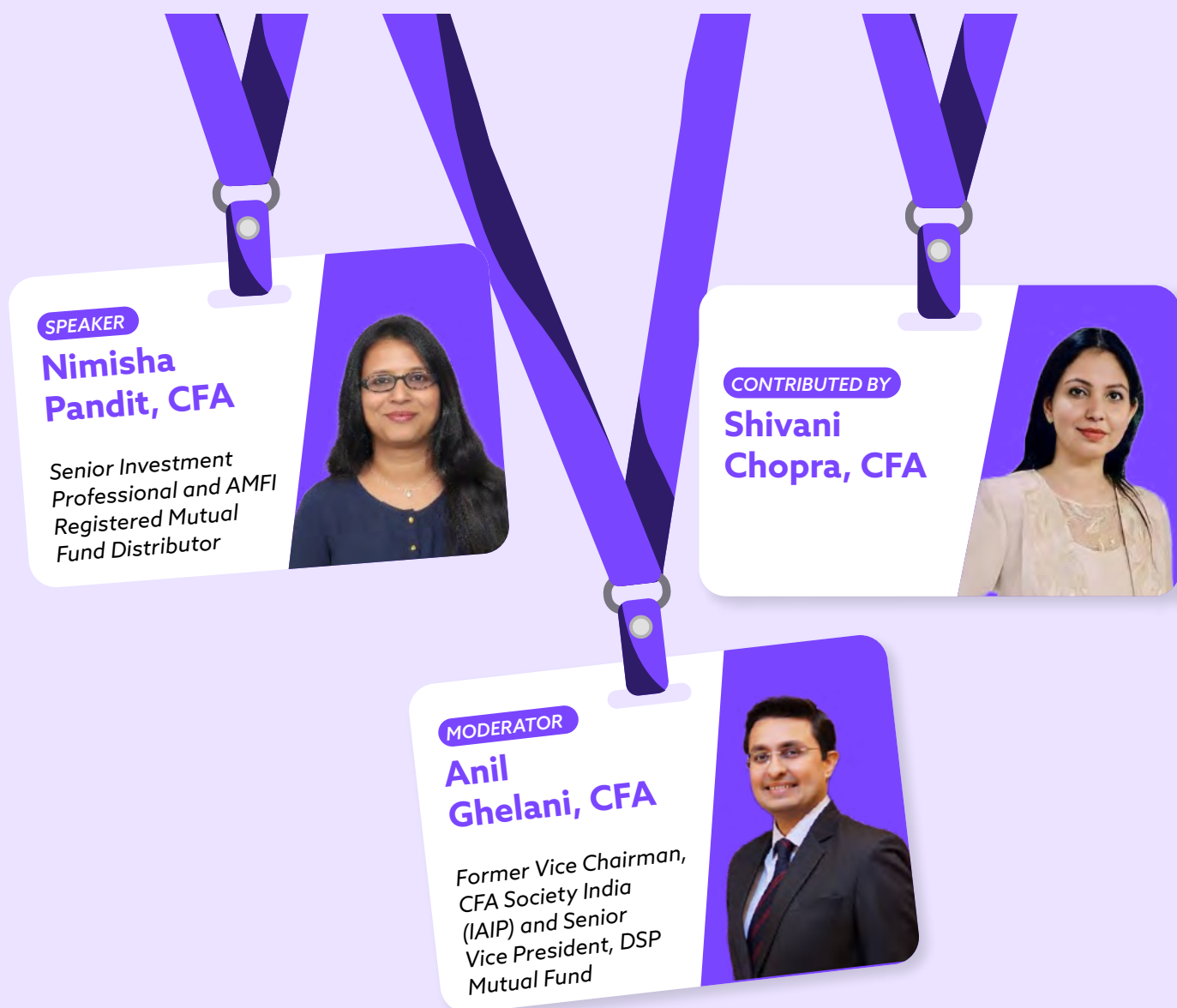


# PRACTITIONERS: INSIGHTS: VALUATION IN STRESSED TIMES

By

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## Webinar notes

1. Conventions of valuation (Market based)
  - Historical valuation- Use of company's past price multiples
  - Relative valuation – Can be used when historical valuation is not available or relevant. Also, when market participants want to assess the relative expensiveness or cheapness of a company as compared to its peers
2. Normative valuation (Absolute)
  - Discounted Cash Flow (DCF) – Used to estimate company's true intrinsic value.
  - Net assets valuation – Methods like Replacement cost of assets (RCA), Book value (BV), NAV, etc. are used
3. Which method to choose during distressed times- Use normative /absolute valuation methods:
  - In a trend market either bull or bear market, the historical prices/multiples reflect the current or recent sentiment. So, as long as the market continues to hold that sentiment, historical valuation might be right but once the attitude of investors changes, the historical reference point also changes. The market sentiment has indeed changed post the outbreak of Covid-19, hence its prudent to employ absolute valuation models.

