



Corporate Fundamentals and Intrinsic Value, the Real Investment Drivers

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ABSTRACT

Every investor is interested in knowing the appropriate timing for investment, as well as the best avenue for investment. Thus, investing in equity is always a challenging and a rewarding task. While in the process of investing, to know the real value of the scrip becomes primary thing for the investor. There comes the fundamental and technical analysis to help the investors in finding out the real value / intrinsic value of the scrip and thereby selecting a best stock. Fundamental analysis helps to evaluate financial stability, financial strengths and weakness of the companies. Which in turn help the investor to identify undervalued and overvalued scrips. Thus, this research work aims at finding the intrinsic value of shares facilitating the investor to know about the real worth of the scrip before taking any investment decision. More importantly, the research studies the relevancy of the applied methodology in finding the intrinsic values of sample scrips, then by comparing, and revalidating them with the prevailing average annual market prices of the years 2012 and 2013 respectively.

KEYWORDS : Intrinsic Value, Fundamental Analysis, Dividend Per Share, Dividend Payout Ratio, Price Earnings Ratio

Introduction

There are many different ways to value scrips. Equity shares can be described more easily than fixed income securities. However, they are more difficult to analyse as they neither have a limited life nor a well defined cashflow stream. The growth and the risk create greater complexity in the valuation of equity shares. Fundamental analysis is a scrip valuation method that uses company financials, industrial and economic analysis to predict the movement of scrip prices by calculating their intrinsic values which tends to be high or low when compared with their market values. It is assumed that the market price of scrip tends to move towards its fair value or intrinsic value.

Intrinsic Value & Decision

Intrinsic value refers to the value of a security which is intrinsic to or contained in the security itself. The intrinsic value helps to make investment decisions. A comparison of intrinsic value with the prevailing market price helps investor to decide whether to buy, sell or hold the scrip.

If the intrinsic value of scrip is above the current market price, the investor would purchase the scrip because investor knows that the scrip price would rise and move towards its intrinsic value. If the intrinsic value of scrip was below the market price, the investor would sell the scrip because investor knows that the scrip price is going to fall and come closer to its intrinsic value.

Objectives of the Study

1. To calculate the average Dividend Payout Ratio (DPR) and Average Retention Ratio (b).
2. To determine the growth rate in equity and Expected EPS of the scrips.
3. To calculate the intrinsic values of the select scrips.
4. To compare the intrinsic value with the prevailing market price of scrips.

Scope of the Study

This research examines 3 major company scrips from Information Technology sector: Tata Consultancy Services Limited, Infosys Limited, and Wipro Limited. The analytical period covers 8 years data from the year 2005 -12 which is primarily obtained from the respective company annual reports and Historical pricing data from Bombay Stock Exchange's Website.

Research Methodology

The study uses select corporate fundamentals to derive the intrinsic values of the sample scrips in the first place. Then it compares the in-

trinsic values with the annual average market prices prevailing in the year 2012 of the respective scrips to arrive at a decision whether the scrip is Overvalued or Undervalued or Appropriately Priced. Further, the study validates its findings/conclusions about the intrinsic values by comparing again with the average annual market prices prevailing in the year 2013 of the sample scrips. This lets us to know the relevancy of the applied methodology.

The fundamentals used include Dividend Per Share (DPS), Earnings Per Share (EPS), Dividend Payout Ratio (DPR), Dividend Growth Rate, Return On Equity (ROE), and Price to Earnings (P/E) Ratio.

Where, the aforementioned variables are defined / calculated as follows:

Dividend Payout Ratio (DPR) = (DPS/ EPS)

Average Retention Ratio = $b = (1 - \text{Average DPR})$

Average Return on Equity = $r = \text{Sum of ROE for 8years}/8$

Long term growth rate in equity (g) = (Average Retention Ratio x

Average Return on Equity) ÷ 100 = $\{(b*r)/100\}$

Price Earnings Ratio = Market Price Per Share (MPS)/ EPS

Forward EPS = {Earnings Per Share x (1+g)}

Intrinsic Value = (Forward EPS x Average PE ratio)

ANALYSIS

The following table summarizes the select and/or calculated corporate fundamentals of the sample scrips.

