Anatomy of an Expensive Stock

As macroeconomic factors remain centre stage, markets may continue to be choppy for some more time. We believe Indian markets are taking a breather for the next round of rally over next 3-5 years. There are good money making opportunities available across sectors and across the market capitalization curve.

We have used the opportunity provided by the elevated volatility in last three months to rejig our portfolio by adding some quality stocks that we had considered expensive earlier. Obviously we see money on the table for which we have taken positions in these stocks and are looking to add further in future if we find attractive price points again.

We present below some perspectives on stocks whose P/E (or P/BV if that is relevant) multiples are at a significant premium over market or sector or historical multiples.

Entry price is one of the keys for wealth creation. We are extremely wary of the approach to buy stocks, however good they are, at any price. This aids healthy returns over long term and limits the downside if things do not pan out as expected. To us everything has a fair value and we consider a purchase only if the price is sufficiently below the fair value. Gold is considered valuable. One may buy 10 grams of gold for Rs 45,000, or Rs 50,000, may be Rs 55,000, or even Rs 60,000. However, at some point – at say, Rs 70,000 one may let it pass. Gold is valuable but at some point its value may not justify the price.

The important thing here is to estimate the fair value of a stock and to see how much is the gap between fair value and the stock price.

Earnings or asset based multiples are a good starting point to evaluate a stock but they should not be the only factor.

a) When using P/E multiple both, trailing twelve months as well as future- 1 year forward, and/or 2 years forward multiples should be used;

b) P/E should also be examined in the context of earnings growth, ROE, cost of capital, earnings volatility, visibility of earnings, and confidence with which earnings forecast can be made for the company;

c) P/E multiple should also be used versus past multiples of the stock and peer group multiples.

Quality and growth - one has to pay a price as long as the fair value is higher

Remember, to make money – or at least, serious money- one needs to take calls that are different from consensus (and then, go right). If the market believes in every good thing that is known about the company then there is a high probability that the fair value is equal to the current market price. If you believe that consensus is right in its analysis then fair value, per your estimate, is not too different from consensus estimate of fair value which in turn is quite close to the current stock price. Then where will your upside come from?

If you are buying a stock at 100x P/E aren't you buying something on which market – as reflected in the high P/E multiple- is already quite bullish? Isn't your call in line with consensus view ? The company may have a solid brand, difficult-to-replicate distribution system, sustainable cost advantage, possibly even a legal monopoly – but aren't these all fully reflected in 100x P/E ? These are genuine concerns.

Chances are high that answers to these questions are all in the affirmative – there is not much upside in the stock from here. But then how does one justify the movement in stocks like Asian Paints, Pidilite, Bajaj Finance, HDFC Bank, Kotak Mahindra Bank HUL, Nestle etc. in last 10-15 years? These have all been expensive on even 2 years forward P/E multiples (or on P/BV multiple in case of HDFC Bank and Kotak Bank).

At times a company may look expensive on P/E multiple on one year forward basis but its earnings growth over next 3-4 years may seem quite exciting to the investor. In that case if the call is taken for 4-5 years the stock may start looking inexpensive in 4-5 years from now – versus peers, and versus its own past multiples. Here the investor is taking a call that is different from consensus in terms of time horizon. Market consensus with its fixation on P/E (or P/BV) multiples is looking at 1 year or 2 years forward multiples while the investor armed with his detailed work is looking at earnings and cash flows 4-5 years from now.

If there is high – and increased versus earlier – conviction on future earnings with good growth, or at least stability of earnings then the fair value can turn out to be attractive. The most important driver for seemingly high near-term forward multiples for a stock is high earnings growth over a sustained period.

"Expensive Limited" Versus "Modest Growth Limited"

We present below the output of a quick exercise that we performed. There is a company, "Expensive Limited", that is trading at one year forward P/E multiple of 50x and that is set for EBIT (Earnings before interest & taxes) CAGR (Compound annual growth rate) of 25% over next 15 years. There is another company "Modest Growth Limited", that is trading at one year forward P/E multiple of 35x and is likely to witness EBIT CAGR of 15% over next 10 years. Both the companies will likely deliver EBIT of Rs 100 crore each in F23. The below assumptions are common for both the companies to keep things simple – WACC (weightage average cost of capital) of 10%, interest cost in F23 of Rs 10 crore, tax rate of 25%, capex of 12.5% of EBIT, and change in working capital of 1.5% of revenues, and terminal growth rate of 4%.

Expensive Limited's fair equity value turns out to be Rs 3,887 crore-15% higher than the current market capitalization even though it is trading at an exalted P/E multiple of 50X. On the other hand, Modest Growth Limited's fair equity value is just about Rs 1,249 crore implying a downside of 38% versus its current market capitalization. Thus we may consider Expensive Limited more constructively for further investigation and possibly a purchase even though it seems more expensive on P/E multiples.

