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Publication	:	**The Economic Times**
Date	:	**Sunday, May 04, 2008**
Edition	:	**Pune**
Page	:	**11**

FATHOM the depths

Often under-rated and out of radar, deep value stocks can do wonders to your equity portfolio. **Aman Dhall** reports on what it takes to spot them

THEY are believed to carry hidden treasure on Dalal Street. While investors call them the low-lying unpolished gems of the stockmarket, brokers say there are big bucks to be made if you can identify these stocks early. No prizes for guessing this, we are talking about deep value stocks which can do wonders to one's portfolio when market re-assesses them.

According to analysts, a deep value stock can be defined as something which is low priced in relation to the margin of safety the stock provides, to limit losses when a mistake is made. **SundayET** provides you an insight into how to identify these stocks, what should be your ideal portfolio allocation and reasons behind their low valuations in the market.

SLEEPING GIANTS

They are like any other stock traded on the exchange, but there is no hypothetical understanding of them. A section of traders on the Bombay Stock Exchange even call these stocks as 'sleeping giants'. Manish Sonthalia, vice-president, equity strategy, Motilal Oswal Securities, believes that there are two ways in which you can identify a deep value stock. First, what Benjamin Graham recommends for the defensive investors in his 1949 classic — that the stock price should not be more than 15 times its average earnings per share over the past three years and the overall PE of the portfolio should not be more than 13. Or second, the stock should be trading below its 10-year median PE. "The other things to be kept in mind is to stick with companies that have a long history of consistent profit growth and steady dividend payouts and the fact that not every cheap stock would turn out to be a bargain," says Sonthalia. He believes that PSU banks like Oriental Bank of Commerce, which is trading at a PE of 5.6 with book value of Rs 240 for FY09, is a perfect example of a deep value stock. "In a growing economy like India, banks should do well as the GDP expands," he reasons.

According to Ketan Karani, vice-president, research, Kotak Securities, these stocks generally remain neglected by the stock markets. "The best (or you may call it worst) part is that people know it's a great story but still they don't want to touch it. If one saw the real estate boom in India five years back and bought into Unitech, his portfolio returns would have multiplied phenomenally," he sums up.

As far as portfolio allocations are concerned, analysts feel that an investor could invest 80% in growth stocks and 20% in value stocks (after keeping some cash balance or investments in fixed income instruments). In case of a pure deep value investor, Sonthalia says that typically 80% the investment of investible funds should be in these stocks and 20% of the funds should be kept aside for fixed income instruments or cash balance. "However, a hybrid investor should follow a strategy in between the two. The basic principle followed is the Pareto's principle — the 80/20 rule," he points out.

SOW TO REAP

Though opinions differ on an ideal investment horizon, most analysts agree that it should not be less than a year and which could extend up to three to five years to reap big dividends. Karani says the first thing an investor needs to do is to ask himself whether he is a speculator or an investor. "If he is a speculator, then there is no chance for him to stay in these stocks. If he is an investor, a time period of three to five years is what makes sense," he feels. However, if the stock does not give the required return even after holding for three years, there is something more than one 's own understanding about the stock. "In such a scenario, you could sell the stock and move to something else. However, if there are compelling reasons, you could continue holding the stock," says Sonthalia.

On why these stocks have ridiculously low valuations, Karani says that "the market sometimes tends to overlook an industry. And usually these stocks are not popular with brokers." Apart from that, analysts explain that there could be reasons such as high transaction impact costs (small caps can have transaction impact costs as high as 30-50%) and fear of uncertain events or adverse macro environment conditions such as rise in oil and interest rates, government policies, etc. "You must also understand that fear always resides in the near term. And that's why there is lower visibility of the future even though the broad picture remains intact in these cases," he says.

UNPOLISHED GEMS

Here are some deep value stocks which experts feel have great potential

ONGC

The stock is in a sector which is very strategic in nature, has a history of good profitability and dividends and trading at ridiculous valuations.

MAHINDRA & MAHINDRA AND MARUTI

The industry is in a growth phase in India as opposed to a saturation phase in the western world – trading at a PE of around 10 for FY09

LIC HOUSING FINANCE

A company growing at 25-30% available at a PE of 7x for FY09 and EPS of Rs 55. Book value of the company in FY09 would be Rs 260 and ROE would be 20% (Assuming no dilution)

BIRLA CORPORATION AND INDIA CEMENTS

Trading at single digit price multiples for FY09. Overall infrastructure spending is close to $500bn in the 12th five year plan and that we are nowhere close to capacities that exist in China

MANISH SONTHALIA
VP, equity strategy, Motilal Oswal Securities

HDIL

It is trading at a considerable discount. The infrastructure sector has strong revenue visibility, and growth opportunity in the target markets with possible value unlocking opportunity.

SBI

The stock is trading at single digit multiple for FY10E. Apart from holding largest land bank holdings, it has an x-factor too – human resource valuation

KETAN KARANI
VP, research, Kotak Securities