



Is This a Time to Look at PSU Stocks?

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Most investors ignore us. No one wants to touch us. The hate is real.

Many investors often say “I do not buy PSUs, I do not look at PSUs,”

What do investors want from us?

We are available at cheap valuations. Dividend yield of some companies will even beat G-Sec yields. Not to mention, the financial performance of selected PSUs is steady and improving.

Just look at top ten companies by revenue. You will find 6 out of 10 companies from the PSU space.

Top ten companies by net profit? Well, 4 out of 10 companies are PSUs.

*Top ten companies by market cap? **Zero.***

Well, there you go.

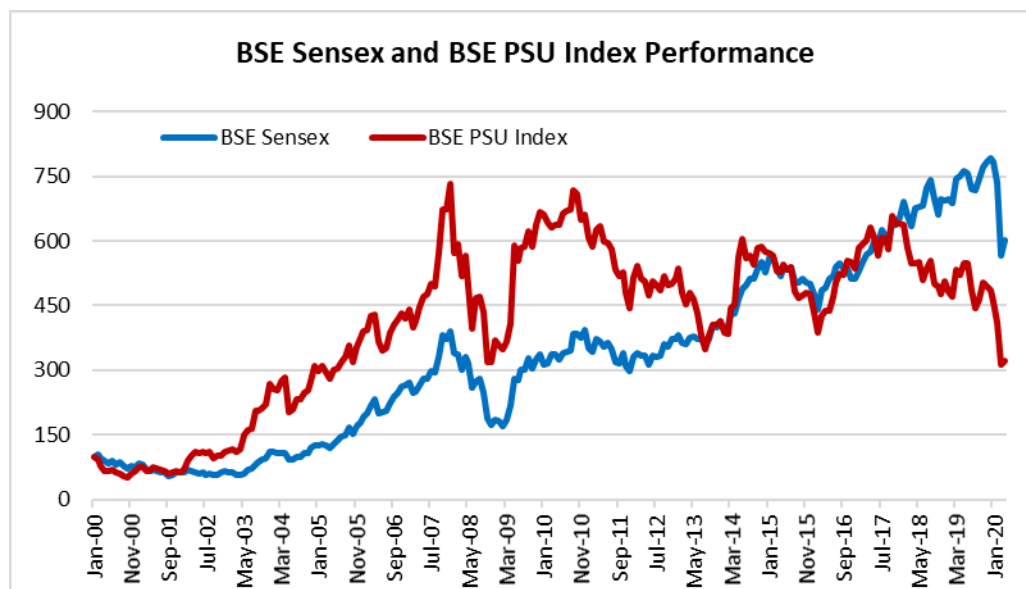
That's a bunch of PSUs (public sector undertaking) complaining about unfair treatment in my dream.

Yes, I do see some weird dreams and this is one of them.

PSU stock, in general, have negativity surrounded.

Just look at the PSU index performance compared to the market index.

BSE PSU Index Underperforms Broader Market Index



Data Source: BSE

Over the last 20 years, the BSE PSU index has given returns at a CAGR of 5.9% compared to the BSE Sensex performance of 9.3% CAGR during the same period.

Interestingly, both had similar performance up to Dec 2017.

The sharp decline post-2017 could be attributed to a sharp decline in the stock prices of public sector banks.

In the BSE PSU index, the banking sector has the highest weightage and If we look at the Nifty PSU Bank index performance from Dec 2017 till date, it has declined by 66%.

There are plenty of other reasons as well for this underperformance and many of them are valid.

PSU stocks are at the mercy of the government. Not all PSU business decisions are taken with profitability and a reasonable return on capital in mind.

Excessive government interference by way of frequent demands for dividends and buybacks, forced mergers and inter-company deals impact overall performance.

Similarly, after liberalization, competition has increased, erasing monopoly status of some of the companies. With inefficiency and constraints, they are unable to compete with private sector enterprises. Several PSU banks, telecom companies such as MTNL, BSNL come in this category.

