Secrets of identifying undervalued stocks

I belong to a category, what they term as 'Small Investor'. Often those smart marketing executives from brokerage houses call me with their brilliant market/stock ideas and promise that if I trade with their company they will double my money with in few days. They are even ready to lend me money in case…. They probably know that as a 'Small Investor', I am the easiest prey for them!

I often ask them some very simple questions…and the replies most of them gave ensured that I don't have a 'Relationship Manager' till now. I want to share some of my simple learning's of stock picking with you all.

The 5-step investment approach

- **Understand** the stock market movements– It generally follows similar pattern over a time.
- **Identify** the Industries in favor with big investors.
- Look for **undervalued** companies with excellent businesses.
- Buy the stocks at **reasonable** prices
- Sell the stock when you feel it's **stagnated** – Don't fall in love with your stocks.

Presuming that the biggest problem with all of us is identifying undervalued stocks, I limit my future discussion only to it. As we all know valuation is a relative term (relative to intrinsic value) and therefore, a security can be undervalued either in terms of present market price (Value Investing) or future growth potential (Growth Stock).

What is Intrinsic Value?

It is defined as the **perceived** actual value of a security, as opposed to its market price or book value. Investor perception does matter but perceived value does not come from vacuum. It is possible to estimate value of a security from its financial fundamentals and the price should not deviate too long form this value. The most frequent technique of value estimation is discounting the free cash flow (FCF) by a risk factor. Using the intrinsic value as benchmark I place undervalued stocks under two broad heads – Value picks and Growth Stories.

Value Picks

Value picks are those stocks that currently trade at a low price relative to their fundamentals (i.e. dividends, earnings, sales, etc.). Therefore, stocks that have a relatively high dividend yield; low price to sales ratio; and/or low PE ratio would tend to be classified as value stocks. The low valuations that value stocks enjoy are often as a result of some type of bad news (i.e. poor earnings report, bad press, legal issues, etc.).

Value-stock investors believe that the market always overreacts to news, either good or bad. When the news is good, the stock price rises out of proportion to the long-term affect that news is likely to have on the company's future performance. By contrast, when unexpected bad news happens, the share price typically takes a worse drubbing than the fundamentals dictate.

To be a value investors look out for companies with sound financial statements after assuring yourself that the problems are temporary, or manageable. For example, Hindustan Lever (HLL) was a certain value pick at Rs. 100-105. Keep constant watch on such fundamental blue-chips and look out for lower than average price-to-book or price-to-earning ratios. In the long-term the scrip should confirm to its averages. Hold these stocks as their prospects brighten and they become growth stories. One caution- You may have to hold the scrip patiently for 2-5 years to unlock its value.

Growth Stories

The recent rally in mid-caps relate to this theme. Growth stories are companies whose earnings are expected to grow at an above average rate relative to the market. A growth stock usually has a high P/E ratio and won't pay a dividend as it has large capex & other expenses. I am not disclosing any such scrip

in this article as it is not what the article is meant for. The article will drive you to discover such ideas yourself by inspiring you to get answer to the following questions:

1. Is there indication of **market correction** in the near term? Remember patience is the key to finding value picks and growth stocks may fall sharply in event of any market correction.
2. Has the company demonstrated a **consistent history** of growth in revenues?
3. **Future -** Importantly, examine how fast the company is expected to grow and how? Look for its order book, existing clients, technical tie-ups and above-all market acceptance/size for its products.
4. **Price to Sales ratio -** I am particularly for companies with comparatively low price/sales ratio over a period of 2-3 years, as it shows that the share price is not appreciating with rising income. However, do satisfy the reasons why a company is trading at a low multiple. There may be compelling reason to stay away.
5. **Price Earnings Growth Ratio (PEG) –** Current PE ratio tells about past. Try to project 3-5 year earnings growth (use historical CAGR to start with) and then calculate PEG ratio. A PEG of less than 1 indicates that the firm may be undervalued.
6. **Free Cash Flow (FCF)** – At the end of the day it's the free cash in your hand that matters. Free cash flow is the cash from operations less capital expenditures and other investments that are necessary to sustain and grow the business. Prefer companies generating more free cash.

Exit

Don't get panicked by intermittent downs. Share prices take breather in-between wherein few investors get-out and many more buy-in for a value/ growth story. However, always do periodic reviews to ascertain in-case there has been a substantial change in the fundamentals or qualitative characteristics of the company. A good idea is to set a target return from the share and sell it off without regretting later in case its price moves up further!

Happy Investing Folks!!!!

Bratin Biswas
E-mail: bratin_biswas@hotmail.com

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