Edelweiss Value Scanner

Adding value to investments

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Edelweiss
Ideas create, values protect

Shaurya Chandra
+91 22 4009 4512
shaurya.chandra@edelcap.com

Edelweiss Securities Limited

Introduction

At the onset of every quarter, companies start lining up with their results that investors are keen to watch out for. Results are keys, providing vital insights about the future growth prospects of the company. At times investors face an arduous task of interpreting these numbers and occasionally end up holding the wrong end of the sword. With a view to help the investors make sense out of these vital numbers and further ease their evaluation process, an attempt has been made to integrate the power of mathematics and fundamental analysis. As an initiative to deliver a premium blend of fundamental and technical outlook on financial analysis, these screens have been offered.

Edelweiss Value Scanner (EVS) enables one to search through an array of potential stocks using different criteria suiting one's investment needs. Some investors prefer value stocks, while some have an inclination for growth stocks. Taking into consideration these aspects, EVS assists the investors to sort out stocks based on their customized investment preference.

Price to book value versus ROE: This screen follows value investment philosophy. Comparing P/B and ROE helps in identifying companies that trade below what we think as intrinsic P/B value, given a specific ROE. The screen would help an investor who is looking at the book value and ROE as important criteria to determine soundness of the company. Our underlying assumption here is that within an industry, firms tend to become more like each other or they go out of existence.

Double- barrel growth play: Consistent growth in sales and earning form the pillar of this screen. Moreover, this screen chooses companies that trade at a healthy multiple compared with their peers and have further scope for appreciation.

Price momentum and value: This screen filters those stocks, which are performing robustly and improving their earning performance, but are still cheaper to counterparts. Here, we have developed two different baskets of stocks based on two different valuation perspectives, viz P/BV and P/E ratio.

Price earnings multiple: The *Relative PE ratio approach* looks back at the relationship of the PE ratio of the stock to the PE ratio of the sector. Changes in the relative price-earning ratio over a period of time may signal that the market is changing its expectations about the future earnings of a firm, or the change could be because of mere oversight of the earning potential and continued mis-pricing. We assume that long term growth and risk profile for the company remain same.

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Price to Book versus ROE

Introduction

A company's price to book value (P/B) is one of the most easily accessible measures of valuing the assets of a firm. The higher the P/B, the more favorable the market views the company and its ability to generate returns using these assets.

This screen has been designed to compare the P/B to Return on Equity (ROE)[1] . The purpose of such a comparison is to identify companies which trade below what we think should be the intrinsic P/B value given their specific ROE's.

Model description

This screen compares a company to its peers in the same sector.

Theoretically, P/B is a function of return on equity (ROE), G and R;

R is the risk adjusted discount rate and

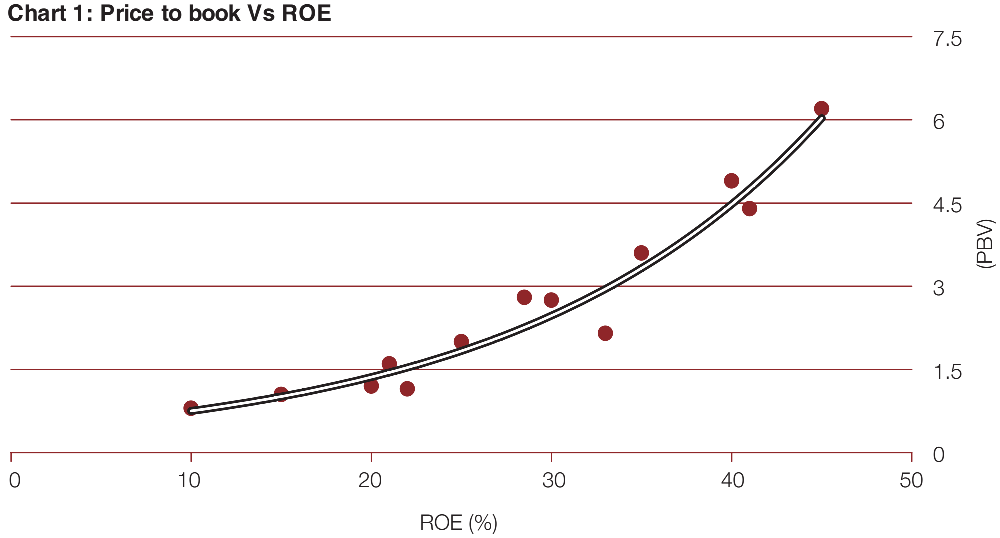
G is long-term growth rate.

