the company that it planned to demerge and list its hotel business separately. Our DCF based sum of parts valuation exercise suggested that hotel business was less than 4% of ITC's fair value. Even if there was market mispricing of 40-50% on the hotel business it would not swing the needle by more than 1.5-2% for ITC's fair value on the whole. Accordingly, for us the event was of low interest level. We were rather spending time on trying to assess risks on the company's cigarette business and the opportunities for its FMCG business.
3. Captures the prospects of a company in entirety – This methodolology inherently assigns weightage to factors like revenue (volume of product/ services, pricing power, industry dynamics), margins (costs- fixed, variable, sustainable advatages), capex (specific capex, asset turnover), return on equity, working capital , cost of equity(10 year government bond yield, market risk premium, stock beta) etc that they respectively deserve for the evaluation of a company, unlike other valuation methods. Probability of mistakes are lower in this process.
4. Rigour and flexibility – This method strives to make use of almost every important piece of information about a stock. Thus it involves some hard work in understanding the company's business model, in formulating the earnings model properly to ensure that various business drivers are performing their function in the model too, and then in looking for data and in fixing the assumptions. At the same time the model allows flexibility to the investing practitioner. In DCF method one can shut out some business/model driver if it is no more relevant for the company's future cash flows or risks. Similarly, it can be used to derive what is the current stock price reflecting by reverse calculating the assumptions from the current stock price. The methodology offers scope to vary one or two variables keeping other business variables constant to see the impact on the stock's fair value. This exercise is helpful if the investor believes that in medium term the other variables will largely remain in a narrow range.
5. Helps in working with ranges and probabilities – DCF methodology is a valuation method that is highly amenable to flexing for outcomes in ranges and to isolating probabilities for various outcomes. This is possible since it works in a systematic fashion by breaking up the problem of valuation into small stage problems.

The good point is the DCF valution exercise does not require much knowledge of accounting. Just some basic concepts, common sense, understanding of the business of the company in question, and attention to detail are what are required to run and extract the most out of DCF valuation exercise.

Some common objections against DCF methodology-

Despite it being one of the most robust, practicable, and logical approach to valuation DCF does not find many takers amongst investors. Some commonly cited objections - and our counter arguments - are as follows -

1. Too many factors to consider - Many invetors get overawed and frustrated by the seemingly high number of variables that need consideration in this methodology.

However, the number of key factors , depending on the company and the sector in which it operates, is typically not more than 5-6 in this exercise. Secondly, Albert Einstein's statement is quite apt here " Things should be made as simple as possible but not simpler". In search for simplicity we should not let go of the essence of our analysis. Variables like revenue growth, margins, terminal growth rate, capex and working capital requirement, cost of equity, capital structure etc have to be addressed when one is evaluating a company – there cannot be escaping these. Yes – this method involves hard work but then in doing so, it reduces dependence on luck in investing.

2. Extremely sensitive to some factors –

As mentioned above, these fundamental business drivers can have varying impact on the fair value of a company depending on the company's business. If the earnings model has been formulated based on sound understanding of the company's business then this should not cause any concern. For example, for a company like Zomato even minor tweaks in selling/distribution expenses as a % of sales causes large swings in earnings forecasts and the stock's fair value. This is in line with the company's business model and hence should not be a cause of concern.

3. Doesn't work in cyclicals -

Quite to the contrary, this method works better than competing methods like multiples method for cyclical companies too. In cyclicals, prices of finished goods and raw materials move in cycles that often last for 4-5 years. In addition, new projects for such companies have gestation of 3-4 years or more. This necessitates building in forecasts for 4-5 years instead of working with one year forward forecast as is done in price to earnings, or price to book value , or EV/ EBITDA multiples that are generally applied in such cases. Unlike in other sectors here the terminal stage of DCF model kicks in earlier – say, in 4-5 years from the current year, depending on visibility on prices etc. Terminal year's commodity price can be derived as the long term incentive price based on industry cost curve of the commodity.

4. How can you know what will happen 5 years or 7 years down the line ? How do you forecast cash flows for such far out periods in future ?

True – this model works on forecasts of earnings, even if in a cursory fashion. The risks of forecasting can be mitigated by having two or three scenarios for forecasts (say, base case, bull

case, and bear case). In any case, investing is all about future. We can use whatever term we may like for the exercise but we can not escape taking a peek into the future - irrespective of the methodology that we use. For example, if we prefer P/E multiple, then we must use the forward multiple - which uses future, forecast earnings- for it to have some chance of catching at least the direction of the stock price right.
Yes - this is not easy but then, when has investing been easy?

5. It can't predict short term stock price volatility-

This is true but short term volatility can not be predicted which ever valuation methodology one uses. Price to earnings or price to book or enterprise value to ebitda, or replacement cost - none of them can predict short term price fluctuation. These fluctuations are driven largely by emotions and depend almost entirely on luck in short term. DCF is to be used and gives good outcomes only for long term stock evaluation.

Make no mistake…

There are some areas where DCF comes up as far from ideal - but even in such places it turns out to be much better than other methodologies of valuation. DCF is not a magic wand. Instead it prompts an investor to think more and work more. The result is higher conviction which allows the investor to ride out stock price volatility. At the same time, DCF, like other valuation tools, does not and can not help on the Behavioural side of investing.

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