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The Opportunity for Intelligent Investor

The insanity of Indian institutional investor continues. Even as inflation touched a seven year high of 8.75 per cent, based on latest weekly data, Indian institutions continue to buy into large cap companies with an average valuation close to 20 times trailing earnings. Inflation is poised to cross into double digits when the latest fuel price increase is incorporated into figures. If the full increase of fuel prices is transferred to consumers the inflation figure would be close to 15 per cent. The chart below is indicative of where the share prices should be. At the 10 per cent inflation the trailing price earnings ratio is close to 10 for developed markets. Real inflation is running higher than that in India. If we adjust for higher growth that is expected, it is still difficult to justify the current valuation of large companies. The buying by Indian institutions has reached their highest level ever. In this year, they have bought shares worth Rs 45,000 crores according to BSE data.

Trailing p/e ratio implied by a given level of inflation*

Annual % change in CPI	Average p/e Europe	US
1	26.5	37.8
2	20.5	24.8
3	17.6	19.3
4	15.9	16.2
5	14.6	14.1
6	13.7	12.7
7	12.9	11.5
8	12.3	10.6
9	11.8	9.9
10	11.3	9.3

* Monthly data Jan 1973 – Feb 2008

Sources: Citigroup; UBS

The flight to "quality" by Indian institutional investors has opened a huge opportunity for holders of shares who are willing to take a long term view. Along with companies where holders of shares are hoping for annual increase in profit to the tune of 20-30 per cent and even more, there are companies in small cap space where expectation is of zero growth to negative growth. Typically, small cap space is held mostly by domestic share holders, either at retail level or institutional level. The foreign institutions are largely absent because of absence of coverage by large brokerages of these small companies. When the sell off started in January, the small cap went into a free fall as retail shareholders started selling these shares, while domestic institutions confined their buying in large cap "quality" shares. The small cap shares were least expensive in January and after downturn the valuation discount has expanded to almost 60 per cent. Among these shares some are more attractive than others. We will illustrate some feature of these companies:

1. **Trade at 6-10 times trailing earnings**: These valuations imply an expectation that growth in earnings would be zero or even negative. We think for some of these companies that expectation is too pessimistic.
2. **Steady cash flow from operations**: Unlike the telecom companies these companies have sound cash flows. The cash from operations is close to stated profits and sometimes even higher. Investments in fixed assets in lower than

operating cash flow. Free cash flow is positive. Profits are not an illusion but backed by sound cash flow.

3. **Sound business fundamentals**: These companies have been in existence for more than two decades. Their business has been doing and is expanding. Even with 6 per cent GDP growth these companies would continue to flourish.
4. **High dividend yield**: Typically these companies yield in excess of 3 per cent as dividend and some yield up to 6 per cent. That is much higher compared to general market and even on absolute basis would be attractive.
5. **Low debt**: In an increasing interest rate scenario this feature would add to financial safety of these companies.

One can expect a lot of volatility in these shares. That is the basic nature of small cap stocks as not too many market participants are familiar with these stocks. Still it is worth while to remember that BSE Small Cap index has delivered the maximum return in last 5 years, compared to any other index or category of mutual funds. (Source: Value Research Online). At this point again, valuations of quite a few of these companies are very attractive.

For details on how one can exploit these opportunities contact us.