The plot of P/B- ROE should be an exponential function for a company which will achieve a state of no excess returns in x years[2] .For a higher ROE one will pay an exponentially higher P/B justified by a higher rate of return.

Each company will have its own independent equation. We have made some assumptions (described later) in order to have a single equation for all the companies in a particular sector.

A sector on the whole may be valued efficently; there may still be anomalies at an individual company level. For a sector, the relationship between P/B and RoE can be caluculated using the actual P/B as a dependent and RoE as an independent variable. The equation[3] that we derive is a best-fit equation, the "derived P/B"- as calculated from the best-fit equation for each stock in that sector is compared it to its actual P/B.

Chart 1: Price to book Vs ROE



Source: Edelweiss research

[1] *Return on equity encompasses the three main "levers" by which management can poke and prod the corporation—profitability, asset management, and financial leverage.*

[2] *What this means is assuming that a company will reach a state of no excess returns x years from now, present P/B and present ROE are exponentially related*

[3] *For the equation, P/B is the dependent and ROE is the independent variable.*

If the derived value is greater than actual value, it implies that under these conditions holding true the stock is undervalued and vice versa.

As can be seen in the chart 1, anything lying above the curve is overvalued and below it is undervalued. For our screen, we pick stocks which are undervalued; the ratio of actual P/B to derived P/B is less than 1 for these stocks.

Assumptions

External economic factors affect different firms in the same industry in similar ways; within an industry firms tend to become more like each other over time, or they go out of existence. For this screen we have made the following assumptions:-

- The Risk adjusted discount rate R has been assumed to be a constant for the sector, this has been done for the sake of long term comparison, and we realize that varying capital structures and risk perceptions would impact the results.
- The second assumption is that in the longer term all companies that survive will reach the stage of *"no excess returns over cost of equity"*. Firms have advantages which are more temporary in nature, new ideas or innovations that distinguish them from others but the forces of competition and the ability of like minded managements to imitate and drive out the temporary advantage.

For our screen, we omit P/B and ROE values which are less than half or greater than twice their sector median values. This is to make our predicted equations more robust and accurate and to eliminate the effect of outliers on our model.

