Demystifying Valuations **February 2017**

In our October 2016 communiqué - ***Cash is King*** - we argued that cash flows are a better measure of a company's profitability rather than margins. This month, we take this thought forward to argue that cash flow based valuation metrics are a better investment tool compared to earnings based valuations.

Typically, analysts tend to ascribe higher earnings multiples (P/E) to businesses that are churning out superlative revenue/PAT growth, irrespective of return ratios and cash flow profile. Conversely, analysts make the error of omission by ignoring companies that are growing at a steady pace, but trade at a higher P/E ratio. In our view, relying on growth ratios is not a reliable sign that a company has made progress and is worth more. Many a times it is the other way around; higher growth may lead to a weak balance sheet while steady growth stocks may generate enormous wealth.

In ***Cash is King***, we noted that:

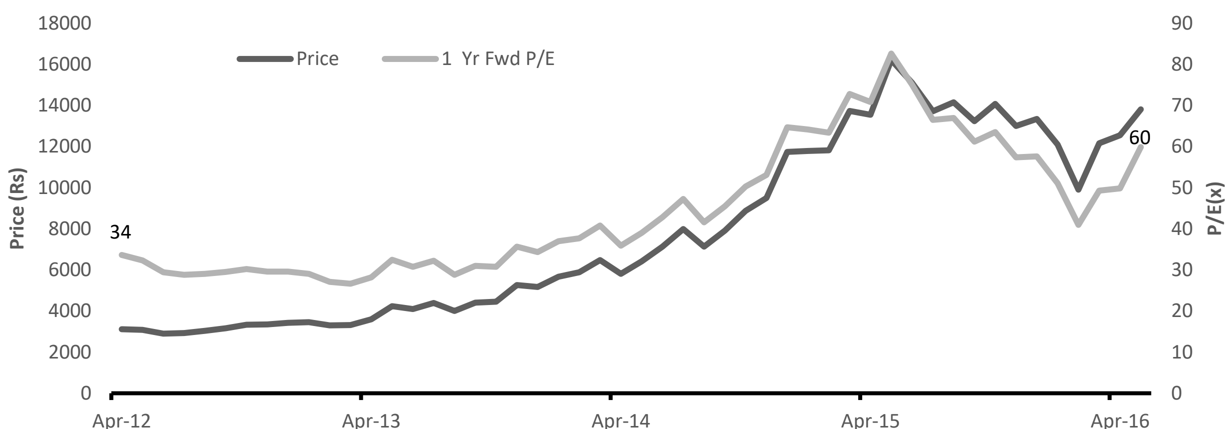
The above example enumerates that, ceteris paribus, it is not profits but cash flows that fund the growth of the company. Profits are just half the picture. Profits measure how much the company earns for every unit of revenue, whereas cash flow measures how much the company retains for every unit of earnings. Retention, as we saw in the above example, is important as it affords the company to (a) fund future growth without external funding (leverage or dilution) and (b) return money to investors (dividends or buy backs).

Thus, between one company growing its earnings at 20% while earning a 10-12% return on equity and another growing its earnings at 12-15% while earning a 20% return on equity, it is the latter that is more valuable as it would need to invest only half of its profits to achieve the 12-15% growth [*earnings growth = profits reinvested x ROE*]. In valuing both the companies, however, a P/E of 20x for company 1 may be justified by analysts using a PEG (P/E to Earnings Growth) ratio, while the same would render company 2 expensive (since PEG would be higher than 1). This, we believe, is an anomaly. We present three examples to make our case:

Example 1:

It is a leading inner-wear company in India. Its valuations were expensive in April 2012 - 34x one year forward P/E. Despite this high P/E, the stock continued to give strong returns as underlying free cash conversion from operating cash flows improved, and return ratios were not compromised for the underlying growth.

Figure1: Supernormal returns despite rich valuations



Source: Capitaline, Tamohara

If one were to follow the rule that high P/E stocks are expensive, then the best strategy would have been to avoid the stock. But when we look at the result in hindsight, the stock return is over ~3.4 times in 3 years even if someone had bought the stock at P/E of ~34x in 2012.