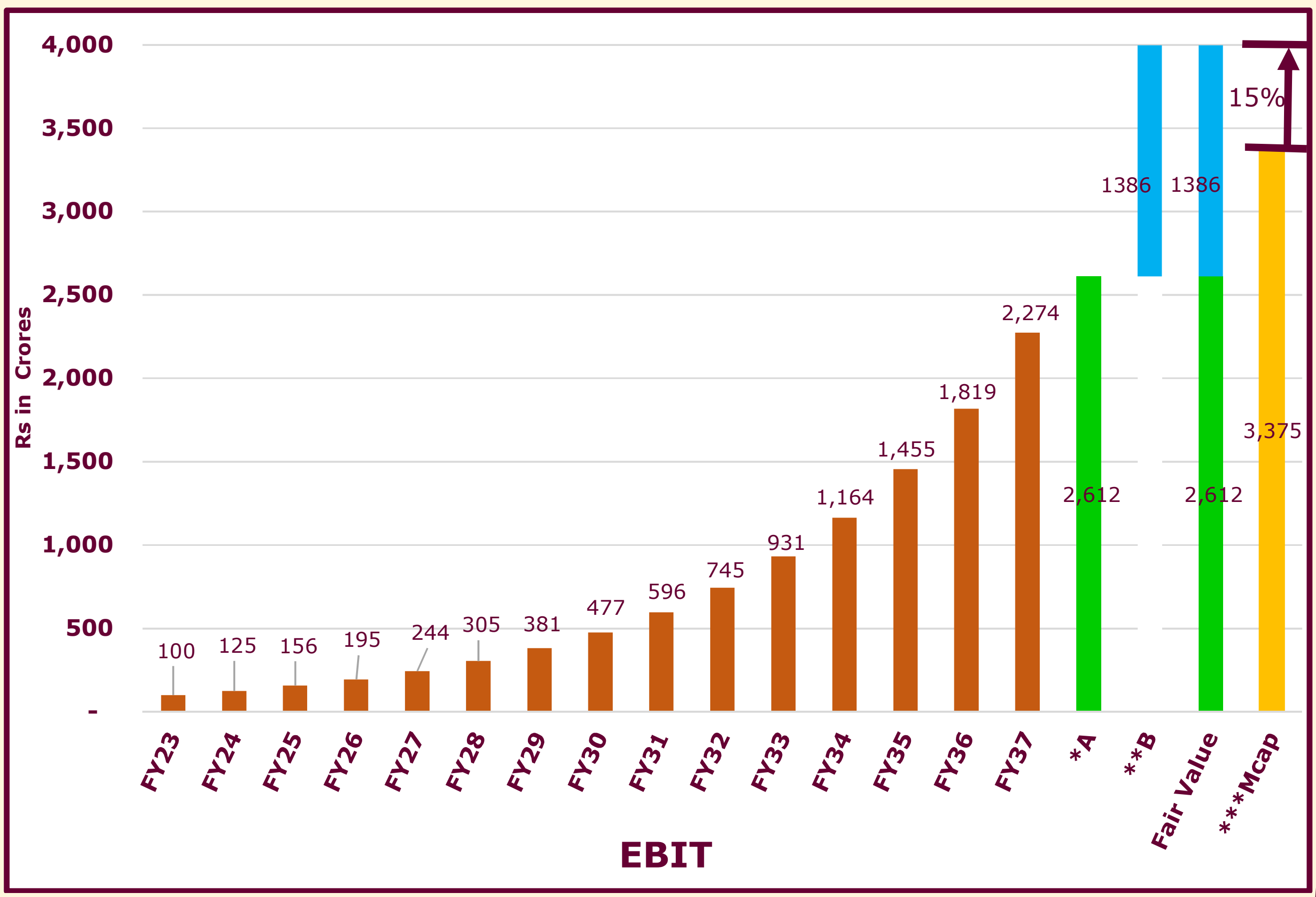
The key differentiators that we can see from the above analysis are –

1. Pace of growth – Expensive Limited is likely to grow its EBIT at 25% versus 15% for Modest Growth Limited. The potential drivers for this assumption can be – faster growing market, improving market share with intensifying brand strength, expansion of addressable market by entry into adjacencies, bolstering margins with focused execution on improvement areas for cost reduction and by product mix change, further augmentation of distribution etc. Such firms have the benefits of scalability and high operating leverage. There are many stocks, e.g. Asian Paints, HDFC Bank, Kotak Mahindra Bank, Britannia, Titan, Indus Ind Bank, ABB India etc. that have resemblance with Expensive Limited at various points over last 20 years.