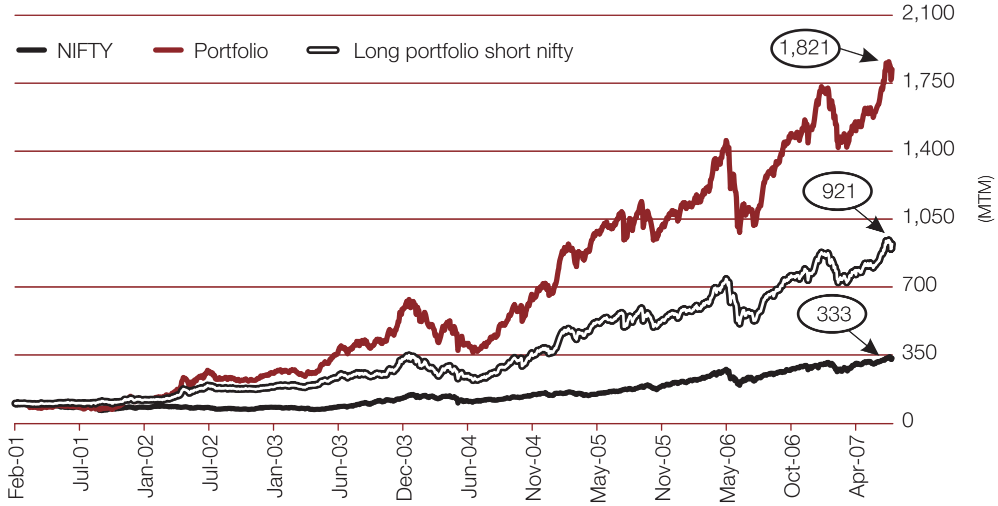
Screening criteria

- Companies in the following sectors are included: Auto & Auto Ancillary, Banking & Finance, Chemicals, Engineering & Capital Goods, IT, Oil & Gas, Pharma Indian, Metals & Mining, Textiles & Apparals, FMCG and Cement & Construction
- Only those companies for which Price to book and ROE more than half and less than two and half times their sector median values is included
- The YoY ROE growth as well as the QoQ ROE growth are positive
- Companies are ranked on basis of ratio of "derived PB" to actual PB multiple with the most undervalued getting the highest rank. The top 30 percent of the universe are included.

Historical performance

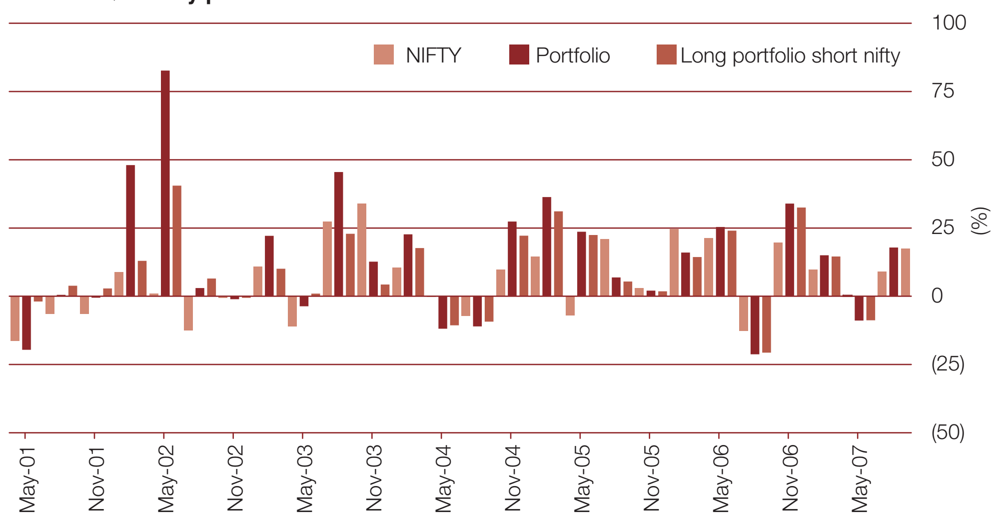
The graph below depicts the historical performance of the stocks based on our selection criteria for the screen. On an average, there are 15 companies in a quarter which meet these crtieria.

Chart 2: Performance (Feb'01 - Jul'07)



Source: Edelweiss research

Chart 3: Quarterly performance



Source: Edelweiss research

Table 1: Consolidated performance*

	Long portfolio	Long portfolio short Nifty	Nifty
Feb' 01-Jul'07			
CAGR (%)	56	41	20
Standard Deviation (%)	36	24	23
For last 3 years			
CAGR (%)	64	57	40
Standard Deviation (%)	36	33	24
Quarterly			
Average (%)	14	10	6
Best (%)	83	41	34
Worst (%)	(21)	(21)	(16)
Standard Deviation (%)	23	15	14
Monthly			
Average (%)	4	3	2
Best (%)	52	31	15
Worst (%)	(23)	(13)	(18)
Standard Deviation (%)	12	8	7

Source: Edelweiss research

* *Quarterly and monthly statistics are for the entire back-tested period and not just for the last three years.*

Companies for the current quarter (1st Aug '07 - 31st Oct '07)

