



Ideas @ Edelweiss Multi Strategy Funds – Asset Pricing

The Indian stock market is littered with asset heavy companies trading at apparently mouth-watering discounts to their stated book-values. A majority of these are value-traps but you can occasionally find a diamond in the rough. In this month's Ideas @ Edelweiss Multi Strategy Funds we share an asset pricing framework for pricing assets.

As a thought experiment, consider a company with a single asset (like a land-parcel) and no earnings. A reasonable assumption on the rate of appreciation of the asset is the rate of inflation because the rate of inflation is by construction equal to the rate of increase in economy-wide asset prices. The long-term WPI inflation rate is 5.62% although the reader is free to substitute any other rate of appreciation. The stock is subject to the same risk-premium as other listed entities. The long-term return on the NIFTY is 12.05%, although our experience is that such stocks are more likely to be found in the mid and small cap space where the long-term return is 18.36% and 23.74% respectively. For the sake of argument, we will use the mid-cap long-term return as the required discount rate. Two things become apparent from this set-up. First, if assets appreciate at 5.62% and the required return is 18.36%, the DCF value of stocks diminish rapidly in the absence of cash-flow. Hence, the common refrain that stock prices are slaves to earnings-power. Second, if there is no plan to convert assets to earnings the value of the stock is zero - the ultimate value trap.

So what is a fair price-to-book for an asset-rich-earnings-poor stock? To answer this question, we will invert the problem. As mentioned above there has to be some point at which assets are converted to earnings otherwise the fair P/B is 0. We will assume that the asset gets converted to earnings after N years and it subsequently earns zero economic profit (ROIC = WACC). The implied number of years to conversion can be backed out from the present P/B ratio as $N = \ln(P/B) / (\ln(1+i) - \ln(1+r))$ where i is the inflation rate and r is the discount rate. For example, a stock trading at half times book value will have an implied 6.09 years to conversion while one trading at a quarter times book value will have an implied 12.17 years to conversion.

We leave the decision on what a reasonable number of years to conversion is to the astute equity analyst but this is a novel technique to ascertain the value of a majority of Indian companies.