Learn to Peg It Right

A crash course in how to assess 'value' in share issues from companies that do not have a performance track or any peers.

Investing in a company, says legendary investor Warren Buffett, is a bit like seeking out a mate. You have to have more than a passing acquaintance with the company, get to know it well-and be ready to commit for a lifetime. Of course, even Buffett, despite his characteristic conservatism, was "polygamous" in terms of the number of companies he owned, but his point is well taken: know what you're committing to, and get a sense of the relative merits (and demerits) of your chosen one among a peer set.

But what do you do when you don't know anything about a company that is coming to the market to raise funds-or if you have nothing to benchmark it against? Would you commit yourself to a perfect stranger? Would you get all mixed up with an entity you can't get a measure of- because there's nothing to compare it with?

Consider the upcoming IPO (awaiting Sebi clearance) from YES Bank, India's newest, which began operations in September 2004. There are several banks that are listed on the bourses, and so there is a large enough peer set to evaluate YES Bank against-and decide if it's worthy of investment. But since YES Bank itself doesn't have a sufficiently long track, you don't really know the first thing about it, do you? In Buffett's analogy, wouldn't investing in it be a bit like committing yourself to the young woman who moved into your neighbourhood just yesterday-about whom you know nothing more?

Then again, consider some recent IPOs from companies that operate in sectors where there wasn't any or much listed action in the Indian stock markets: Jet Airways (airlines), India Bulls (online trading), Bharati Shipyard (shipbuilding), PTC India (power trading) and Gokaldas Exports (garments exports). How do you get the measure of a company when there is nothing to compare it with-in terms of size or quality of offering? How do you know you're dealing with a David or a Goliath? Here are some pointers.

Know the business. To take a cue from Buffett's successful strategy, buy into a business you understand. Samir Rach, head of research, Emkay Share and Stock Brokers says: "It is unlikely that you will discover value when you don't understand the intricacies of a business. And to understand a business, a good starting point is to use common sense."

Even where you don't have a peer set, you can begin to understand the business by reading the company's prospectus. The industry overview section in the prospectus, for instance, offers a detailed explanation of the business and its dynamics. The section on risk factors addresses the concerns relating to the industry, and specifically the company.

For instance, the Bharati Shipyard's prospectus spelt out the factors that would influence the fortunes of the shipbuilding business. And a diligent investor would have gleaned from India Bulls' prospectus that over 90 per cent of its revenues comes from its broking subsidiary, India Bulls Securities, making the company susceptible to the vagaries of a bear market.

Says S. Subramanian, head of investment banking, Enam Financial Consultants: "The unique dynamics of the industry, the market conditions surrounding the company, and the regulatory issues it faces, will all point to the specific basis of valuation that should

be used to assess investment worthiness in an IPO."

All companies bring out details of their financial performance in their IPO prospectuses; established businesses share five-year historical financial statements with potential investors. What this means is that YES Bank's prospectus will only detail its track record over the short time it has been around, whereas a Gokaldas Exports' prospectus had a longer track to showcase, even though the company was an unlisted player all along.

"With information of this kind in your quiver, you can well assess the company's business model, anticipate its net cash flows and check for consequent returns on capital employed," adds Subramanian.

Global benchmarks. Reading the prospectus and understanding the business is one thing, assessing fair value of a company is quite another. And that job is made more difficult in the case of unlisted businesses, in the absence of benchmarks. Some investment advisors suggest that you use established global standards as a basis of comparison and appraisal-but it is critical to factor in the differences in growth expectations among different markets.

"Draw out the differences between operational realities in the domestic market and in the global markets, which could be the key differentiating factor in arriving at profitability estimates," says Vaibhav Kapoor, CIO, IL&FS. For instance, the valuations of Singapore Airlines and Virgin Blue were used to benchmark the Jet Airways IPO to factor in the risk associated with the airline business. But it was just as important to factor in the variances in the three airlines' market growth rates, airline usage levels and quantum of funds required to maintain their growth pace.

Likewise, comparing two companies in different industries in the domestic market amounts to flawed logic-even if the two businesses seem similar. For instance, says one investment advisor, it would be disastrous to compare Jet Airways with a heavy engineering company locally. While both companies may be highly capital-intensive, the latter operates in a regulation-free environment and does not have to wait for government approval to venture into new markets or explore new territories.

Know the promoters. Never commit to a potential mate without meeting the 'parents'. In other words, get to know the promoters and the management. Says Subramanian: "Promoters are an important consideration across the board: even when analysing companies with comparable listed peers, never overlook promoter quality." Adds Prithvi Haldea, MD, PRIME Database: "Valuation is in the buyer's mind. The critical success factor for any company is its promoter. Everything falls in place, including the price of the offering, if a good promoter backs the company."

How do you appraise promoter quality? Haldea suggests that you look at another listed venture from the same promoter. If there isn't one such, research the promoters' expertise, experience and previous performance. For instance, in the case of YES Bank, a greenfield project with no antecedents, the promoters' background and experience should speak for itself. Experts believe that the YES Bank IPO will be evaluated first on the basis of its management's competencies, then on the market conditions it operates in, and then its ability to price its cost of funds towards the lower end of the range for the industry.

Apart from reading the IPO prospectus closely, do some online research. A good starting point: www.watchoutinvestors.com, a site sponsored by the Ministry of Company Affairs' Investor Education and Protection Fund, and developed by PRIME Database. The site contains details on over 38,000 entities and 15,000 individual promoters against whom some form of regulatory action has been initiated.

"Investing in a company with no proven track record," says investment strategist Gul Teckchandani, "is akin to venture capitalism in some manner." Or, to invoke Buffett's

analogy again, like getting hitched while on a blind date. Don't go in blind, choose wisely and well, commit for a lifetime-and savour the rewards of the relationship.

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