Alembic Ltd.
Allahabad Bank
Alok Industries Ltd.
Amara Raja Batteries Ltd.
Apollo Tyres Ltd.
Aztecsoft Ltd.
Bank Of Baroda
Ceat Ltd.
Chennai Petroleum Corp Ltd.
Corporation Bank
Dabur Pharma Ltd.
Dalmia Cement (Bharat) Ltd.
Elgi Equipments Ltd.
Engineers India Ltd.
Esab India Ltd.
F C I Oen Connectors Ltd.
Graphite India Ltd.
India Glycols Ltd.
J S W Steel Ltd.
Jindal Stainless Ltd.
M R F Ltd.
Monnet Ispat & Energy Ltd.
Orchid Chemicals & Pharmaceuticals Ltd.
Patni Computer Systems Ltd.
Ruchi Soya Inds. Ltd.
South Indian Bank Ltd.
Tube Investments Of India Ltd.
Uco Bank
V S T Industries Ltd.
Vijaya Bank
Wheels India Ltd.

Performance for the last quarter = 17.9%; Nifty returns = 9.1%

Double-barrel Growth Play

Introduction

This screen has been designed to highlight stocks which have displayed a consistent growth in earnings and sales, taking into consideration their current valuations.

This screen helps to reveal a collection of companies exhibiting strong earnings and sales growth, and safe price-earnings ratios relative to the sector. This screen follows the Martin Zweig approach for picking up stocks to a large extent. Martin Zweig was named stock picker of the year two years running in the 1990s by the Hulbert Financial Digest and is chairman of the Zweig Funds, leans toward the growth methodology.

Model description

As the name suggests this screen uses a model which tries for identify stocks that satisfy the twin criteria of sales as well as earnings growth

Earnings

This screen begins its search by examining the quarterly earnings to find stocks with positive growth (YoY) in earnings and same-quarter growth in earnings going back several quarters. Besides this, the screen also tries to examine the set for stocks exhibiting persistence and momentum in earnings.

Earnings persistence

The screen also looks for companies with persistent, rising earnings on an annual basis[1] . The screen prefers stocks that exhibit "strong" longer-term growth rates.

Earnings momentum

The next parameter under earnings is increasing momentum in earnings growth, both over the short term and longer term. We compare the growth rate in earnings between the last quarter and the same quarter last year, to the growth in earnings between the sum total of the prior three quarters and the same three quarters one year ago.

Sales

On the sales front, the screen filters companies that have positive YOY growth in sales and positive growth in same-quarter sales, we also screen for companies that are able to increase this same-quarter growth rate in sales. To capture this element, our screen compares the same-quarter (YOY) growth rate in sales for the most recent quarter to the same-quarter growth rate (YOY) in sales for the previous quarter. Those companies that have been able to increase this growth rate pass this criterion.

While the above are the earnings and sales parameters, the screen checks for their valuations using the PE's.

Price-earnings ratio

The other key element of this stock selection is the price-earnings ratio. This filter has been added to weed out the financially troubled firms and at the same time find out companies which have scope for P/E expansion.

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[1] *Here, our screen requires that a company's earnings for the last four quarters (trailing 12 months) be greater than or equal to the earnings for same quarters last year as well as requiring year-to-year increases in earnings for last year also*

The screen invests in only companies with a multiple higher than or equal to the median price-earnings multiple for its sector (to avoid potentially troubled firms) and less than 1.5 times the same. Thus one invests in companies that trade at a healthy multiple compared to its peers and also have a scope for further appreciation.

