Fundamental Analysis

By

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Ajcon Global Services Ltd.

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About Ajcon Global Services Ltd.

1) Well diversified financial services Company offering a whole gamut of services such as Stock Broking, Commodity Broking, Depository Services, Project Consultancy, Equity Research, Loan Syndication, Corporate Advisory Services and Merchant Banking.

2) The Company went public in 1995 and its IPO was oversubscribed by over 25 times demonstrating the faith and confidence the investment community reposed in the Company.

3) Member of National Stock Exchange, Bombay Stock Exchange, MCX – SX and is a depository participant of CDSL.

4) Executed more than 300 assignments of Project Financing and Loan Syndication and gained recognition as a leading project consultancy firm, possessing strong implementation skills to transform corporate vision and strategy into profitable reality

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About CA. Ashok Ajmera – CMD

1) CA. Ashok Kumar Ajmera, aged 60, is a well known Chartered Accountant (1977) and a capital market expert with an experience of over 35 years.

2) Elected on the Board of Brokers Forum of India (BBF) for the term 2013 - 15. Served as a Managing Committee member in BBF since 2011.

3) Served as an Independent Director on the board of Canara Bank Securities Ltd.(subsidiary of Canara Bank) in 2004.

4) Significantly contributed to streamline operations and systems at NSE and has represented broker community. Worked closely with NSE for replacing the then prevailing Badla system by introducing Automated Lending and Borrowing Mechanism (ALBM). He chaired the NSE committees for resolving disputes of members. He addressed and resolved a large number of disputes over a 3-year term as the member of Dispute Resolution Committee (DRC).

5) Contributed several Articles and interviews in leading Newspapers & magazines. Leading media channels, namely, Doordarshan, B.B.C, Star, Zee, CNBC, NDTV, Sahara, Reuters, Awaaz, Aaj Tak, Headlines Today, Bloomberg UTV, India News, Times Now etc. interview him as a Capital Market Expert / Stock Analyst.

6) He also presented a well-researched paper on the 'Indian economy', with a foreword by the eminent tax expert and Supreme Court Advocate, Mr. Y.P Trivedi in Japan before 14,000 delegates in the year 1992, just after the second budget of Dr. Manmohan Singh as Finance Minister.

About Ajcon Research

1) Ajcon Global Services Ltd. is a SEBI Registered Research Analyst

2) Ajcon Research is headed by Mr. Akash Jain, MBA (Financial Markets) under the mentorship of our CMD. – CA. Ashok Ajmera

3) The research team has introduced various products for its Institutional and retail clients like Market Round up Report, Investor’s Delight, Xpress Idea, and Weekly review .

4) The team also specializes on carrying out sectoral research and company specific due diligence report.

5) The reports are published by Ajcon Research through leading portals like Bloomberg, Moneycontrol and Researchbytes.

6) The reports are viewed by fund managers of around 500 institutions (domestic and global).

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What is Fundamental Analysis

1) **Fundamental Analysis is an important pillar of long term investing. It's a broader concept and involves a) Economy Analysis, b) Industry Analysis and c) Company Analysis**

2) **When talking about stocks, fundamental analysis is a technique that attempts to determine a security's value by focusing on underlying factors that affect a company's actual business and its future prospects. On a broader scope, you can perform fundamental analysis on industries or the economy as a whole.**

3) **Also known as quantitative analysis, this involves looking at revenue, expenses, assets, liabilities and all the other financial aspects of a company. Fundamental analysts look at this information to gain insight on a company's future performance.**

4) **Fundamental analysis serves to answer questions, such as: Is the company's revenue growing? Is it actually making a profit? Is it in a strong-enough position to beat out its competitors in the future? Is it able to repay its debts? Is management trying to "cook the books"?**

Economy Analysis

Economy Analysis - Fundamental Analysis

Economy analysis (global and domestic) involves analysis and implications of key macroeconomic indicators on the Company:

A) Domestic Economy Analysis

a) GDP
b) Monetary policy
c) Inflation
d) Economic policies
- **Import – Export policy**
- **Interest rates**
- **Exchange rates**
- **Duty structure**
- **Fiscal and Revenue Deficit**
- **Foreign Investment policy**

e) Employment data
a) Geo political situation

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Ingredients – Macro Economic Factors

1) Global Economy Analysis

a) The Global Macroeconomic Analysis includes analysis of the major advanced economies and research on topical cross-country issues, such as the global business cycle, capital flows to emerging markets, EM bank lending conditions and key risk factors affecting the global economy.

b) Macroeconomic factors are national and global events which are out of your control. The recent ISIS attacks on France and France attacks in Syria, Nepal and Japan Earthquake crisis, concerns on US Fed rate hike, terrorists attack on Indian Parliament, Indian September 11th terrorist attacks, the financial meltdown of 2008-2009 and the European sovereign debt crisis of 2009-2011 are prime examples of macro factors. Macro factors are dangerous and unpredictable, and a savvy manager must be agile to sidestep a cascading macroeconomic crisis to keep the company intact.

c) Negative macro factors tend to occur in a cascading chain reaction. For example, increased unemployment in the United States may lead to lower consumer spending, which in turn leads to reduced imports from China, which also causes the Chinese GDP to decrease. A lowered Chinese GDP then leads to lowered expectations for growth, and leads to a decreased demand for natural resources, such as crude oil, iron or silver. This causes commodities to plummet globally, which can adversely affect the profits of miners in multiple countries.

