12 WAYS TO PICK STOCKS

12th in the series

Value a company as if for a buy-out

Account for the enterprise' debt and surplus assets to arrive at fair value

Whether you're buying a stock or the whole company, valuation plays a key role in determining the price you pay for ownership. And this is measured in terms of market capitalization—the number of outstanding shares multiplied by stock price. The hidden costs? Buying a stock means owning the business and that means taking on its liabilities as well as the assets. Market capitalisation ignores debt and that can be substantial enough to alter the picture remarkably. Then there's that thing called cash that we all love so much and liquid investments that can come quite handy in times of need. This is why equity analysts rely on enterprise value (EV) rather than market cap to value a business. EV represents the cost of acquiring a business and is arrived at by adding market capitalisation to the debt repayable by the company minus the liquid assets (which can be readily used to pay off such debts).

To understand the concept of EV, imagine two companies that have similar market caps. One has no debt on its balance sheet, while the other is laden with heavy borrowings. Whoever owns the latter will be stuck paying lots of interest year after year. It goes without saying that you wouldn't want to pay the same price for each company. Now imagine two companies, each with a market cap of Rs 1,000 crore and no debt. One has negligible cash, while the other has Rs 500 crore in its coffers. If you bought the first one, you'd have a company worth Rs 1,000 crore. But if you'd bought the second company for the same price (Rs 1,000 crore), it would have cost you just Rs 500 crore, since you instantly get Rs 500 crore in cash. These are the kinds of things that EV takes into account.

When EV is viewed in relation to the profits a company earns, it can indicate how attractive or unattractive a business really is. True, the price-earning ratio can also be used for the purpose, but instead of looking at earnings in isolation, it often pays to also look at the total returns a business generates in relation to the cost of acquiring it. Lower the EV/profit-before-interest-and-depreciation, more attractive the valuation. So a company with an EV of Rs 1,000 crore and generating a profit of Rs 500 crore (EV/PBID of 2) is more attractive than a company available for Rs 1,500 crore and earning a profit of Rs 600 crore (EV/PBID of 2.5), all other things remaining equal. A comparison with peers on this parameter can direct you towards better investment avenues. We applied this ratio to a list of pharmaceutical stocks and came up with interesting results. Ranbaxy may be the cheapest Tier I stock, but there are concerns over business and management issues. Of the remaining three, Dr Reddy's is the clear winner. In the Tier II segment, Nicholas Piramal scores over Wockhardt whose heavy debt weighs it down.

	Market Capitalisation (Rs cr)	Debt (Rs cr)	Cash + Mkt. Investments (Rs cr)	Enterprise Value (Rs cr)	PE	EV/PBID
Pharma Tier I						
Cipla Limited	16548.72	195.01	33.65	16710.08	40.40	**35.08**
Ranbaxy Labs	15993.43	135.87	37.67	16091.63	30.32	**25.16**
Dr Reddy's	9969.41	287.63	922.04	9335.00	33.11	**31.00**
Sun Pharma	14405.33	1814.65	1540.84	14679.14	47.12	**41.96**
Pharma Tier II						
Wockhardt Ltd	5620.49	816.39	669.09	5767.79	27.05	**23.81**
Nicholas Piramal	4961.66	354.11	10.76	5305.01	29.26	**21.87**
Matrix Labs	3858.34	46.06	168.16	3736.24	29.62	**23.70**
Lupin Ltd	3756.70	440.64	20.46	4176.88	45.32	**28.36**
Divi's Lab	2193.44	66.09	4.49	2255.04	33.22	**26.34**
Dishman Pharma	1406.64	104.19	2.18	1508.65	49.34	**32.70**

Each of the article in this series shall also be available on the website of ICICIdirect.com after the release of the same in our magazine

Invest in IPOs and Mutual Funds the *direct* way.

Login. Select Offer. Enter Amount. And its done.

Call 1600-22-9191 or just SMS your CITY and NAME prefixed with DIRECT to 676766. For eg. DIRECT MUMBAI RAHUL

IPOs | EQUITIES | MUTUAL FUNDS | DERIVATIVES | LIFE INSURANCE | GENERAL INSURANCE | POSTAL SAVINGS

Trading through ICICI Web Trade Ltd., Member of National Stock Exchange, SEBI Regn. No. Equities INB 231147639, SEBI Regn. No. Derivatives INF 231147639 | Trading through ICICI Web Trade Ltd., Member of Bombay Stock Exchange Ltd., (BSE). SEBI Regn. No. INB 011147635 | AMFI Regn. No.: (ARN) ARN - 0845 Reg.Off.:ICICI Bank Towers Bandra - Kurla Complex, Mumbai -51 | Mutual Fund Investments are subject to market risks, read the offer document carefully before investing. *The documentation process would be done by us as the customers' Power of Attorney holder.