Screeing criteria

Going back in time →

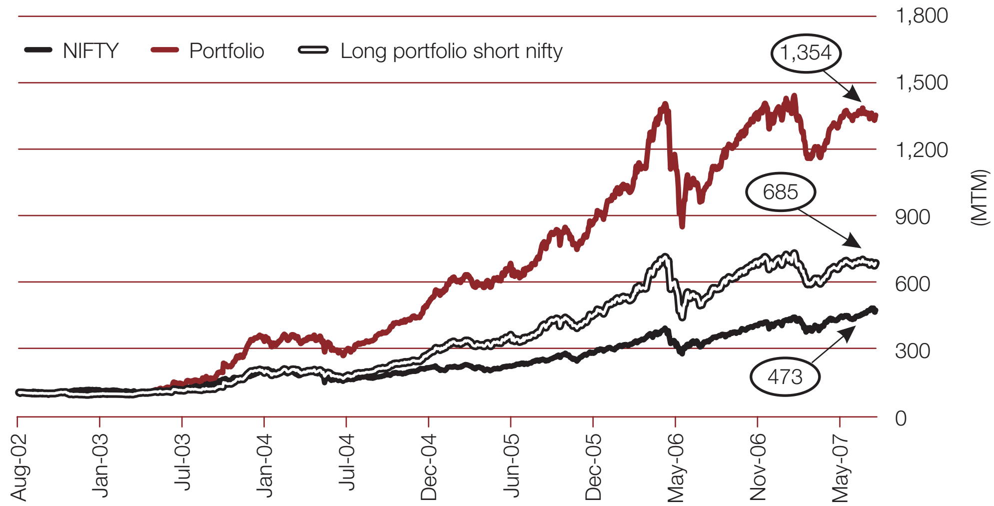
Y1				Y2			
Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8

- Same-quarter growth in earnings before extraordinary items between the last quarter (Q1) and the same quarter last year (Q5) is positive
- Same-quarter growth in earnings before extraordinary items between the quarter one quarter ago (Q2) and the same quarter last year (Q6) is positive
- Same-quarter growth in earnings before extraordinary items between the quarter two quarters ago (Q3) and the same quarter last year (Q7) is positive
- Same-quarter growth in earnings before extraordinary items between the quarter three quarters ago (Q4) and the same quarter last year (Q8) is positive
- Same-quarter growth in sales between the last quarter (Q1) and the same quarter last year (Q5) is positive
- Same-quarter growth in sales between the last quarter (Q1) and the same quarter last year (Q5) is greater than the same-quarter growth in sales between the quarter one quarter ago (Q2) and the same quarter last year (Q6)
- The current (12m) earnings before extraordinary items is greater than or equal to the earnings before extraordinary items for the last year (Y1)
- The earnings before extraordinary items for the last year (Y1) is greater than the earnings before extraordinary items from two years ago (Y2)
- Same-quarter growth in earnings before extraordinary items between the last quarter (Q1) and the same quarter last year (Q5) is greater than the growth rate in earnings before extraordinary items between the sum total of the prior three quarters (Qs 2-4) and the same three quarters one year ago (Qs 6-8) OR the same-quarter growth in earnings before extraordinary items between the last quarter (Q1) and the same quarter last year (Q5) is greater than or equal to 30%
- The price-earnings ratio is greater than the median price-earnings ratio for the corresponding sector and is less than 1.5 times the median price earnings ratio for that sector

Historical performance

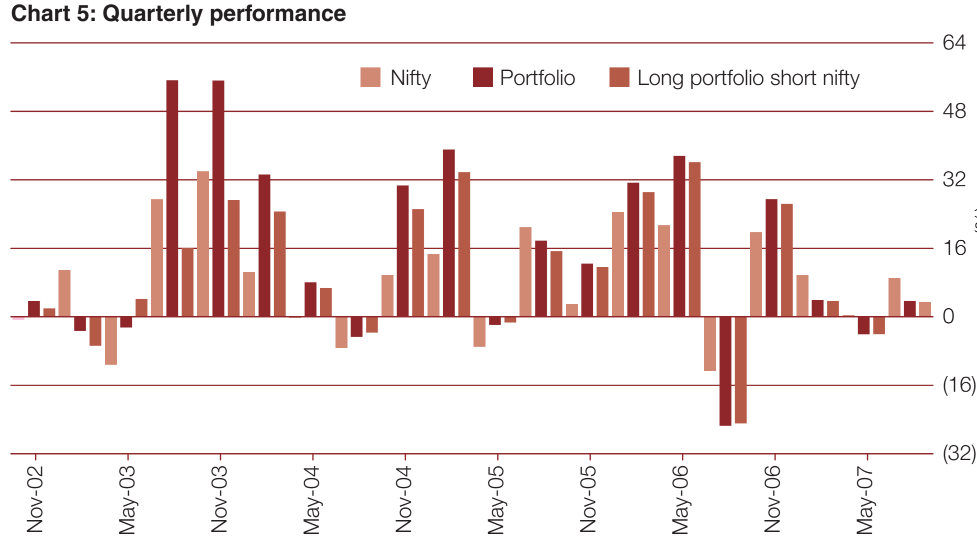
The graph below depicts the historical performance of the stocks based on our selection criteria for the screen. On an average, there are 7 companies in a quarter which meet these crtieria.