Industry Analysis

Industry Analysis - Fundamental Analysis

Checklist for carrying out Industry analysis

1) Understand Industry Drivers:

a) Demand and Supply (current, future) of different products
b) Key raw materials
c) Global and domestic market
d) Business Cycles/Product Life Cycles/Seasonality

2) Understanding product mix in the sector

a) Applications of the products/users of products
b) Manufacturing processes (alternate processes)
c) Technical aspects

3) Current situation of the Industry and outlook

a) Key changes happening in the sector
b) Key drivers for the sector/products of the Company
c) Regulations, Regulatory authorities, key policy change in past
d) Policy changes expected in near future, regional politics
e) Key words, terminologies, jargons
f) International Scenario about the Company/Products
g) Key players (Market share, Brief Financials, Products)
h) Capacities, Common Size Statements, Stakeholders

Industry Analysis - Fundamental Analysis

Checklist for carrying out Industry analysis

4) Porter's Five Forces Industry Analysis

a) Bargaining power of suppliers
b) Bargaining power of customers
c) Competitive Intensity
d) Barriers to entry
e) Threat of substitutes

5) Value chain analysis/relative position in the industry

a) Industry value chain
b) Differences between Industry Value chain and Company value chain with respect to selling prices and costs of various activities

Industry Analysis - Fundamental Analysis

We believe one of the best methods to analyze an Industry is to apply Porter's Five Forces Tool:

Industry Analysis - Fundamental Analysis

Porter's 5 Forces – Industry structure determines profitability

4) Bargaining power of Buyers & Sellers

Both buyers and suppliers tend to be powerful if:

a) They are few in numbers and large in size (Pidilite)
b) How painful will it be to lose that particular customer or supplier?
c) Switching costs are high
d) Can a Company do backward integration & reduce dependence on suppliers (Sangam India, Mayur Uniquoters)

Threat of Substitutes

a) Kodak was killed by Digital cameras – will be likely killed by mobile phones (future belongs to electric cars)

Threat of New Entrants

a) Do the incumbents have an edge in any of the following – technology/brands/prime locations/distribution channels (WABCO/Colgate/Tata Steel/Asian Paints/HDFC Bank etc.)
b) Does government policy restrict or prevent new entrants? (No licenses for any new cigarette and liquor Company?
c) How large are the Capital and Recurring investments?
d) Does the value to a customer increase as more customer's use a Company's product?/Network effect? (Facebook)

Industry Analysis - Fundamental Analysis

Porter's 5 Forces – Industry structure determines profitability

4) Rivalry among existing competitors

a) Lack of industry growth will lead to higher competition as Companies look at growing via market share gains
b) Is the industry leader rational? Often an industry leader has the ability to enforce practices that help the whole industry (Between 2000 – 2012, Parle and Eveready behaved irrationally inspite of being market leaders.
c) High exit barriers – if Companies in a crowded industry have invested heavily (Textiles)
d) Irrational commitment to business. Company may feel its image requires a full product line irrespective of ROI.
e) Price based competition is higher if the product has commoditized in nature (Pharma has R&D based competition, FMCG products have advertising based competition, however pricing based competition is the worst.
f) Business dynamics are such that there are high fixed costs and low marginal costs, creating the pressure to drop prices because any new customer addition will contribute towards covering fixed overhead costs.
g) Is the product perishable or going to lose its value/become obsolete if unused? (A restaurant table, hotel room, an airline seat, an unsold fashion garment – all are perishable)

Industry Analysis - Fundamental Analysis

We have applied Porter's Five Forces Tool to understand the paint industry:

1) **Bargaining power of suppliers (moderate):** Paint manufacturers depend on both local and international suppliers and have a low bargaining power vis-à-vis prices of supplies. While some crude based materials are purchased from Indian suppliers like HPCL and BPCL, others often have a wide international market with multiple suppliers. Some key components like titanium dioxide are also in short supply globally

2) **Bargaining power of buyers (moderate):**

a) Buyers of decorative paints in the B2C market have low bargaining power. Volumes in the industry are not materially affected by price hikes.

b) Buyer power is high for the industrial segment (B2B), especially auto OEMs and infrastructure companies.

c) With increasing consumer awareness of decorative products, bargaining power of buyers is improving.