### Valuation Tools- One size doesn't fit all

1. Valuation methodology of a company should be chosen given the unique dynamics of that firm. Focus on quality of a company and nature of business-
  - Pay close attention to quality of earnings, cash flows, strong or weak balance sheet, sustainable company advantage, barriers to entry, etc.
  - Check if the company can survive during economic downturn

### Classification of companies based on three quality buckets

#### Companies can be classified as low quality, average quality or high quality.

- **Bucket #1 (Low quality)** – Companies suspected to have engaged in accounting manipulations or having untrustworthy management. Red flags could be lack of Free Cash Flows (FCF), poor returns, excessive leverage, suspicious related party transactions and complex structures like lot of subsidiaries, cross holdings, etc. Read more about the quality of earnings – (a) Book titled "Financial Shenanigans" by Howard M. Schilit or (b) Blogs available on CFA institute website and Multi-Act website

#### All other companies can be placed in remaining two buckets depending upon sustainable competitive advantage like "Economic moat"

1. How to determine if a company has an economic moat or not- seek an answer to the below:
  - "Can a competent and well financed entity enter into this business and compete effectively with the existing players?". If the answer is "yes", then it is a non moat business else it is a moat business

Read more about this topic by going through, (a) Warren Buffet's letters to shareholders, (b) Pat Dorsey's "The Little Book That Builds Wealth" or (c) Blogs available on Multi-Act website

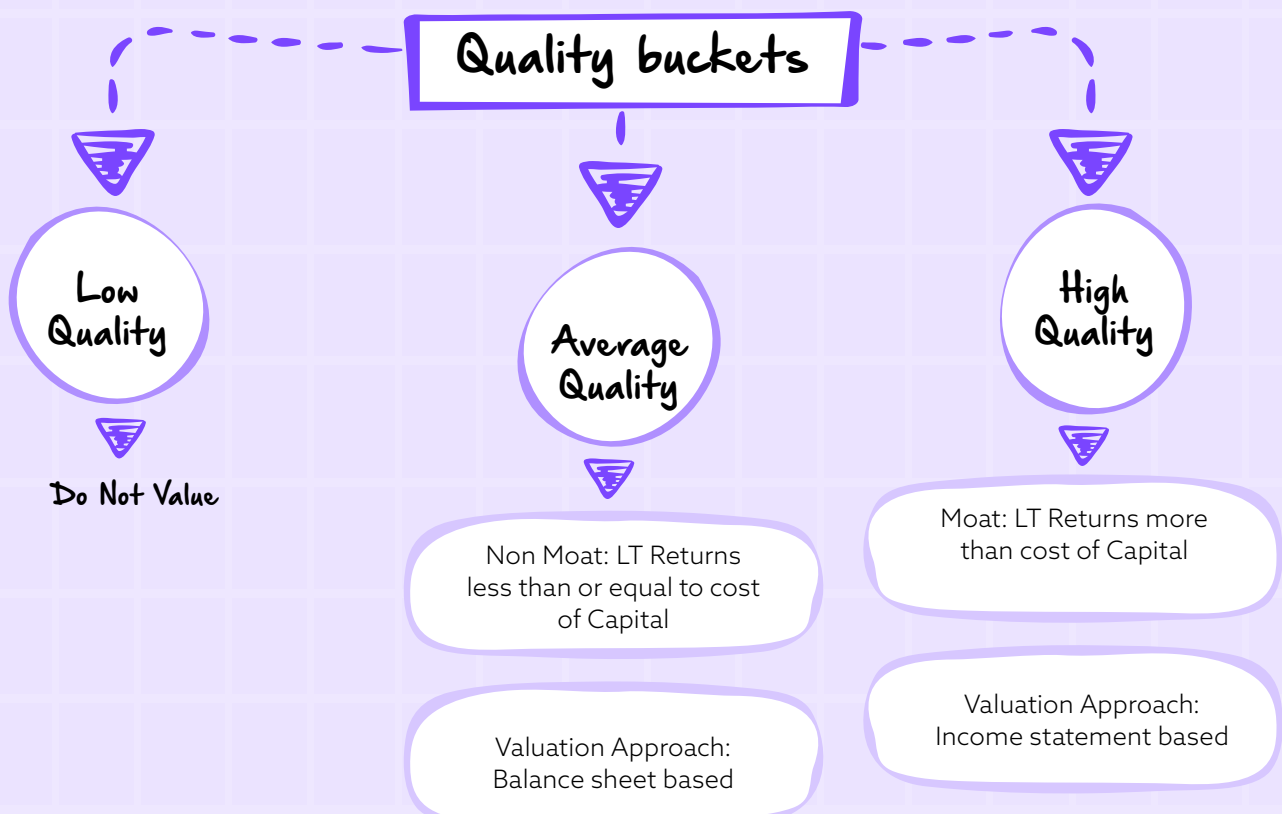
2. **Bucket #2 (Average quality)** – Place all non-moat businesses here. They will generate long-term returns less than or equal to cost of capital.
3. **Bucket #3 (High quality)** – Place all moat businesses here. They will generate long-term returns more than the cost of capital