Chart 4: Performance (Aug'02 - Jul'07)



Source: Edelweiss research

Chart 5: Quarterly performance



Source: Edelweiss research

Table 2: Consolidated performance*

	Long portfolio	Long portfolio short Nifty	Nifty
Aug' 02-Jul'07			
CAGR (%)	68	47	36
Standard Deviation (%)	29	23	23
For last 3 years			
CAGR (%)	61	54	40
Standard Deviation (%)	39	36	24
Quarterly			
Average (%)	16	11	6
Best (%)	55	36	34
Worst (%)	(25)	(25)	(16)
Standard Deviation (%)	22	16	14
Monthly			
Average (%)	5	4	2
Best (%)	29	25	15
Worst (%)	(20)	(19)	(18)
Standard Deviation (%)	10	8	7

Source: Edelweiss research

* *Quarterly and monthly statistics are for the entire back-tested period and not just for the last three years.*

Companies for the current quarter (1st Aug ‘07 - 31st Oct ‘07)

Reliance Capital Ltd.

Sintex Industries Ltd.

Performance for the last quarter = 3.7%; Nifty returns = 9.1%

Price Momentum and Value

Introduction

This screen looks for stocks which have witnessed a robust price performance, bettered their earnings performance QoQ and are cheaper than their counterparts.

The two screens together is a basket of stocks which have shown price appreciation and have accelerating growth in earnings. With an improved earnings growth, there is a strong probability that the bullish sentiment will continue.

Model description

As the name suggests this screen uses a model which tries for identify stocks that satisfy the price momentum and valuation criteria.

Price momentum

This criterion helps to identify stocks that have already shown an upward price movement. The weighted relative strength ranking was the primary price momentum indicator used in the study.

The weighting required that the most recent quarterly price change be given a weight of 40% and the previous three quarters each weighted 20%. The weighted price changes are ranked and for the screen, a percentile rank of above 70 is defined as cut-off.

A requirement for momentum, minimum fundamentals

The earnings measure used is to compare a quarter to the same quarter last year—i.e., in our screen, earnings before extraordinary items for the most recent two quarters are required to be positive and above their corresponding quarters last year. To emphasize momentum or acceleration in quarterly earnings, the next criterion specifies that the YOY growth for the most recent quarter be greater than the YOY growth for the previous quarter.

A look at valuations

The low price-to-book screen is very good at identifying neglected firms; this screen specifies a price-to-book ratio to be less than 2.5 and more than 0.5.

The other way of identifying cheaper end of the universe is comparing price-earnings multiple for the stock to the median price-earnings multiple for that sector and pick up stocks which have price-earnings ratio less than the median price-earnings multiple.

So amongst the basket satisfying price momentum and accelerating earnings criteria, this screen picks stocks that come at reasonable multiples.