Industry Analysis - Fundamental Analysis

We have applied Porter's Five Forces Tool to undersatnd the paint industry:

1) **Competitive intensity (moderate):** Strong underlying volume growth in the industry has attracted new entrants like Nippon Paints, Jotun and Sherwin Williams. However, widespread distribution networks of the incumbents have made it difficult for these new entrants to establish a meaningful presence in the industry. Rising marketing spends by top five players has led to a 100bps-150bps reduction in margins and ROEs over the past three years.

   Barriers to entry (high): Despite being a relatively simple product to manufacture, the requirement of a strong supply chain, brand and scale makes it difficult to have a material presence in the market. Global majors such as Nippon Paints, Sherwin Williams and Jotun have found it extremely hard to penetrate the Indian paints industry.

   Threat of substitution (low): Whilst wallpapers can be considered a convenient substitute, it is a much smaller market and is not preferred by customers due to the attached maintenance costs. Lime wash is also used as a low quality substitute. However, consumer patterns are shifting away from lime wash and towards paints

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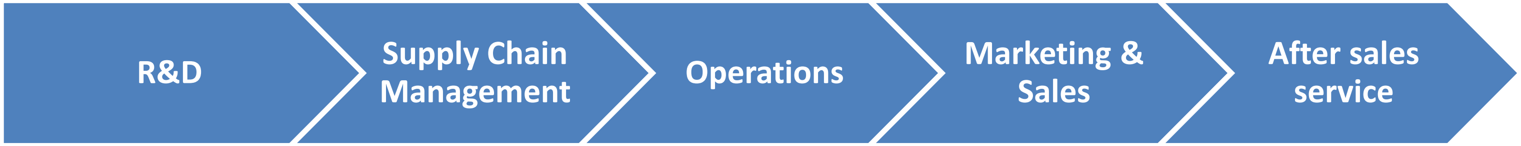
Industry Analysis - Fundamental Analysis

Value chain analysis

a) The sequence of activities a Company performs to design, produce, sell, deliver and support its products is called the value chain.
b) Why does the value chain matter? The value chain is a powerful tool for disaggregating a Company into its strategically relevant activities that result in higher selling price or cost?

Key steps in value chain analysis

1) Start by laying out the industry value chain – Every industry has a dominant approach i.e scope & sequence of activities followed by majority of the Companies in that industry. The key here is to lay out the major value creating activities specific to the industry



Industry Analysis - Fundamental Analysis

Value chain analysis

a) How far backward or forward integration do the industry's activities extended? Eg. A car maker has to decide if he wants to go in for backward integration into making tyres or other ancillary parts. Again he would have to decide if he wants to go in for forward integration by opening a car finance Company

b) What are the key value creating activities at each step in the chain?

c) If there are competing business models, lay out the value chain for each one. Then look for differences among them to understand the difference in their costs and selling prices.

2) Compare your Company's value chain to the Industry's

3) Zero in on price drivers, those activities that have a high current or potential impact on differentiation

a) In order to provide superior quality products, Page Industries manufactures elastic – in house as against players like Rupa and VIP who outsource it from small cottage industries resulting in poor and in – consistent quality of products.

b) Zero in on cost drivers, paying special attention to activities that represent a large or growing percentage of costs.

c) Watch out the differences between the Company and its rivals/peers.

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Company Analysis

Company Analysis - Fundamental Analysis

We believe one of the best methods to analyze a Company's business is to apply Porter's Five Forces Tool:

- **Understanding the Tool**

  Five Forces Analysis assumes that there are five important forces that determine competitive power in a business situation. These are:

  Competitive rivalry: This force examines how intense the competition currently is in the marketplace, which is determined by the number of existing competitors and what each is capable of doing.

  Rivalry competition is high when there are just a few businesses equally selling a product or service, when the industry is growing and when consumers can easily switch to a competitors offering for little cost. When rivalry competition is high, advertising and price wars can ensue, which can hurt a business's bottom line. Rivalry is quantitatively measured by the Concentration Ratio (CR), which is the percentage of market share owned by the four largest firms in an industry.

Company Analysis - Fundamental Analysis

Bargaining power of suppliers: This force analyzes how much power a business's supplier has and how much control it has over the potential to raise its prices, which, in turn, would lower a business's profitability. In addition, it looks at the number of suppliers available: The fewer there are, the more power they have. Businesses are in a better position when there are a multitude of suppliers. Sources of supplier power also include the switching costs of firms in the industry, the presence of available substitutes, and the supply purchase cost relative to substitutes.

Bargaining power of customers: This force looks at the power of the consumer to affect pricing and quality. Consumers have power when there aren't many of them, but lots of sellers, as well as when it is easy to switch from one business's products or services to another. Buying power is low when consumers purchase products in small amounts and the seller's product is very different from any of its competitors.

Threat of new entrants: This force examines how easy or difficult it is for competitors to join the marketplace in the industry being examined. The easier it is for a competitor to join the marketplace, the greater the risk of a business's market share being depleted. Barriers to entry include absolute cost advantages, access to inputs, economies of scale and well-recognized brands.