Figure 2: Price performance and stock return

Date	Price	1 Yr fwd PE	Cumulative Return	FCF Yield
Apr-12	3,120	34		3.2%
Apr-13	3,600	28	15%	1.1%
Apr-14	5,812	36	86%	0.3%
Apr-15	13,545	71	334%	0.7%
Apr-16	12,545	50	302%	1.4%

Source: Capitaline, Tamohara

Tellingly, during this period of re-rating, the company saw a notable improvement in its free cash flow conversion from operating cash flow. Thus, the expansion of P/E multiple was driven by an improving cash flow profile.

Figure 3: FCF/OCF conversion ratio improved

	2013	2014	2015	2016
OCF (INR Mn)	871	747	1,670	2,164
FCF (INR Mn)	422	237	1,136	1,902
FCF/OCF	48%	32%	68%	88%

Note: OCF: Operating Cash Flows; FCF: Free Cash Flows.
Source: Capitaline, Tamohara

Example 2:

This is a leading e-learning company, loved by the analyst/investor community due to its high growth and therefore traded at a higher P/E. However, high growth doesn't get converted into economic value as was the case with this company.

Figure 4: Supernormal revenue growth…

	2007	2008	2009	2010	2011	2012	2013
Revenue Growth	98%	160%	123%	63%	30%	10%	-19%

Source: Capitaline, Tamohara

But when we look at cash flows, the company wasn't generating free cash flows. Initially, the growth came with more debt and unfavourable working capital rather than from internal accruals and therefore was not sustained beyond 2011.

Figure 5: …funded by an expanding balance sheet

	2007	2008	2009	2010	2011	2012	2013
OCF (INR Mn)	132	516	1915	2244	2841	1450.9	-2227
FCF (INR Mn)	(544)	(1,704)	(3,849)	(2,482)	(5,325)	(2,201)	(3,407)
Working Capital Cycle (Days)	108	56	88	124	115	145	334

Source: Capitaline, Tamohara

Thus, even as the high initial growth was rewarded with a correspondingly high P/E, investors soon realized that unprofitable growth and high P/E is a perfect recipe for permanent loss of capital.

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Figure 6: Results are obvious; from glory to oblivion

Date	Price	1 Yr fwd PE	Cumulative Return	FCF Yield
Apr-07	262	33	-	-3.56%
Apr-08	802	53	206%	-2.59%
Apr-09	495	22	89%	-10.65%
Apr-10	681	17	160%	-3.49%
Apr-11	477	24	82%	-13.25%
Apr-12	194	NA	-26%	-11.86%
Apr-13	64	NA	-75%	-44.36%
Apr-14	26	NA	-90%	-308.82%

Source: Capitaline, Tamohara

Example 3:

This company is a leading paint manufacturer, and has generated tremendous wealth despite growth being around the average nominal GDP growth. From the below exhibits, we can deduce that company revenue growth was ~16% CAGR from 2011-16, but stock CAGR was 27% in the same period, mainly led by a higher OCF/FCF CAGR of 25%/20% respectively.

Figure 7: OCF & FCF CAGR surpasses Revenue CAGR by a wide margin…

INR Mn	2011	2012	2013	2014	2015	2016	CAGR
Revenue	80,295	100,323	114,608	134,138	150,689	166,622	16%
OCF	7,625	7,099	11,867	14,020	11,876	23,332	25%
FCF	6,122	1,699	5,499	11,666	7,500	15,272	20%

Source: Capitaline, Tamohara

Figure 8: …leading to superlative stock returns

Date	Price	1 Yr Fwd PE	Cumulative Return	FCF Yield
Apr-10	208	24	-	3.5%
Apr-11	277	28	34%	2.5%
Apr-12	352	31	70%	0.5%
Apr-13	468	38	126%	1.2%
Apr-14	505	37	143%	2.2%
Apr-15	763	45	268%	1.0%
Apr-16	868	44	318%	1.8%

Source: Capitaline, Tamohara

Closing Remarks

In ***Cash is King***, we argued that companies with superior cash conversion capabilities are better investments than companies with higher growth but inferior cash conversion. The examples enumerated in this communiqué not only corroborate this view but also illustrate that even though valuation multiples may reflect mere sales & profit growth in the short-term, in the medium to long-term, valuations are a function of operating cash flows and the conversion of those into free cash flows.

Until next month,
On Behalf of Team Tamohara,
Sheetal Malpani

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