Screening criteria

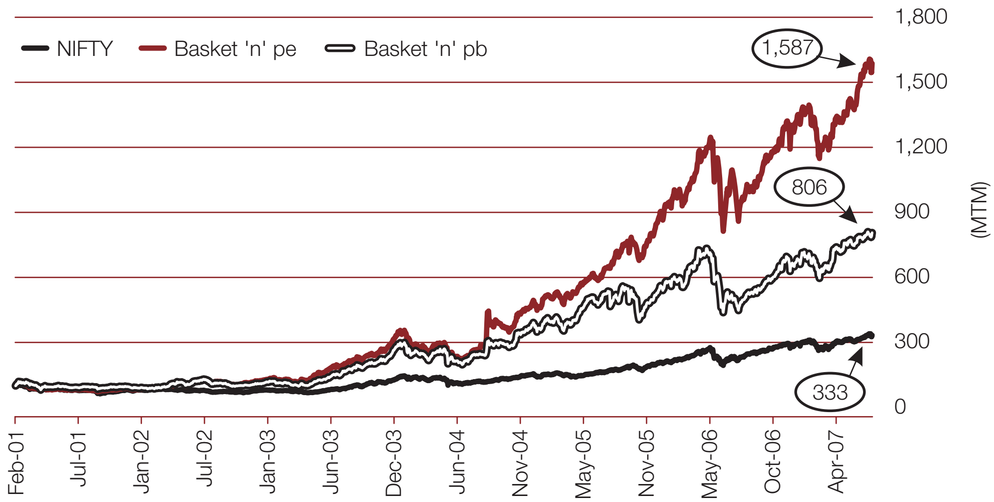
- Earnings before extraordinary items for each of the last two fiscal quarters (Q1 and Q2) are greater than the earnings before extraordinary items for the same quarter one year prior (Q5 and Q6)
- Same-quarter growth in earnings before extraordinary items from Q5 to Q1 is greater than the same-quarter growth in earnings before extraordinary items from Q6 to Q2
- The weighted relative strength for the last four quarters ranks in the top 70% of the entire database (Percent rank greater than or equal to 70)
- The price-to-book ratio is less than 2.5 and greater than 0.5
- The price-earnings ratio is less than the median price earnings ratio for that sector.

"Basket 'n' PB" refers to companies which have a price to book ratio greater than 0.5 and less than 2.5 and satisfy the first 3 criteria. "Basket 'n' PE" are the companies which have a price earnings multiple less than the median price earnings ratio for their sectors and satisfy the first 3 criteria.

Historical performance

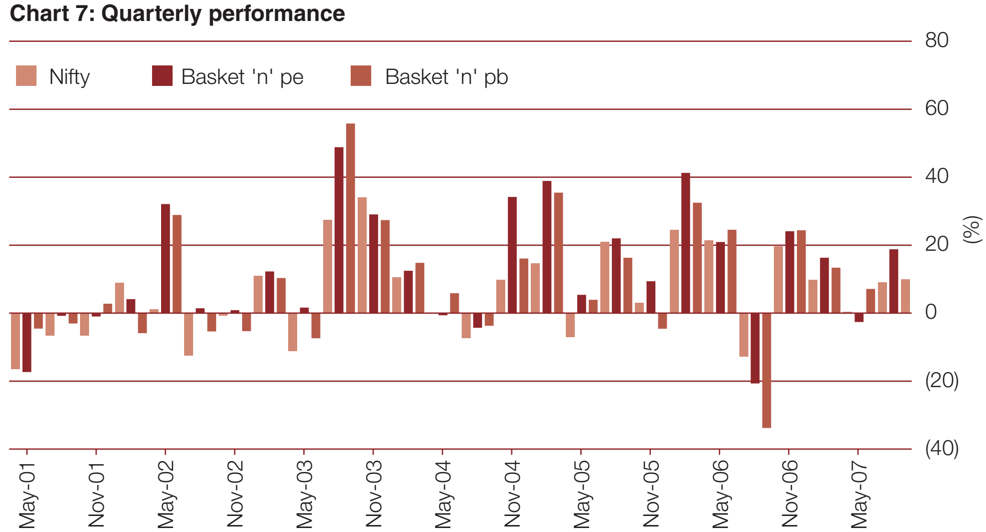
The graph below depicts the historical performance of the stocks based on our selection criteria for the screen. On an average, there are 9 companies in a quarter which meet the basket 'n' PB crtieria and 10 companies in a quarter which meet the basket 'n' PE criteria.