Not to mention, frequent disinvestment by the government is another factor for poor performance.

Recently, the government has chosen to disinvest through ETFs instead of paring individual company stake. Under the ETF route, a pre-decided mix of PSU stocks is offered at a discount. This structure incentivises arbitrage and short-sellers invest in ETFs and exit after the ETF is listed. This creates selling pressure and results in a decline in the share price.

With these constraints, does it even make sense to look at PSU Stocks? Not to mention, we are facing one of the biggest economic challenges related to covid-19 in the coming months.

To answer this question, it is important to look at the source of underperformance.

Is it really because of inefficiency, incompetence, and poor capital allocation leading to a decline in market share and overall business underperformance?

Or is it because of some other reason, such as “PSU tag” or disinvestment (increasing share supply) or any other reason?

Bifurcating PSU stocks in these two baskets could lead to filtering out the real underperformers in terms of poor financials, weak competitive position, inefficient operations etc.

I have filtered out good businesses from the PSU index using ROE (return on equity) as a filter. I have taken average ROE (last 5 years) of 14% as a starting point and have also included earnings growth of the last 5 years, current P/E and dividend yield.

Please note that I have excluded public sector banks from this list. Except for one major bank, all other PSBs are currently in a mess and losing market share to private banks and could be bifurcated as underperformers.

Is This a Time to Look at These PSUs Again?

Company Name	Earnings Growth (%) (Last 5 years)	ROE*(%) (Avg of last 5 years)	PE (x)	Dividend Yield (%)
Bharat Electronics Ltd.	14.3	17.4	12.1	3.6
Bharat Petroleum Corporation Ltd.	15.7	25.9	10	4.8
Coal India Ltd.	6.9	41.8	8.4	5.5
Cochin Shipyard Ltd.	15.2	15.7	10.8	3.3
Hindustan Aeronautics Ltd.	8.0	18.2	10.5	2.8
Hindustan Petroleum Corporation Ltd.	45.4	22.6	6.5	5.6
Indian Oil Corporation Ltd.	39.1	15.5	8.6	5.7
NMDC Ltd.	-1.5	14.8	6.9	5.3
Power Grid Corporation of India Ltd.	18.7	17.3	10.3	4.2
Rites Ltd.	12.3	19	11	4.9

Source: ACE Equity

What remains is decent PSU businesses. Businesses which have a strong balance sheet, have entry barriers and have a reasonable amount of certainty and predictability of growth because of the strong order book or nature of the business.

Don't forget, some of the businesses have monopoly characteristics in the sectors they operate in.

That's good, but what about the margin of safety?

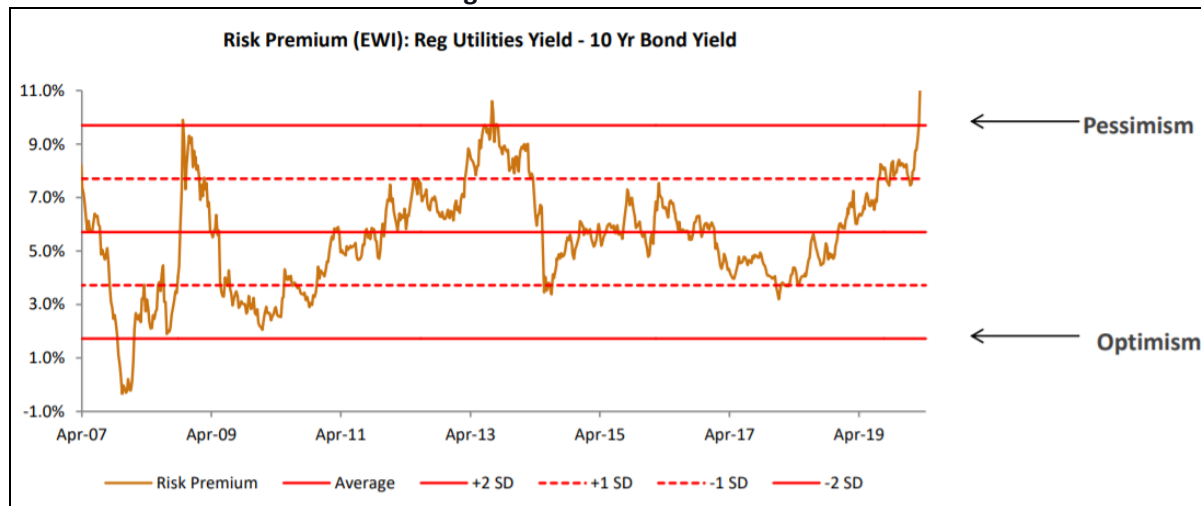
Well, the valuations are at historical lows and many of them are available at single-digit P/Es. With the recent corporate tax cut, it will straight to go their bottom line and further reduce the P/E ratio.

