

WHATSINIT



INVESTMENT prudence

■ HERE are some points to remember.

Evaluation of the business fundamentals and its track record:

■ **Historical evaluation:** Historical performance is a good indicator to judge the potential for future returns. One should compare the profitability of the current asset/business at hand with its historical performance.

■ **Comparative evaluation:** One needs to compare the profitability of the current asset/business at hand with a select set of relevant peers to determine its attractiveness. Financial ratios are the best indicators.

■ **Absolute figures not useful:** Absolute measures (of sales, profits etc.) do not give a fair indication of financial health of an investment because while benchmarking against its peer set, we need to account for differences in size, scale and other such criteria.

Estimation of future potential:

Financial ratios can also be used to project future earnings and cash flows for estimating the EV and profitability of the investment.

Evaluation of the attractiveness of the investment opportunity:

This would involve a combination of the first two factors along with valuations.

There are many companies which satisfy criteria 1 and 2 i.e. have excellent historical as well as bright future potential, though they are currently overvalued. Such companies may not prove to be attractive investment opportunities. At times, though, these companies may also be available at relatively cheaper valuations. For all such instances, however, one should be able to capitalize on such investment opportunities. There could also exist businesses which possess modestly above average fundamentals (partially meeting criteria 1 and 2 above), though are currently undervalued.

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