Company Analysis - Fundamental Analysis

Threat of substitute products or services. This force studies how easy it is for consumers to switch from a business's product or service to that of a competitor. It looks at how many competitors there are, how their prices and quality compare to the business being examined and how much of a profit those competitors are earning, which would determine if they have the ability to lower their costs even more. The threat of substitutes are informed by switching costs, both immediate and long-term, as well as a buyer's inclination to change.

Management – Company analysis

a) A company relies upon management to steer it towards financial success.
b) It makes sense - even the best business model is doomed if the leaders of the company fail to properly execute the plan.
c) In order to execute a business plan, a company requires top-quality management.
d) Investors might look at management to assess their capabilities, strengths and weaknesses. Even the best-laid plans in the most dynamic industries can go to waste with bad management.

Track record

a) A good way to get a feel for management capability is to check and see how executives have done at other companies in the past.
b) You can normally find biographies of top executives on company web sites.
c) Identify the companies they worked at in the past and do a search on those companies and their performance.

Management – Company analysis

Disciplined Management: Credibility builds over time

IDFC

a) IDFC is an infrastructure financier, generating RoE of 12-15%. Despite the infrastructure segment going through tough times, IDFC has maintained healthy profitability while creating floating provisions on the balance sheet.

b) Corporate governance levels are best in class; this has helped IDFC to become one of the two from 26 contenders to get a banking license from the RBI.

c) Focus on long-term shareholder value creation even at the cost of immediate profitability ☐ Diversification: Considering the challenges in infrastructure financing, the management focused on diversification of assets and liabilities.

d) For the banking business, IDFC is focusing on innovation, technology and cross-selling to existing customers to increase profitability.

e) During the troubled times of FY12-15, IDFC's loan CAGR was just 2%. It created provisions of ~4% of loans though reported NPAs were lower at <0.5%. Further, it also created provisions of 60bp on disbursements.

Management – Company analysis

Disciplined Management: Credibility builds over time

Indusind Bank

a) IndusInd Bank (IIB) is a classic case of management change (Mr Sobti and his team took charge in 2008) scripting a turnaround in fortunes.

b) The management targets to be a forerunner in terms of profitability (RoA best in class at 1.9% in FY15; up from 35bp in FY08), productivity (profit/employee up 4x over FY08-15), and efficiency (C/I ratio down from 68% in FY08 to 46%).

c) In the current Three-year planning cycle (2014-17), management plans to: a) Focus on loan growth at double that of industry by capitalizing on niche areas (vehicle loans). b) Build at least 15 home markets (5%+ branch share) to sustain savings accounts.

d) Management plans to focus on high yielding retail loan portfolio by capitalizing on strong presence in vehicle loans and addition of new retail products.

e) Increase share of low cost CASA deposits (15.5% in FY08 to 34%) through focused branch expansion and improving brand image.

f) Gain forex MS (from 1% in FY08 to ~4%) from state-owned banks, driven by lower turnaround time.

Management – Company analysis

Disciplined Management: Credibility builds over time

ICICI Bank

a) Since Ms Kochhar took charge in 2009, ICICI Bank (ICICIBC) has focused on improving profitability (16% PAT CAGR over FY10-15), with structural changes in ALM profile (helping NIM to expand ~100bp) and strong cost control (700bp decline in cost-to-income ratio to 37%, the lowest since 2002), leading to RoA improvement (from 1% in FY09 to 1.6%).

b) Growth consolidation and profit focus has helped improve subsidiaries' performance. From a loss of INR6.7b in FY08, they posted a PAT of INR33.7b in FY15.

c) Focus on subsidiaries is now bearing fruits - have now started throwing back capital

d) Healthy retail loan growth: Retail loans have grown at a CAGR of 24% over FY13-15. The share of the retail segment has increased from 37% in FY12 to 42% in FY15. By moderating growth in loans to sensitive sectors (3% CAGR over FY13- 15), ICICIBC has gradually lowered its exposure to these sectors to ~16%.

e) ICICIBC has regularly repatriated capital (USD2b till date) from overseas subsidiaries and increased dividend payout from domestic subsidiaries (INR29b over FY13-15).

f) Focus on operating leverage: Employees/branch have halved to 16 since 2008, CASA ratio has doubled, and share of retail fees has grown from 33% in 2011 to 52%.

