When it comes to building robust long-term portfolios, investment selection becomes key. Integral to the selection process is assessing the competitive advantage of the company to create sustainable and long-term value and investing in these companies at valuations that offer a reasonable discount to their intrinsic value. Generally, when it comes to valuing a company, the most commonly used metric is the Price to Earnings (P/E) ratio. However, despite its universal adoption, the P/E ratio is not always the most appropriate valuation metric for all companies. This is especially true for cyclical businesses that go through multiple ebbs and flows.

Using the P/E ratio for cyclical businesses would not be apt as it can lead to sub-optimal investment decisions. For example, in the case of cyclicals, at troughs, the P/E ratio could be optically high due to the prevailing market environment, thereby making the stock look expensive. However, the future earnings potential could be high, which would not reflect in the current P/E ratio. Hence, the investor might miss out on an excellent investment opportunity.

The valuation methodology adopted should ideally capture the unique contours of the company under consideration. Let's break this down into a clear decision tree.

The first question to ask: Does the company have a competitive advantage?

A competitive advantage is something that creates a moat around the business, thereby making it sustainable and providing it longevity.

Yes – the company has a competitive advantage.

When one believes any company has a sustainable competitive advantage (moat), these companies could be valued based on their earnings. In such situations, we could value the company based on its historical average P/E ratios.

The P/E ratio, in very simple terms, communicates the number of years a company would take to earn returns that are equivalent to its current value (price). For example, a stock trading at Rs. 100 with an EPS of Rs. 10 would take 10 years to return the current price of the stock (ignoring earnings growth and the time value of money). The P/E ratio is also generally a shortcut to valuing a company using Discounted Cash Flows (DCF). While replacing DCF-based valuations with the P/E ratio, the implicit assumption is that the company converts its profits into cash flows. Since we believe that very few companies (only those with sustainable competitive advantage) have the ability to generate sustained cash flows, the P/E ratio should be used for valuing only those companies.

No – the company does not have a competitive advantage.

When a business does not have a competitive edge, then a company can be valued using the Balance Sheet approach. Generally, there are two approaches that can be used from a valuation perspective:

i) Replacement Cost of Assets (RCA) method: This is highly relevant for asset-heavy companies that derive substantial value from the assets on their books. It simply entails assessing the cost to replace an existing asset with a similar asset at the current market price. For example, this can be applied to cement companies.

ii) Adjusted Book Value (ABV) method: Valuing a business based on its book value. For example, this can be applied to banks and other businesses that rely on their balance sheet/capital to generate returns.

In summary, companies with a competitive advantage can be valued using the Income Statement Approach, which includes P/E valuation and DCF methods, while those without any competitive advantage can be valued using the Balance Sheet Approach, which involves the RCA method and the Adjusted Book Value method. Using the right valuation technique is an unbiased way to determine whether a stock is overvalued or not to make the most optimal investment decisions.

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