## Valuation and Quality Buckets

The idea behind classifying companies in these buckets is to identify the valuation methods appropriate for each set of companies. One should avoid low quality companies and hence there is no need to conduct a valuation exercise. Use asset based methods to value average quality businesses and income statement based methods to value high quality firms

**1. Bucket #1** – Stay away from such companies. If the quality of earnings is poor, no amount of margin of safety is sufficient enough to protect yourself from permanent loss of capital. A case example of Gitanjali Gems was presented. Using a net net valuation method (an approach advocated by Benjamin Graham), we get a value of INR 305 as of 2013. Net net value is computed by deducting all liabilities from current assets and provides a floor value to the equity of the company (since fixed assets and other long term assets are not even considered). At that time, market value of Gitanjali Gems reflected a 25% discount to net net and after one month fell to 75% discount.

- 2. Bucket #2** – It's prudent to value non-moat firms based on the assets which they employ. Valuation methods such as Historical P/B, P/ Net net, Adjusted PB, Replacement cost of assets (RCA), Net asset value (NAV), Asset based valuation (ABA), etc
- 3. Bucket #3** – For high quality businesses, earnings will add value to shareholders, so we should use income statement based valuation methods like DCF, historical multiples such as P/E, P/S, EV/EBIT, etc.
- 4. Valuation tools**- Rather than using fancy elaborative valuation models, one can focus more on quality of business and company dynamics. Also, the principle of mean reversion is used which assumes that a company's historical performance is a good indicator of its future performance. In other words, future will mirror company's long term average historical performance
  - The same mean reversion principle is used while deciding cost of capital and a constant discount rate is used over a market cycle. Also, a country wise cost of capital is used. E.g. for India, a 14% nominal rate and a 8% real rate of cost of equity is assumed



## Asset Based Normative Valuation methods

1. **Net-net:** As discussed before, formula is Current assets - (All ST + LT liabilities). Be extra cautious if a company is available at a discount to its net net value. Probably, the market knows something which you may not. Look through all line items of current assets carefully- Account receivables may be of low quality or inventories may be obsolete
2. **Book value:**
  - Tangible Book value (TBV)= Net worth- Intangibles
  - For Banks and NBFCs , we can employ a bearish view by adjusting the formula as Adjusted Book Value = TBV- ( Gross NPAs - Provision for NPAs).In uncertain times, even the assets under the watch list can be deducted
3. **Justified P/B multiple = Normalized ROCE vs Cost of Debt. E.g.**
  - Co A: Avg ROCE = 11%, Cost of Debt = 11%, Justified P/B = 1x
  - Co B: Avg ROCE = 9%, Cost of Debt = 11%, Justified P/B = 0.8x (A lower P/B multiple since Avg ROCE< Cost of Debt)
4. **Replacement cost of assets (RCA):** This method can be used where capacities of plant & machinery of companies in a sector is standard. Below are the key steps-
  - Check existing capacity either in annual report or any other source
  - Get data of latest capital expenditure by companies in the industry
  - Estimate replacement cost of company's capacity