Management – Company analysis

Disciplined Management: Credibility builds over time

Tata Motors

a) Recently, Mr. Cyrus Mistry took over as Chairman of Tata Motors (TTMT). Further, TTMT appointed Mr. Mayank Pareek (ex-Marketing Head of Maruti Suzuki) as Head – PV Business, to revive its lost franchise in PVs.

b) Since TTMT's acquisition of JLR, it has been investing aggressively in building capabilities in products, capacity and global footprint.

c) India business has seen significant pressure on balance sheet due to continued investments in products, impacting medium-term capital efficiency.

d) Focus on products: JLR has been focusing on filling gaps in its product portfolio. Similarly, India Passenger Vehicles business is focused on correcting under-investment in products.

e) Focus on modular platform: JLR is focused on improving its platform efficiency by increasing model to platform ratio, in turn reducing capital intensity.

f) Focus on diversification of manufacturing footprint: JLR's manufacturing base is entirely located in UK, resulting in high cost structure and forex volatility on imports.

Management – Company analysis

1) Management

Succession Plan

a) Succession Planning is a process for identifying and developing internal people with the potential to fill key business leadership positions in the company.

b) Succession Planning increases the availability of experienced and capable employees that are prepared to assume these roles as they become available.

c) It is a 5 step process which include identification of critical positions, identification of competencies, identification of succession management strategies, document and implement succession business plan, and evaluate effectiveness.

Fundamental Analysis

By

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Valuation Techniques

1) Earnings basis

a) The routine and quick method used is to divide the Market Price by the latest published Earnings Per Share (EPS) to give the P/E ratio. You relate this to the Industry average P/E ratio to determine if the share is undervalued or overvalued as the case may be

b) Market Price: EPS * P/E Ratio or Market Price = EPS/Earning yield

c) Market Price/EPS = Actual P/E, Projected EPS* Industry P/E = Projected Price

d) General case: If actual P/E is lower than the Industry P/E, the scope for appreciation is computed at Projected Price

e) For a fair value, forecast of future earnings is necessary. A variation is of course to mark the Market Price against future EPS to give a more accurate P/E assessment.

Valuation Techniques

2) Discounted Cash Flow Method

a) Valuation using discounted cash flows is a method for determining the current value of a Company OR Company's equity using future cash flows adjusted for time value. The future cash flow set is made up of the cash flows within the determined forecast period and a continuing value that represents the cash flow stream after the forecast period.

b) There are actually two types of DCF models: "free cash flow to equity" and "cash flow to the firm." The first involves counting just the cash flow available to shareholders and is a bit easier to understand.

c) This method has gained general acceptability in recent years as it concerns itself with the timing of cash flows and the cost of capital to give a fairer and truer valuation.

d) A widely practiced method in negotiating Acquisition Deals. It takes into account time value of cash flows and the cost of capital, both real life factors in Investment decisions.

e) It is a suitable method during an acquisition with an intention of making further investments to improve profits. It establishes the maximum price the buyer will be willing to pay for the Target Company.

Valuation Techniques

2) Enterprise Value

a) Enterprise Value (EV) = Market Capitalisation + Debt – Cash or Equivalents

b) Market Capitalisation is arrived at by simply multiplying the market price by the number of outstanding equity shares. When you buy out the full Company at the market capitalisation you also assume responsibility of the debt which adds to your cost of buying. This cost is reduced by any cash or Cash Equivalents that you can use.

c) The enterprise value (EV) measures the value of the ongoing operations of a company. It attempts to measure the value of a company's business instead of measuring the value of the company. It is the measure for calculating how much it would cost to buy a company's business free of its debts and liabilities. It can be thought of as a theoretical takeover price of a company's business.

d) The enterprise value is used as an alternative to market capitalization. It is a more accurate estimate of the takeover price of a company than the market capitalization.

e) This tool useful to identify undervalued companies that could be a possible takeover target. This happens when the EV is significantly below the Value of the Company's assets.

Valuation Techniques

3) EV/EBITDA

a) The division of EV by EBITDA gives **a good measure of value**. It estimates the number of years in which the business will repay its acquisition cost to the buyer through its earnings. For example, if one is interested in buying a firm at an EV of Rs 1,000 crore and its annual earning (EBITDA) is Rs 200 crore, the firm will repay its entire acquisition cost to the buyer in cash in just five years.

b) The EV/EBITDA ratio is a **better measure than the P/E ratio** because it is not affected by changes in the capital structure. Consider a scenario in which a company raises equity finance and uses these funds to repay the loans. This will usually result in a lower earnings per share (EPS) and therefore a higher P/E ratio. But the EV/EBITDA ratio will not be affected by this change in capital structure. This means that the EV/EBITDA ratio cannot be manipulated by the changes in capital structure. Another benefit of the EV/EBITDA ratio is that it makes possible fair comparison of companies with different capital structures.

c) Another positive aspect to the EV/EBITDA ratio is that it **removes the effect of non-cash expenses such as depreciation and amortization**. These non-cash items are of less significance to the investors because they are ultimately interested in the cash flows.

