Ask any serious, long term investor on the type of company he or she would like to invest and you will almost always hear something along the following lines – A high quality[1] company with sustainable competitive advantage (aka Moat) and long term growth prospects, available at a cheap or reasonable price[2].

So what's wrong with the above statement? It's almost a truism and a guarantee of great results.

The main problem in the above statement is the last part – 'Cheap or reasonable price'. If a company is of a high quality which is obvious to most market participants, then the price will reflect these qualities and it is unlikely that the stock will be cheap.

A false dichotomy

As an aside, I have found it amusing that a lot of investors go around discounting the above concept irrespective of the price. Their line of reasoning is that if a high quality company drops in price due to overvaluation (or some short term disappointment), then the whole approach is discredited.

The point which gets missed in all these quality versus cheap discussion is that price changes everything. If you overpay for an asset, it does not matter if it is cyclical or a quality company, returns will be poor. One should call such an act as speculation and not an investment

What causes the price to drop?

If you agree with me that price is an important determinant of future returns, then the next question to ask is why the market, which is full of hardworking and reasonably rational investors, would undervalue a high quality company?

I think this question is important because as a value investor I am looking for mispriced bets. The stock though not always efficient, is usually right and will not give an obvious bargain most of the time.

I posted the following on twitter on the reasons why the stock market sometimes gives a mispriced bet. This is definitely not a comprehensive list, but it better than saying that I can see a bargain because I am smarter than almost everyone else.

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[1] For the purpose of this note, lets define a high quality company as one which is 'most likely' (one can never be 100% sure, unless you are on TV) to earn a high return on invested capital (greater than 20%) for a considerable period of time (my assumption is 5 years or more).

[2] My personal definition of cheap is when using various models of valuations and assumptions, you can reasonably estimate that the asset in question is selling at a discount of 30% or more to its intrinsic value.

Rohit Chauhan @rohitchauhan · Mar 6
@rohitchauhan Some of my thoughts to this question. There are ofcourse more reasons

I have been thinking of the following question

> **Rohit Chauhan** @rohitchauhan · 43m
> Everyone would like to buy a quality business at a cheap price.The interesting question to think is why the market would give such a bargain
>
> 1 1

Looking back at some of my past experiences and general reading, I can think of the following. The list is not exhaustive

- A small, obscure company which is performing well within its niche. A company of this type would be ignored as it may be too small for a lot of investors
- A company after several years of average or poor performance, starts turning around and is now performing well – either due to managerial effort or changing industry structure
- A spin off or demerger where the price drops due to non- fundamental reasons. This coupled with poor market conditions can create a bargain
- A high quality company which has delivered below par growth for several years. A lot of investors lose patience and bail out. A subsequent improvement can lead to above average returns
- A company going through temporary distress such as a cyclical downturn. The key being cyclical and not a structural downturn.
- Full scale panic in a sector or the entire market, where the baby gets thrown out with the bathwater.

Let's explore each of these reasons in more detail

A high quality micro/small cap

This is the most fertile ground for finding mispriced bets. There are high quality companies operating in a niche, but too small for large investors such as Mutual funds, HNI investors etc. In addition to the small size, the trading volume on these companies is low and hence it is not worth the while for brokerages to cover and recommend these firms.

This is a prime hunting ground for ambitious small investors who are ready to turn a lot of rocks and work hard at finding such opportunities. The upside is that a few good ideas in this space can change your financial future completely. The downside is that out of every 100 stocks in this space, only a handful are worth investing and hence one has to work really hard to find the good long term ideas.

Cyclical downturns

The stock price of a company tends to drop if the growth rate falls or turns negative. The market reaction can often be quite severe in some cases, where the expectations were recently high.

In such cases, the stock may appear to be cheap relative to the recent performance. The trick in these cases is to figure out if the downturn is structural or cyclical. If it is cyclical, then one also needs to have an idea on how long it will take for the industry to recover.

Let me share a few examples

Bharti airtel appeared cheap in 2010 and a lot of investors thought that the slowdown was cyclical (see my post on this topic [here](#) and also read some of the comments). The problem was that the drop was not due a slowdown in the telecom market alone. The competitive intensity of the industry increased as the market slowed and then on top of that Bharti made a few bad capital allocation decisions (such as acquisition of Zain) which destroyed value further.