## CASE STUDY OF A SUGAR COMPANY WAS PRESENTED

The firm has a plant with cane crushing capacity of 76,500 tons per day and industry capex data indicates a cost of INR 450,000 per ton. This converts into a value of INR 34,425 million. Using this replacement cost of the primary asset - sugar, we can get total enterprise value (TEV) and equity value. In this instance, the RCA method gives INR 165 as against a book value of INR 66. However, during stressed times, one should be conservative and consider the book value of INR 66 and RCA value of INR 165 can be more appropriate in an optimistic market as some other entity might buy this company rather than setting its own. During normal times, one can also consider market multiples based EV/RCA valuation. Using this approach, we get a range of INR 78 to INR 156 (-1SD to + 1SD)

## Earnings Based Absolute Valuation

DCF technique-

1. CASE STUDY of an adhesive company having an economic moat was presented. For key points and assumptions, refer to the data below-
2. Intrinsic Value: PV of future cash flows discounted at the cost of capital.

3. DCF:
  - Growth Rate  
Company's historical growth subject to
    - Change in Corporate Life Cycle
    - Industry Growth & Market Share Changes
    - Value Migration
  - Free Cash Flow Generation
  - Terminal Value
    - $1/(\text{Cost of Equity less Growth})$  subject to quality
    - Premium for higher returns and growth

Assumptions		
LT Expected Growth Rate -		8
FCF/EPS (%)		60
Discount Rate - Real (%)		8
Terminal Multiple		18
Year	EPS	FCF
2018	18.9	11.4
2019	20.5	12.3
2020	22.1	13.3
2021	23.9	14.3
2022	25.8	15.5
2023	27.8	16.7
2024	30.1	18.0
2025	32.5	19.5
2026	35.1	21.0
2027	37.9	22.7
Terminal Value		682
PV-Cash Flow		114
PV-TermValue		341
<b>DCF Value for March 2018</b>		<b>455</b>

4. Focus should be on organic growth while building projections
5. Use of real growth rate and real discount rate
6. DCF model yields a value of INR 455
7. During normal times, a valuation based on P/DCF can also be considered which gives a range of INR 342 to INR 862 (-1SD to + 1SD). But during distressed times, a naïve DCF approach will work best

8. Stress test of DCF value can be performed as well. Considering today's situation, impact on near time earnings (loss of revenue and supply side constraints) and long term business (change in business practices, impact on competitors and government regulations) should be analyzed
9. The subject company has a defensive business and hence even during a volatile market situation, the overall impact of stress test will not be that severe. As a worst case scenario consider zero FCF generation for the next one year (e.g. for 2021FY due to Covid-19 outbreak) and run the model to check the result. You will notice that the value doesn't fall significantly. So when the long term growth story of a company is intact, DCF value will just show a minor drop.
10. It's worth noting that in this case example, ~75% of the value is coming from the terminal value and one may question the effectiveness of the model. In such cases, we can probe the quality of terminal value by using 3TV approach

### 3TV Approach

Depending upon the valuation drivers of a business, we can have three tranches:

1. **Tranche 1 (Asset value):** Tranche 1 is the value of the tangible assets (or the value of the regular assets of the company)
2. **Tranche 2 (No growth value):** Tranche 2 is the value of current earning power (or franchise value from current competitive advantage)
3. **Tranche 3 (Total value):** Tranche 3 is the value of growth (or ability to protect and grow firm's competitive advantage)

Going back to our Adhesives company example, Tranche 1 is INR 58, Tranche 2 is INR 109 and Tranche 3 is INR 455 (DCF value). The moot question now is whether you feel comfortable paying a premium of ~ INR 346 (Tranche 3- Tranche 2) for sustainable growth value and invest accordingly.

Link to complete video - <https://www.youtube.com/watch?v=Z7gwCchA3ts&t=3151s>

Link to session presentation - <https://cfasocietyindia.org/blog/practitioners-insights-valuation-in-stressed-times-by-ms-nimisha-pandit-cfa/>

# ABOUT NIMISHA PANDIT



Nimisha Pandit, CFA is a seasoned investment professional with over 16 years of experience in equity research, financial analysis, investing and training.

