Analysis: Why investing in PSUs is a good idea

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Public Sector Undertakings (PSUs) are amongst the largest and most profitable organization in India. These enterprises have been set up to serve the broad macro-economic objectives of higher economic growth and self-sufficiency in production of goods and services. PSUs are broadly classified in three categories:

1) CPSEs (Central Public Sector Enterprise) - Companies where the direct holding of the Central Government or of other CPSEs is 51% or more. As of 2012 there are as many as 260 CPSEs (excluding 7 insurance companies) of which about 50 are listed on stock exchange.

2) PSBs (Public Sector Banks) – Banks where the direct holding of the Central/State Government or other PSBs is 51% or more. As of 2012 there are as many as 35 PSBs of which nearly 28 are listed on stock exchange.

3) SLPEs (State Level Public Enterprises) – Companies where the direct holding of the State Government or other SLPEs is 51% or more. As of 2012 there are over 850 SLPEs of which only 6 are listed on the exchange.

The listed PSUs taken together accounted for nearly 19% of total market capitalization i.e. 12.5 lakh crore in Oct 2013. Investors have whole gamut of stocks and sector to choose from amongst PSUs. There are number of companies one can find in the universe which have strong financials with cash rich balance sheet and low leverage. They have significant strength in their business and are enjoying multiple decades in operation. These companies have seen several business cycles and have ample resources to tackle crisis like situation. These companies have really long term relationship with their customers and therefore are able to deliver stability in the business. Some of these PSUs are leading companies in India with significant market-shares in sectors such as petroleum, (e.g. ONGC, GAIL and Indian Oil Corporation), mining (e.g. Coal India Ltd. and NMDC), power generation (e.g. NTPC and NHPC), power transmission (e.g. Power Grid Corporation of India Ltd.), heavy engineering (e.g. BHEL), shipping and trading (e.g. Shipping Corporation of India Ltd, and State Trading Corporation of India Ltd.).

Although BSE PSU Index has underperformed BSE 500 Index over last 3 years but valuations for some quality PSUs are beginning to enter into attractive valuation range. Average Price to Trailing Earnings ratio of PSUs stock is around 7.4x against Nifty's 16x times. Price to Book for the PSUs is around 1x while Nifty is at 2.5x. PSUs are earning an average return on equity of nearly 17% while for Nifty it is about 15%. Nearly 70% PSUs trading on the exchange have a strong balance sheet with low debt to equity ratio. Considering the attractive fundamentals of PSU stocks available at a significant discount to market pricing one is better of buying them.

Of number of PSU stocks available at a cheap valuation, ArthVeda is overweight on some of theblue-chip PSUs with proven track record. One such stock from ArthVeda's overweightbasketis NMDC. NMDC established in 1958, is one the largest producer of iron ore by volume in India. It is also one of the leading low-cost producers of iron ore globally. The lower cost of production results in fat margins for NMDC. With these fat margins NDMC is in a strong position to absorb any price shocks and maintain its profitability. Further, domestic demand for iron ore remains strong. During 2007-12 India's steel production has gone up at a CAGR of about 7.8%. While during the same period domestic consumption of iron ore (key raw material to steel production) has gone up at a CAGR of 9.2%. India is expected to double its steel production in next 5-6 years. This should results in sustainable demand for iron-ore in future. Taking into account above fundamentals and the fact stock is trading at about 1.8x book value, 8.0x trailing earnings and about 3.0x EV/EBITDA multiple. Over long run these valuations should expand and thus stock should deliver higher returns to investor.

Another PSU stock from ArthVeda's overweight basket is Coal India Limited (CIL). Based on the data provided by industry bodies CIL is the largest pure play coal producing company in the world. CIL has the highest coal reserves in India with its annual production of 452MT (in 2013) accounting for nearly 81% of domestic coal production. CIL has a monopoly in the sector with burgeoning deficient problem and is extremely important to meet India's growing energy need. Coal demand is expected to double in this decade. CIL being largest coal provider would be the biggest beneficiary of this growth. CIL shares are trading at about 10.5x its trailing 12 months earnings, Price to Book is nearly 3.0x and has a current dividend yield is about 5%. Considering the future expected investments in favour of Coal India, strong demand and stable customer base Cola India commands higher valuation multiple and thus should deliver good returns to investors.

Third PSU stock from ArthVeda's overweight basket is BHEL –India's largest manufacturer of power generation equipment in India. BHEL is the only Indian company capable of manufacturing large-size gas-based power plant equipment and one of the few companies worldwide involved in the development of Integrated Gasification Combined Cycle (IGCC) technology. In long run power sector should continue to see strong demand because huge energy deficit in India. BHEL shares are trading at about 6.7x its trailing 12 months earnings, Price to Book is nearly 1.4x and has a current dividend yield is about 5%. Considering high profitability, high dividend yield, cheap valuations and net cash, all of which put together makes it a strong buy with limited downside.

While all these stocks look attractive one should keep in mind equity investments are subjected to risk. There are number of risk associated with PSU investing however not every risk may materializes. One of the biggest risk specific to PSU investing is government ownership. Cash rich PSUs could become source of cash for government where they might be forced to pay out higher dividends or buy back stake. This could be a highly likely event given the fact that government is running behind in its divestment schedule. Further there is a big risk that cash rich PSUs may be forced to buy-out other loss making government business. Such corporate governance error at government part leads to significant undervaluation in PSU stocks. Investors should take a cautious view of these opportunities but should take advantage of such mis-pricing through trough analysis.

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