In contrast, the textile machinery or automotive industry was hurt very badly in late 2008 / 2009. I still recall that in early 2009, [ashok Leyland](#) had to stop production for a month to stop the inventory buildup. LMW ([Lakshmi machine works](#)) was selling for less than cash on book in early 2009 which meant that the market thought that the company's business was worth less than zero.

Lakshmi Machine Works Limited (BOM:500252) Add to portfolio

3,575.00 +78.75 (2.25%)
Apr 13 - Close
BOM real-time data - Disclaimer
Currency in INR

Range	3,426.30 - 3,575.00	Div/yield	37.50/1.05
52 week	3,050.00 - 4,199.00	EPS	115.02
Open	3,447.00	Shares	11.27M
Vol.	475.00	Beta	-
Mkt cap	40.36B	Inst. own	-
P/E	31.08		

G+1 1

Compare: Enter ticker here Add BSE Sensex 521182 504959 522267 505358 522292 504786 more »

Ashok Leyland Ltd (NSE:ASHOKLEY) Add to portfolio

110.05 -1.30 (-1.17%)
Apr 13 - Close
NSE real-time data - Disclaimer
Currency in INR

Range	110.00 - 112.90	Div/yield	0.45/0.41
52 week	63.80 - 112.90	EPS	-0.63
Open	112.50	Shares	2.85B
Vol.	19.08M	Beta	-
Mkt cap	312.05B	Inst. own	-
P/E	-		

G+1 40

Compare: Enter ticker here Add TATAMOTORS ATULAUTO HINDMOTORS 500033 500100 MARUTI more »

So unless one assumed that the market for textile machinery or commercial vehicles was completely gone, it was not difficult to see that this was more of a deep cyclical downturn and not a structural problem.

How does one distinguish a structural versus a cyclical downturn? There are no simple answers. It requires understanding an industry in depth, looking at its history and making some educated guesses.

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A positive structural change

An industry performs poorly for a long period of time and acquires the label of a 'bad' industry. Most investors then shun all the companies in this industry and refuse to dig deeper.

This is a reasonable approach as one has limited time and needs to allocate it to those segments of the market where there is a higher probability of finding a good idea.

Occasionally however an industry starts changing for the better, which is not noticed by most participants who still consider this improvement to cyclical (than structural). As a result, such companies remain undervalued for a long time till the market finally recognizes this change.

An example of the above is the shrimp / shrimp feed industry. The shrimp industry was a boom industry in the late 90s and saw a lot of fly by night operators. By the early to mid-2000, poor industry practices, disease and demand related issues caused the entire industry to collapse. A lot of investors burnt their fingers and swore never to touch a stock in this sector again. The industry practices started improving by 2008-09 and with the introduction of the vannmaei shrimp, the export sector took off.

Avanti feeds took advantage of this tailwind and with a strong sales and distribution structure has been able to increase its profits by 16X in the last 5 years. As a disclaimer, I hold a small position in Avanti feeds, but I did not see this change till it was obvious to everyone[3]

So is there any such industry now? Let me give my guess – Real estate

[3] Some investors were able to identify this much earlier. See this post by my good friend Ayush mittal.

Under appreciation of quality

This is a case of value hiding in plain sight. Take the example of companies like HDFC bank, ITC, Asian paints or nestle. Ask any investor and they will agree that these are high quality companies with good prospects in the future. This has been the view for the last 20 years.

Inspite of the obvious nature of such companies, most active investors do not hold these stocks. For starters, a lot of people assume that if the quality of these companies is so obvious, why should they be undervalued?

My personal view is that the stock market and most investors, under estimate the durability of their competitive advantage (see my note on the topic here) and hence these companies, deliver high returns, though they appear to be expensive in retrospect.

As long as one does not overpay a lot (how much is a topic in itself) for these companies, the returns for an investor are likely to be above average with much lower levels of risk. I think a portfolio of 10-12 such companies would be a good low maintenance portfolio for a lot of investors. As an aside, if I decide to stop investing actively (hopefully never), I would most likely follow this approach

Full scale panic – sector or market level

This is the most obvious reason why high quality stocks can get cheap. Look at the period 2008-09 when this happened on a large scale (80% drop in small cap index)

This seems to the most obvious way to invest in quality stocks at a cheap price. There are however several caveats to it

For starters, panics don't have happen too often. One has to wait for a long period of time, before a true large scale panic causes the stock market to crash (a 10-15% drop in the index is not a panic, just a mild correction)

The second and more crucial point is that, during such panics the world truly appears to be coming to an end. It require a huge amount of courage to just hold onto your stocks.