Nimisha is a CFA Charterholder, has completed the Chartered Accountancy course of ICAI, and holds a Master of Arts degree in Economics.

Nimisha is AMFI-registered Mutual Fund Distributor and a long-term value investor who enjoys studying companies to understand their business model, moat, management, financials and valuations. She has been researching

Indian & Global companies for years, earlier as part of her job and now for her personal investments.

Previously, Nimisha served as an Associate Director and Head of Research at Multi-Act, an investment outfit offering research, advisory and portfolio management services.

As Multi-Act's head of research she was responsible for providing independent, unbiased, and objective analysis to Multi-Act's portfolio managers, investment advisors, and institutional research clients. As an Associate Director she was also involved in developing and implementing business strategies. She also briefly worked with Club Millionaire, a PMS firm as a Senior Analyst.

Nimisha also volunteers at CFA Society of India and has given honorary lectures at various investment and academic forums.



# ABOUT SHIVANI CHOPRA

Shivani Chopra, CFA, is a finance professional with over 15 years of diverse experience across investment management, private equity, and academia. She currently serves as a Vice President at Truemind Capital, a SEBI-registered, fee-only private wealth management firm known for its research-driven and client-centric advisory approach. Over the course of her career, she

has worked at the intersection of investments and financial strategy, bringing analytical depth and practical insight to high-net-worth client portfolios. Shivani's academic foundation includes the CFA Charter (CFA Institute, USA), CFA (ICFAI), MA in Economics, and the CFVM certification from Wall Street Prep, USA.

Shivani is deeply passionate about financial education, and has served as visiting faculty at several leading B-schools across India, where she teaches courses in investments, valuation, and applied finance. She is also a long-standing and active volunteer with CFA Society India, currently serving as Co-Chair of the Public Awareness Committee (PAC).

# ABOUT ANIL GHELANI



Anil Ghelani, CFA, has been associated with the DSP Group since 2003—one of India's oldest and most respected financial institutions with a legacy spanning more than 160 years. He currently serves as the Head of Passive Investments & Products at DSP Investment Managers. Over the course of his career within DSP, Anil has held several influential leadership roles, including CEO & Chief Investment Officer of DSP BlackRock Pension Fund Managers and Head of Risk & Quantitative Analysis at DSP BlackRock Mutual Fund, where he oversaw portfolio risk, analytics, and buy-side credit research across multiple sectors. He also served briefly as Chief Operating Officer – Sales & Marketing, gaining unique cross-functional insights that enriched his leadership profile. Prior to joining DSP, Anil began his professional journey in 1998 and worked with IL&FS Asset Management Company, S.R. Batliboi (EY member firm), and V.C. Shah & Co.

Beyond his corporate responsibilities, Anil has been a long-standing volunteer with CFA Society India since 2007, serving in various capacities including Director and Board Member from 2011 to 2023, and Vice Chairman of the Board from 2018 to 2021. He has contributed

extensively to industry development through roles such as induction into the India-UK Financial Partnership (IUKFP) for the Pensions focus area and membership on AMFI's Standing Committee on ETFs and Index Funds. Anil has also volunteered with the CFA Institute globally and was prominently featured in the Institute's international advertising campaign in 2016–17. Widely engaged with academic institutions such as IIMs, TAPMI, SP Jain, SIMSREE, and IMI, he frequently speaks at events, judges student competitions, and contributes to editorial boards. His professional excellence has been recognized through the IAAIF "40 Under 40" Alternative Investment Professionals – 2018 list. Anil also contributes to social initiatives as part of DSP's internal CSR Committee.



## Resources & Guidelines (ARX, CFA Society, CFA Institute)

- <https://blogs.cfainstitute.org/investor/2025/01/13/the-discounted-cash-flow-dilemma-a-tool-for-theorists-or-practitioners/>
- <https://rpc.cfainstitute.org/research/foundation/2024/valuation-handbook-2023>
- <https://blogs.cfainstitute.org/investor/2025/04/03/top-10-posts-from-q1-valuation-models-inflationary-shocks-private-markets/>
- <https://rpc.cfainstitute.org/research/multimedia/2011/relative-valuation-improving-the-analysis-and-use-of-multiples>

