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Value is not in the eye of the beholder

Assess a stock based on a conservative outlook and compare it to a security that you understand

Before buying anything please keep in mind that you should allocate not more than 10% of your equity allocation to a single stock. Photo: Ashesh Shah/Mint

Buy a rupee for 50 paise, **Warren Buffett** advised. Alright, he used dollar instead of rupee and cents instead of paise. All value investors love to brag that they do this. But how?

It will be difficult to go to your neighbourhood store or bank and try to do that. But it is possible on the stock market. You might be able to exchange your 50 paise for shares that are worth more than a rupee.

How does one arrive at the worth or value of something? Value is the core concept behind value investing. Even the most well-trained and talented professionals find it difficult to arrive at a value of something, The concept of value and valuation for the purpose of investing will become clear with the following discussion. Occam's razor is being used to simplify a lot of things so that the focus remains on what is relevant and important to clarify the concepts.

Let's start with a product that most people seem to understand intuitively and through frequent use. Consider a fixed deposit or a bond that pays you 9% interest every year. So `100 invested in the bond would provide you `9 as interest income every year. Suppose the bond was a perpetual bond. Then it would continue paying the `9 interest to you permanently. Since you willingly paid `100 for the bond, probably after comparing the interest on other similar bonds, the value of the bond which pays you `9 every year is `100 forever.

Assuming you are in the highest tax bracket of 30%, you would receive `6.30 after taxes for your investment of `100. So this becomes your benchmark. All investments that give you more than `6.30 after taxes could become an attractive choice to investigate further as potential investment.

Now, consider **Infosys Ltd** today. It made a net profit of `10,656 crore in the year ended 31 March. Its total market capitalization is `170,800 crore. The market cap is the price one would have to pay to buy the whole of **Infosys**, and net profit is the return one can be deemed as receiving. Of course, a share represents a share in the whole of Infosys and one can buy one share if one wants to. However, we will do the valuation of Infosys as if we could buy the whole of Infosys.

Infosys has cash of `25,950 crore on its balance sheet. We can subtract this from the market cap since we are paying a rupee and getting a rupee on the balance sheet. So the remaining market cap of Infosys, that is, the net amount we are paying, is `144,850 crore. So one is paying `144,850 crore and getting annual earnings of `10,656 crore. That is a return of 7.3% on our investment. It is assumed that Securities Transaction Tax has been paid and shares have been held for at least a year and, hence, making the returns non-taxable. This is a higher return than the bond that gave a post-tax return of 6.3%.

So it looks like a good purchase. Further, this is not fixed at 7.3%. It will most likely be higher next year. How do we know? We don't know, but we can look at the track record to understand it better. The net profit track record of Infosys for the past 10 years has continuously been increasing. It was `1,891 crore in March 2005, then `3,867 crore March 2007, almost double of that at `9,429 crore in March 2013, and `10,656 crore in March 2014.

One can see that it has been continuously increasing every year for the past 10 years. This includes extremely volatile periods in terms of the global economy and also the rupee-dollar exchange rates. Under all those conditions, the company has been able to steadily increase its earnings. So the 7.3% return on the current price of Infosys is actually going to be higher in future years. Then what is the value of Infosys?

While that is a difficult question to answer precisely, value investors need only establish that the current price is significantly below its value. It is clear that in buying Infosys one is getting a better return than a bond yielding 9% pre-tax and 6.3% post-tax return. Also, the return is likely to increase in future. So it is something worth considering for further analysis. Also, before buying anything please keep in mind that you should allocate not more than 10% of your equity allocation to a single stock.

Parenthetically, one should also bear in mind that in reality there is a chance of price to earnings (PE) re-rating, too, for Infosys and this should give much higher returns of the order of 15-20% per annum or even higher. But that is not the focus of this article. The idea is to convey that you can assess a stock based on a conservative outlook and compare it to a security that one understands better.

It might help to understand this kind of evaluation process through a slightly different situation that Buffett describes in his 1988 letter to shareholders: “Finally, we had to ask ourselves what the redwood claim might be worth. Your chairman, who can’t tell an elm from an oak, had no trouble with that one: He coolly evaluated the claim at somewhere between zero and a whole lot.”

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