The last point is that, it is only in hindsight that one can identify when the panic ended and the market started recovering. During the actual panic, one gets constant negative feedback as whatever you buy keeps getting cheaper by the day.

So a full scale panic may appear to be the most plausible, but the least actionable of the reasons for getting quality at a deep discount

Technical reasons

One can find a bargain for some technical reason too. Some of these reasons could the demerger of a division, where the demerged company faces selling pressures from arbitrageurs and hence gets undervalued for a short period of time. The other reason could be forced selling by an institutional investor due to redemption pressure or losses in other parts of the portfolio.

In such cases, the reason may not be obvious and it requires a deep understanding of the company to have the courage to buy when a reasonably well informed institutional investor is selling.

Superficial analysis

There are often companies which are difficult to understand. These companies could have a complicated corporate structure (multiple businesses under one company) or could be undergoing some sort of restructuring in the business which causes the profits to dip temporarily for non-business reasons.

A recent example is Bajaj corp (not a current holding). The company acquired the No-marks brand and started amortizing the goodwill quite aggressively. As a result, the reported profits dropped though the true free cash flow of the company actually improved as the company swapped treasury investments for a high margin brand.

The market in all its wisdom, knocked down the price as it was fixated on the reported profits. The discrepancy has since corrected.

These cases of undervaluation are mainly due to the reason that a lot of investors look at the headline numbers and make a buy/ sell decision without making the effort of digging into the true economic performance of the company. An investor who is ready to dig deeper can occasionally find such discrepancies and make a decent profit.

Why do this analysis ?

It is nice to have these categories, but the question at this point is why should one think in this manner?

For that I come back to the point I made earlier – the market is often, but not always efficient. What this implies is that if you analyze stocks, almost 80-90% of the time the market would be valuing the company appropriately.

In the balance 10% of the cases, it is possible that the market has got it wrong. It would be quite convenient to stop at this point and close the matter. I would however like to introduce the concept of probability/ odds at this stage.

As an investor, one need to keep in mind the probability of success in the area one is investigating. For example, the odds of finding a great investment in an IPO is low (though not zero) and hence my thumb rule is to avoid them. In a similar fashion the chances of making a high return over the long term in industries with poor economics such as sugar or steel is low (trading is a different matter). If you hold a company earning 5% return on capital for the long term, it is very unlikely you will make a high return on the investment.

If one wants to be successful, it important to look in areas where the probability of success is high (fish where the fish are plenty).

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Odds of success

One way to categorize the above patterns of undervaluation would be to look at the probability of success. I have arranged the causes of undervaluation in a reducing order of predictability – in other words, one is likely to have a higher success rate in finding a high quality, undervalued company in something which is higher up on the list

- A high quality micro/small cap
- Under appreciation of quality
- Technical reasons
- Cyclical downturns
- A positive structural change
- Superficial analysis
- Full scale panic – sector level
- Full scale panic – Entire market

The above sequencing is not based on any statistical study, but generated based on my experience and gut feel (short form for daydreaming with a nice cup of coffee). As a result, others may order this list in a different manner. The more important point is to develop a list for yourself and keep it in mind when searching for new ideas.

If I am small investor, it would make sense to dig into the micro/small cap space where the likelihood (odds) of finding a truly great idea on the cheap is high. In contrast, it is probable though unlikely that something is cheap in the nifty 50 list. As a small investor, I think it is a waste of my time to research a company like Infosys which is the most researched and followed stock in the Indian market.

At the other end of the list, a full scale panic in the market will throw up a lot of opportunities but it is a rare event and one cannot wait for a decade or two to build a portfolio.

Combining screens with the list

As I wrote at the start of the post, the stock market is usually efficient and will not hand over a free lunch. However if one can identify the patterns which cause temporary undervaluation, then the odds of finding a high quality but cheap stock are improved.

One can definitely find these kind of companies by running various screens which can serve as the first filter. A list similar to the one I have shared can be used to further segment the list into buckets with varying odds of success. For example a simple PE based screen would have thrown up Avanti feeds and Bharti Airtel in 2011. However applying the next level of filter, would have helped the investor eliminate Bharti Airtel from the consideration set.

Once you have shortlisted and bucketed the companies which appear to be cheap for a reason and where the probability of success is high, the real work of digging deeper can begin.

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