Valuation Techniques

3) EV/EBITDA

The EV/EBITDA ratio is not usually appropriate for the comparison of companies in different industries. Capital requirements of other industries are different. Therefore, the EV/EBITDA ratio may not give reliable conclusions when comparing different industries.

a) How it differs from P/E ratio?

a) The PE ratio measures the money that investors are willing to pay for every rupee a company earns. It is a metric used for valuing the firm's equity as it takes into account the residual earning available to equity shareholders.

b) Though widely used, PE ratio has its limitations as it cannot be used for valuing loss making companies and fails to overcome the distortions caused by different accounting policies and capital structures.

c) The EV/EBITDA ratio is better as it values the worth of the entire company. PE ratio gives the equity multiple, whereas EV/EBITDA gives the firm multiple. The latter is based on the notion of most successful investors, who propose that equity investing is not just buying/selling shares, but buying/selling the business.

Identifying Great, Good and Gruesome companies

Criteria	Great	Good	Gruesome
Nature of Business	Stable business. i.e. no rapid or continuous change	Subject to moderate change	Business likely to have rapid changes
Competitive Advantage	High and rising long term competitive advantage from brand/lowest – cost production	Steady competitive advantage	Low or no competitive advantage
Pricing Power	High pricing power	Moderate pricing power	Pricing power absent
Management	Low dependence on greatness of management	Management, key success factor	High dependence on management
Growth	Typically moderate growth; high growth rates a rarity	Moderate-to-high growth rate	Typically high growth rates
Capital Intensity	Low capital intensity, high level of intangible assets	Moderate-to-high capital intensity	Very high capital intensity

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Identifying Great, Good and Gruesome companies

Criteria	Great	Good	Gruesome
RoE	Very high and rising RoE	Stable and attractive RoE	Low/falling RoE
Dividend Payout	Typically, high dividend payout	Reasonable dividend payout	Low or zero dividend payout
Examples	Nestle, GSK Consumer, Gillete, Eicher Motors, Gruh Finance, Page Industries	HDFC Bank, Larsen and Toubro	Tata Tele, Hindustan Motors, Arvind

Strengths of Fundamental Analysis

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Strengths – Fundamental Analysis

Long term trends

a) Fundamental analysis is good for long-term investments based on very long-term trends. The ability to identify and predict long-term economic, demographic, technological or consumer trends can benefit patient investors who pick the right industry groups or companies.

Value spotting

a) Sound fundamental analysis will help identify companies that represent a good value. Some of the most legendary investors think long-term and value. Graham and Dodd, Warren Buffett and John Neff are seen as the champions of value investing. Fundamental analysis can help uncover companies with valuable assets, a strong balance sheet, stable earnings, and staying power.

Business Acumen

a) One of the most obvious, but less tangible, rewards of fundamental analysis is the development of a thorough understanding of the business.

b) After such painstaking research and analysis, an investor will be familiar with the key revenue and profit drivers behind a company. Earnings and earnings expectations can be potent drivers of equity prices.

c) A good understanding can help investors avoid companies that are prone to shortfalls and identify those that continue to deliver. In addition to understanding the business, fundamental analysis allows investors to develop an understanding of the key value drivers and companies within an industry.

d) A stock's price is heavily influenced by its industry group. By studying these groups, investors can better position themselves to identify opportunities that are high-risk (tech), low-risk (utilities), growth oriented (computer), value driven (oil), non-cyclical (consumer staples), cyclical (transportation) or income-oriented (high yield).

Weaknesses of Fundamental Analysis

Weakness – Fundamental Analysis

Time constraints

a) Fundamental analysis may offer excellent insights, but it can be extraordinarily time-consuming. Time-consuming models often produce valuations that are contradictory to the prevailing current price . When this happens, the analyst basically claims that the whole street has got it wrong. This is not to say that there are not misunderstood companies out there, but it is quite brash to imply that the market price is wrong.

Industry/Company Specific

a) Valuation techniques vary depending on the industry group and specifics of each company. For this reason, a different technique and model is required for different industries and different companies. This can get quite time-consuming, which can limit the amount of research that can be performed.

b) A subscription-based model may work great for an Internet Service Provider (ISP), but is not likely to be the best model to value an oil company.

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Key mantra - Fundamental Analysis

Key Mantra – Fundamental Analysis

Price is not value

a) It is essential to differentiate value and price. The concept of price has the advantages of availability, transparency and frequent changes. Functioning markets and rapid reporting mean that we can all agree on the price of a security. Prices change constantly, and those changes are updated instantly on a variety of pricing sources, widely available to professional and personal investors alike. The problem with prices, is that they can be quite volatile.

b) Value, on the other hand, has the opposite attributes of price. Value is opaque, unavailable and stable, but it enjoys less volatility. Whereas an investor can watch the price of a stock change throughout the course of a trading session, the value of the underlying company is only derived through patient and careful analysis and is therefore a far more robust notion than price.

c) A value can be defined as the worth of the business. A stock price is what is perceived by the investor as the value of the business but may differ in actual terms. To understand the real worth of the business it is important to assess the Intrinsic value of the business which is dependent on several factors.

d) For eg: One may see sudden rise in the stock price when being bid by an acquirer, who generally has to pay something closer to its intrinsic value. Investors should understand that the share price is like the tip of iceberg – you can see it, but you have no idea how big or small the iceberg is below the surface unless you put a dive suit.

