

The Case of Two Values

Many Indian stocks have two intrinsic values. One is *things-will-continue-as-before* value. I will call this as the *going-concern value*. The other is *something-interesting-is-going-to-happen* value. I will call this the *catalyst value*.

The going-concern value is the value of the company if its assets are likely to be managed as they have been managed in the past. State Bank of India (SBI) is a good example. I often ask my students a trick question about SBI: What business is it in? As expected, they tell me that SBI is a bank. But, is SBI really a bank? Perhaps, it is. On the other hand, perhaps, it is not a bank at all. Perhaps, it is a real estate company which also does a side business - that of running the largest bank in India.

The huge branch network of SBI (it typically has at least one branch in the most valuable part of every large Indian city) is also one of the most valuable real estate portfolio in the country. If we were to value, at current prices, the real estate portfolio of SBI, we would find that, perhaps, it is far more valuable than the market value of its all its outstanding shares and debt. Does that make SBI a bank, or a real estate company?

Suppose, one was to do a branch-by-branch valuation of SBI. I would not be surprised to find that the market value of the land underneath several hundred of its branches turned out to be worth a lot more than the value of the banking business that these branches are doing. Does that mean that SBI will close these branches, sell them, and distribute the after-tax proceeds to its shareholders as tax-free dividends? Well, for all sorts of reasons, we know that the answer to that question is "no", at least for now.

What does that mean for the valuation of SBI? It means that so long as SBI continues to operate all its branches as going concerns, even though it may make economic sense from its shareholders' viewpoint to shut down and sell many of them, the market is correct to ignore much of the value of the real estate portfolio owned by it. In the stockmarket, SBI, then, can *either* be a bank *or* a real estate company but not *both*. It would, therefore, be correct to value SBI on the basis of its earning power of its banking business, but it would be incorrect to then add a large premium to that valuation because SBI owns valuable real estate.

Now suppose, one fine day, the Chairman of SBI, in an interview, announces that the bank will shut down many branches and sell them because this makes economic sense for its shareholders. Also, suppose that he also announces that the customers' (depositors as well as borrowers) accounts would transferred to other branches which are near those which are to be closed and sold. Moreover, the after-tax sale proceeds of these branches would be utilised, first to make a one-time very attractive redundancy payment to employees of these branches, and the balance to be returned to the shareholders by way of a large, special dividend.

On the date of this announcement, and for several days thereafter, the market value of the shares of SBI would rise dramatically. Why? Because, now the other value - *the catalyst value* - will dominate the *going-concern value*. The market would no longer assume that the assets of SBI will be managed as they have been managed in the past. Now, the probability that "*something-interesting-is-going-to-happen*" to this company will rise significantly warranting an increase in the valuation of SBI's shares. The market would now view SBI, more like a real estate company which is also a bank, rather than the other way round.

What applies to this SBI example, also applies to hundreds of other Indian companies. These companies are not managing their assets in an optimal way. So long as these assets are likely to be managed on a going-concern basis, they would be valued by the market as such. But the moment the prospect of their being managed in a different, and better, way increases, the market value of these companies would also move away from going-concern valuation towards catalyst valuation. (If Great Eastern Shipping were to sell half its fleet of ships, even

at today's distress prices, and distribute the after-tax proceeds to its shareholders, its stock could easily double before the dividend payment).

What are the events which could result in the company to shift from going concern value to catalyst value? In other words, what can happen that could unlock the value hidden inside a company? These catalysts could be acquisitions, demergers, spinoffs, liquidations, open-endings (in case of mutual funds) or even the simple act of the promoter reducing or increasing its stake in the firm.

Perhaps, a few examples would help. A few months before Narmada Cement got acquired by L&T, its stock price was languishing at Rs 7-10 per share. This stock price was justified on the grounds of poor operating results produced by the company. However, when L&T announced its decision to acquire the company at Rs 34 per share, the stockmarket was forced to shift the valuation it accorded to Narmada Cement from going concern value basis to catalyst value basis.

In this example, the value hidden inside the firm was unlocked due to the company being acquired. Sometimes, the catalyst that unlocks the value is a demerger or a spinoff. One outstanding example is that of Aptech Computer Education. The stock, which today sells in the range of Rs 920 to Rs 1,000 has come out of a stock, belonging to Apple Finance, which today sells at Rs 10. There are plenty of other Indian examples including Stephan Chemicals (renamed as Hind Lever Chemicals) spun off from Hindustan Lever, and Clariant spun off from Sandoz.

Sometimes, the catalyst event that forces the market to re-value a stock is a change in the shareholding pattern. You are probably well aware of what happens to the stock of an Indian company which has an MNC as a co-promoter and the MNC announces its intention to hike its stake in the company. The stock price tends to zoom up around the announcement date. When the controlling stake is with the Indian co-promoter, the market tends to assume, perhaps correctly, that the assets of the firm will be managed in an inferior way than when the controlling stake shifts to the MNC.

I have a similar observation about the valuation of many PSU stocks in which the government holds more than eighty percent stake. Due to its own financial problems, the Indian government will be forced to sell its stake in many such companies in the years to come. As the stake of the government falls from above eighty percent to 51%, or less, the valuation accorded by the market is likely to change from going concern value to catalyst value. If, as the government recently announced, many PSU holdings are disposed off as strategic sales made to foreign and Indian companies, a similar effect can be expected. The shares of a company in which the government owns only forty percent are worth more than the shares of the same company in which the government holds an eighty percent stake. Keep a watch on PSU stocks which are sold off by the government in the years to come.

In all the above examples, the catalyst value of the company turned out to be more than the going concern value. This is not always the case. Sometimes, the company gets acquired at a price which is substantially below its market value prior to the acquisition. Two examples are that of ITC Classic Finance and Anagram Finance, both of which got acquired by ICICI. In both cases, the shareholders received shares in ICICI which were worth significantly less than the total market value of the shares they held prior to the acquisitions.

Corporate transaction such as mergers, acquisitions, demergers etc. get done after companies and their businesses have been valued by experts who are provided access to information which the market may not have. That is why the catalyst value usually turns out to be a more accurate reflection of the business being valued than the market value of that business prior to the catalyst event.

I find a study of these catalyst events, as well the opportunities they produce, an interesting aspect of the discipline of security analysis.

Note

Sanjay Bakshi is Managing Director, Corporate Investment Research Private Limited. He can be contacted at sanj@vsnl.com.

© Sanjay Bakshi. 1999.