2. Period of growth – Expensive Limited is not only growing faster than Modest Growth Limited but is also expected to continue growing at a fast clip for a longer period. Here the expectation is that the market in which the company operates is not too prone to disruption, the company itself is, at the forefront of and a dominant leader in innovation, the market is severely underpenetrated and presence of sizeable entry barriers. Such businesses are typically led by brands, technology, R&D and engineering. It can be imagined that companies like HUL, Britannia, Titan etc in India, or Google, Apple etc in the USA market fall in this category.

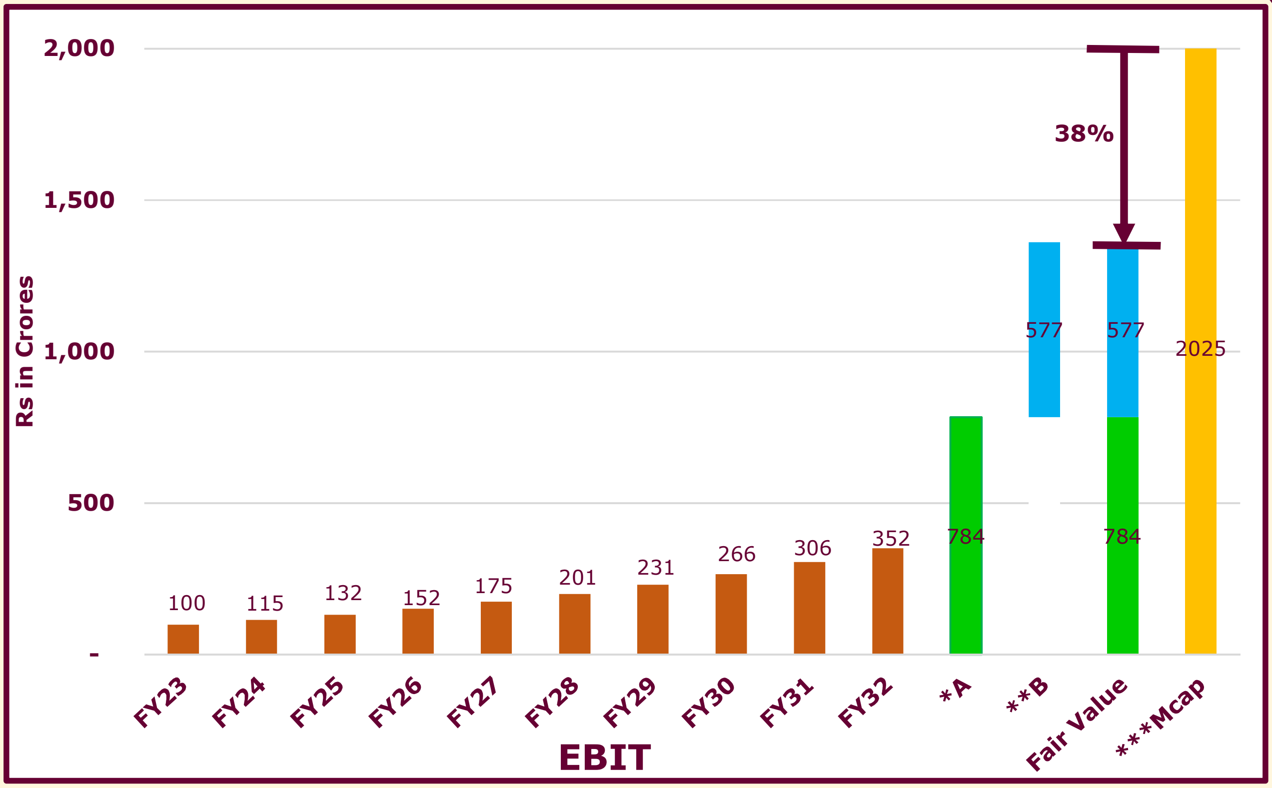
   One must appreciate that the two set of companies above – those displaying high pace of growth, and those that have a long period of growth, are not mutually exclusive.

Expensive Limited



**A - NPV of explicit value; **B - NPV of terminal value; Fair Value = A+B;*
****Mcap - Current market capitalization*

Modest Growth Limited



**A - NPV of explicit value; **B - NPV of terminal value; Fair Value = A+B; ***Mcap - Current market capitalization*

To reiterate, the above chart is just one way to start the analysis. At this juncture one is far from the conclusion. Just based on the above analysis it will be naive to conclude either way. However, it does indicate that a stock should not be rejected just due to seemingly high P/E multiple.

On a related note, in the month of June we had built fresh positions in Asian Paints, Titan and HUL with the view that they all have robust earnings growth ahead, long runway of growth with meaningful opportunities, and possibilities of margin expansion from here. In June the three stocks had witnessed considerable softening of their multiples even though they could not be termed as cheap on trailing or on one year forward multiples.

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Investment Approach Launch	August 2021
Minimum Investment	Rs. 50,00,000/-

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