Table 1 Select Corporate Fundamentals during the Period 2005-12

Scrip Name	Avg. EPS	Avg. DPS	Avg. DPR	Avg. ROE (r)	Avg. Retention(b)	Growth(g)	(1+g)	Forward EPS
TCS	29.5	15.63	0.61	0.38	0.39	0.15	1.15	33.925
Infosys	88.82	22.39	0.25	0.29	0.75	0.22	1.22	108.36
Wipro	15.06	5.5	0.42	0.25	0.58	0.14	1.14	17.168

Source: Computed from Company Annual Reports

Further, Intrinsic Values of the select sample scrips are calculated by taking 8 years average P/E ratio and Forward EPS as follows

Table – 2 Intrinsic Values Vs Market Prices of Select IT Scrips during 2012 & 2013 Respectively

Scrip Name	Forward EPS	Avg. P/E	Intrinsic Value	Yearly Avg. MPS @2012	Conclusion	Yearly Avg. MPS @2013	Review of Conclusion
TCS	33.925	48.02	1629.08	1167.85	Undervalued.	2170.95	Appropriate
Infosys	108.36	34.27	3713.5	2864.95	Undervalued.	3485.5	Appropriate
Wipro	17.168	43.83	752.5	439	Undervalued.	559.05	Appropriate

Source: Computed from Company Annual Reports

From the sample IT scrips it has been observed that the all the IT companies are Undervalued as their intrinsic values are greater than their prevailing average market prices during the year 2012. Thus, Fundamental analysts usually suggest a BUY decision before they become fully priced.

Conclusion

Every investor will do investment with a motive to earn high return. Intrinsic value analysis supports to look at the scrip's performance and

then choosing the scrip. Especially the investment seeker can choose intrinsic value as a base for analyzing the scrip and with the above analysis it is clearly evident that all the scrips are undervalued when compared with their prevailing average annual market prices giving an indication that in the coming future the value of the scrips would appreciate. Furthermore, in sync with the conclusion, it is observed that the market prices of the select scrips have got increased by the year 2013. Therefore the research concludes that the applied methodology is in relevance.

Appendix

Corporate Fundamentals and Average Values of the Select IT Companies During the Period 2005-12

Company	Year	2005	2006	2007	2008	2009	2010	2011	2012	Average
TCS	ROE	0.56	0.49	0.47	0.40	0.05	0.38	0.37	0.35	0.38
	EPS	11.84	15.16	21.53	25.68	26.81	35.67	46.27	53.07	29.50
	DPS	11.50	13.50	13.00	14.00	14.00	20.00	14.00	25.00	15.63
	D/P	0.97	0.89	0.60	0.55	0.52	0.56	0.30	0.47	0.61
	P/E	105.44	105.70	54.16	37.18	21.20	20.06	23.68	16.75	48.02
Infosys	ROE	0.33	0.30	0.31	0.30	0.34	0.24	0.24	0.26	0.29
	EPS	33.78	44.79	64.23	81.30	113.36	103.27	116.96	152.86	88.82
	DPS	11.50	7.50	11.50	23.25	23.50	25.00	29.87	47.00	22.39
	D/P	0.34	0.17	0.18	0.29	0.21	0.24	0.26	0.31	0.25
	P/E	82.41	56.84	35.45	21.85	13.07	21.21	25.32	17.98	34.27
Wipro	ROE	0.28	0.26	0.29	0.25	0.26	0.23	0.22	0.20	0.25
	EPS	6.82	8.58	12.04	13.32	16.01	18.96	21.86	22.91	15.06
	DPS	5.00	5.00	6.00	6.00	4.00	6.00	6.00	6.00	5.50
	D/P	0.73	0.58	0.50	0.45	0.25	0.32	0.27	0.26	0.42
	P/E	116.89	62.60	45.04	36.51	21.10	29.36	21.62	17.49	43.83

Source: Company Annual Reports

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