Key Mantra – Fundamental Analysis

Price is not value

a) The true value of a business is known as its ‘intrinsic’ value and is difficult, though not impossible, to ascertain.

b) Most investors preoccupy themselves with measures of ‘relative’ value which compare a valuation ratio for the company (perhaps the price-to- earnings, price-to-book or price-to-sales ratio) with its industry peer group or the market as a whole. Inevitably though, something that appears to be relatively cheap on that basis can still be overvalued in an absolute sense, and that’s bad news for the Value Investor who prefers to tie his sense of value to a mast in stormy waters. Intrinsic valuation looks to measure a company on its economics, assets and earnings independently of other factors.

- **As Ben Graham has observed: “the price is what you pay, value is what you get”, meaning that big swings in the market don’t necessarily mean big swings in value.**

Key Mantra – Fundamental Analysis

Investors must know what they own

a) To avoid any risk of permanent impairment to capital, the investor should actually assess the risk and value which requires deep study of the Company.

b) There are at least two strong implications that follow from the idea of knowing what you own. First, it does not make sense to invest in securities or portfolios where you don’t have visibility into the investment rationale, process or holdings. When performance is weak and very little is known about the underlying causes, what is an investor to do? Buy more because it’s cheap? Sell before it falls further? Ignorance of the underlying fundamentals leaves only emotion as a driver of action, and hope and fear make for poor investment strategies. We prefer to rely on analysis and conviction when others are buying and selling based on emotion.

c) Second, holding too many investments prevents an investor from knowing them well enough. Portfolios should be appropriately diversified, but they can easily become over-diversified, thereby introducing the risk of not acquiring knowledge of and conviction in what is owned. Maintaining fewer investments allows investors to dig deeper into each one, which will serve them well when price volatility inevitably tests their convictions.

Key Mantra – Fundamental Analysis

Markets are always irrational

a) Market prices are inefficient because of investors' behavioral biases, exuberance and irrationality which drive prices away from fair value.

b) Don't panic –

a) People tend to invest based on psychological biases rather than analysis of market fundamentals. They buy when the price of a particular stock is rising or when the value of the market as a whole appears to be rising. On the flip side, when the price of a particular stock is declining or when the value of the market as a whole appears to be falling, myopic loss aversion forces most people to sell their stocks. Instead of keeping their losses on paper and waiting for the market to change directions, they sell.

b) The early 2000's tech bubble and the mid-2000's housing bubble were fueled by dramatic levels of overinvestment that bid up the prices of tech stocks and real estate beyond what the underlying companies and properties were worth. When the unsustainable highs began to fall, investors panicked and a crash ensued, causing some stocks to be priced closer to their true values and others to fall below their true values.

Key Mantra – Fundamental Analysis

Herd behavior is common, hence – "Stand out"

a) The tendency of human beings to be swayed by crowds has been long documented and used by tyrants over time to impose their will on us. The desire to be part of the crowd is due to more than peer pressure. While there is a tendency to describe herd behavior as irrational, it is worth noting that you can have the same phenomena occur in perfectly rational markets through a process called information cascade.

b) All to often, in investing, investors at early stages in the process (initial public offering) pile into specific initial public offerings and push their prices up. Other initial public offerings are ignored and languish at low prices. It is entirely possible that the first group of stocks will be overvalued, while the latter are undervalued. Since herd behavior is made worse by rumors by the spreading of rumors, you could argue that the coming together of the available data and news channels has made it more possible for herd behavior to spend and not less.

- **The madness of growth**

a) Is the name even important? This is not a one off case. Look for any company – good, bad or ugly. If the company shows a couple of quarter of growth, the stock price shoots up with no link to valuation, quality or sanity. On the other hand if the music stops, even for 1-2 quarters, the response is brutal. The herd which rushed in blindly, now heads for the exit.

b) I don't think this can be called investing – it's a mad hunt for growth.

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Key Mantra – Fundamental Analysis

Preservation of Capital

a) Preservation of capital should be the highest priority goal of asset allocation investing. Unfortunately, despite a great deal of lip service, preservation of capital is one of the most neglected aspects of most asset allocation plans.

b) Warren Buffett's 'First Rule of Investing' is never lose money. Rule No. 2 is never forget rule No. 1. The priority of managing a portfolio is to minimize losses and try to avoid exposure to equities as much as possible in a correction.

c) The bear markets of 2000-02 and 2008-09 have proven investors accept too much risk and most of the time do not understand compounding and the importance of exponential growth. This is a failure of the financial services industry and an excellent reason for investors to consider self-directed investing.

d) The laws of compounding make risk management a crucial part of investment management. If an investor loses 50% of a portfolio, a 100% gain is required to get back to break even. An investor that loses 10% of a portfolio requires only an 11% gain to get back to break even. Losing a large portion of a portfolio can wipe out many years of positive gains