Not to forget, with the correction in the stock price, the dividend yields are attractive.

And, strategic disinvestment of few selected PSUs could be the real cherry is on the cake.

The below chart shows RU (regulated utilities) index has spiked beyond +2SD. This time, it even breached 2013 levels, suggesting extreme pessimism.

RU Risk Premium Pessimism at the Highest Level



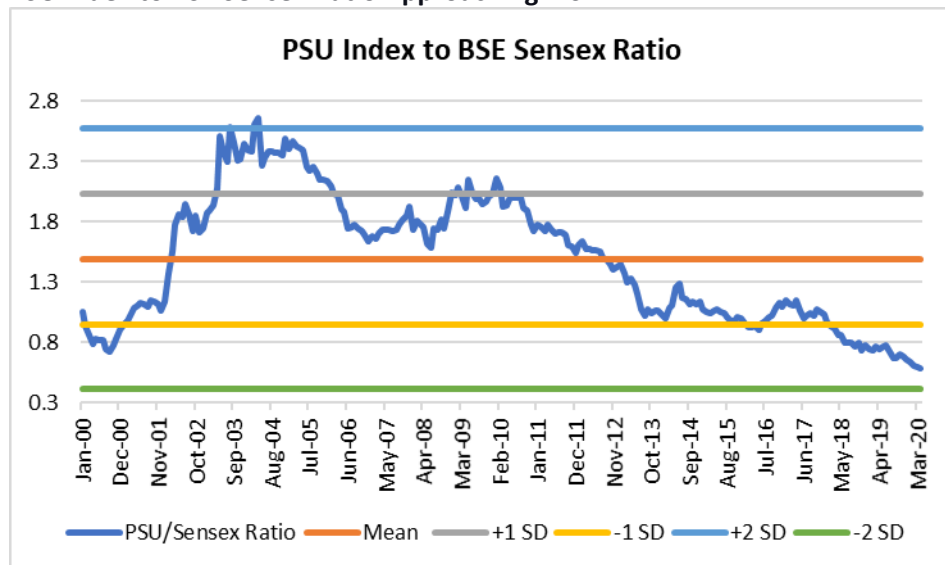
Source: Multi-Act Macro and Market indicator Report- April 2020

Regulated utilities Risk premium is the difference between the IRR based earnings yield of 5 companies and the 10 Year GOI bond yield. This measure tries to capture the risk premium that market participants are associating with these regulated entities which have relatively stable businesses. Thus, it highlights the optimism/ pessimism amongst market participants.

Here's another interesting chart.

If I take PSU Index to BSE Sensex ratio, this ratio is approaching towards -2 SD. It is currently at the lowest levels in the last 20 years.

PSU Index to BSE Sensex Ratio Approaching -2SD



Data Source: BSE

A Strong Case of Mean Reversion?

May be or maybe not...

But a rational investor should keep his eyes and mind open for exploring investment opportunities where the margin of safety is visible.

Ultimately, the famous quote from the Oracle of Omaha applies here... *"be greedy when others are fearful"*

Happy Investing!

Statutory Details: Multi-Act Equity Consultancy Private Limited
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