Key Mantra – Fundamental Analysis

Only buy with "Margin of Safety"

a) Margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck or extreme volatility. In other words, once you are certain that you have a fair estimate of a share's intrinsic value, you must only buy the share when you are offered a price at such a discount to that value that you are safe from all unknowns.

b) The difference between the price paid and intrinsic value is margin of safety. For the disciplined investor, volatility is an essential contributor to investment success. Price volatility creates the opportunity for a patient investor to acquire a security at an appropriate discount to intrinsic value. That discount creates a margin of safety should unanticipated changes occur, either at the level of the company or issuer or in the broader investment environment.

c) At the same time, upside price volatility requires the discipline to sell securities – even ones with good fundamentals – if a rally pushes the price beyond the intrinsic value of the asset.

d) As Warren Buffett once opined "When you build a bridge, you insist it can carry 30,000 pounds, but you drive 10,000 pound trucks across it. In the same way, you don't try and buy businesses worth US$ 83 million for US$ 80 mn. You leave yourself an enormous margin.

Key Mantra – Fundamental Analysis

Big potential in small names

a) Everyone wants to invest in the next big thing or even the current big thing. But that's when herd mentality kicks in and ruins everyone's chances.

b) Look for companies that might sell for less than they're worth because they're under the radar. Small cap stocks, foreign stocks, and any other stocks that aren't in the headlines or aren't household names sometimes offer great potential but don't get the attention they deserve.

Pitfalls to avoid – Fundamental Analysis

a) Overlooking Extraordinary Gains or Losses

Some years, companies will experience unusually large losses or gains from events such as natural disasters, corporate restructuring or unusual lawsuits and will report these on the income statement under a label such as “extraordinary item – gain” or “extraordinary item – loss.” When making your calculations, it is important to remove these financial anomalies from the equation to get a better idea of how the company might perform in an ordinary year.

b) Listening to Your Emotions

Once you have purchased the stock, you may be tempted to sell it if the price falls. You must remember that to be a value investor means to avoid the herd-mentality investment behaviors of buying when a stock’s price is rising and selling when it is falling.

c) Not Comparing Apples to Apples

- Comparing a company’s stock to that of its competitors is one way value investors analyze their potential investments. However, companies differ in their accounting policies in ways that are perfectly legal. When you’re comparing one company’s P/E ratio to another’s, you have to make sure that EPS has been calculated the same way for both companies.

Wealth creation through capital markets

1) **Wealth Creation is the process by which a company enhances the market value of the capital entrusted to it by its shareholders.**

2) **It is a basic measure of success for any commercial venture. Wealth Creation is achieved by the rational actions of a company in a sustained manner**

3) **Every year, legendary investor Warren Buffett personally writes the Chairman's annual letter to shareholders of his diversified company, Berkshire Hathaway Inc.**

4) **His 2007 letter has a section on "Businesses – The Great, the Good and the Gruesome", where he discusses what kind of companies Berkshire likes and what it wishes to avoid.**

Wealth creation

Buffett equates the Great, the Good and the Gruesome companies to three types of bank savings accounts, where the interest rate is RoE (return on equity).

He says, "Think of three types of savings accounts. The Great one pays an extraordinarily high interest rate that will rise as the years pass. The Good one pays an attractive rate of interest that will be earned also on deposits that are added. Finally, the Gruesome account both pays an inadequate interest rate and requires you to keep adding money at those disappointing returns."

Story of Infosys

The capital appreciation via Infosys shares is out of this world. But, let's go down the history lane to find out how it all originated

a) In 1982, Infosys opened an office in Bangalore which soon became its headquarters.
b) Infosys made an initial public offer at Rs. 95 a share in February 1993 and was listed on stock exchanges in India in June 1993
c) Interestingly, **Infosys IPO was undersubscribed** but Morgan Stanley bailed it put by picking up 13% of equity at the offer price of Rs. 95 per share
d) The trading opened at Rs.145 a share, almost a 60% premium on the day of listing.
e) The share price surged to **Rs. 8,100** by 1999 making it the costliest share on the market at the time. **6 years and the share multiplied 85 times**
f) According to Forbes magazine, since listing on the Bombay Stock Exchange till the year 2000, **Infosys' sales and earnings compounded at more than 70% a year**.
g) Your head spinning as yet!! Wait before I tell you the numbers that are hair raising.
h) Infosys is currently trading at ~**37 times** of its IPO price – But more than that it has given handsome dividends quarter on quarter. And don't forget the bonuses and splits that this share has gone through.

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Key takeaways

By harnessing the power of your logic and combining it with a bit of the business study, you can make enormous wealth too in stock markets. All you have to do is create enough discipline and have the required conviction in your mind.

Worst times would always provide the chances of making best of returns in the better period.

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