Chart 6: Performance (Feb'01 - Jul'07)



Source: Edelweiss research

Chart 7: Quarterly performance



Source: Edelweiss research

Table 3: Consolidated performance*

	Basket 'n' pb	Basket 'n' pe	Nifty
Feb' 01-Jul'07			
CAGR(%)	38	53	20
Standard Deviation(%)	29	28	23
For last 3 years			
CAGR(%)	49	81	40
Standard Deviation(%)	37	36	24
Quarterly		0	
Average(%)	10	13	6
Best (%)	56	49	34
Worst(%)	(34)	(21)	(16)
Standard Deviation(%)	18	18	14
Monthly		0	
Average(%)	3	4	2
Best (%)	26	66	15
Worst(%)	(22)	(21)	(18)
Standard Deviation(%)	10	12	7

Source: Edelweiss research

* *Quarterly and monthly statistics are for the entire back-tested period and not just for the last three years.*

Companies for the current quarter (1st Aug '07 - 31st Oct '07)

basket 'n' PB

Amara Raja Batteries Ltd.
Bank of India
Deccan Chronicle Holding Ltd.

Performance for the last quarter = 9.9%; Nifty returns = 9.1%

basket 'n' PE

Amara Raja Batteries Ltd.
Bank of India
Deccan Chronicle Holding Ltd.
Exide Industries Ltd.
Performance for the last quarter = 18.8%; Nifty returns = 9.1%

Price Earnings Multiple

Introduction

The price-earnings ratio or earnings multiple, is one of the most popular measures of valuing companies. It is followed so closely because it relates the market's expectation of future company performance, embedded in the price component of the equation, to the company's actual recent earnings performance. This however, does not mean that all stocks with low price-earnings ratios have little or no growth prospects; there are companies with low price-earnings ratios due to neglect or overreaction.

Model description

The relative price-earnings ratio approach looks back at the relationship of the price-earnings ratio of a stock to the price-earnings ratio of the sector.

The relative price-earnings are determined by dividing a company's price-earnings ratio by that of the sector[1]. Based on relative growth and risk expectations, companies trade at multiples greater or smaller than that of the industry multiple.

Changes in the relative levels of the price-earnings ratio over a period of time may signal that the market is changing its expectations about the future earnings potential of a firm, or the change could be because of mere oversight of the earnings potential and continued mispricing.

Estimating Stock Value using the Relative P/E Model

Calculating the relative price-earnings

Market Data Price-Earnings Ratio Company Data: BHEL

Table 4: Calculating relative PE

BHEL	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
High PE (company)	10.8	11.3	12.9	12.3	12.9	14.7
Low PE (company)	7.2	9.3	9.8	10.7	10.1	11.4
High PE (sector) – median	6.6	7.5	8.3	7.7	8.1	9.1
Low PE (sector) – median	8.3	9.3	10.7	11.7	12.2	13.1
Relative High PE	1.6	1.5	1.6	1.6	1.6	1.6
Relative Low PE	0.9	1.0	0.9	0.9	0.8	0.9

BHEL	Dec-05	Mar-06	Jun-06	Sep-06	Dec-07	Mar-07
High PE (company)	18.9	21.6	17.4	16.9	17.0	14.7
Low PE (company)	11.8	16.2	11.6	14.3	13.8	11.2
High PE (sector) – median	9.0	8.7	9.7	9.0	13.2	14.3
Low PE (sector) – median	14.6	16.0	11.3	14.2	14.9	14.3
Relative High PE	2.1	2.5	1.8	1.9	1.3	1.0
Relative Low PE	0.8	1.0	1.0	1.0	0.9	0.8

Source: Edelweiss research

[1] *The sector price to earnings is the median price to earnings value for the sector*

2-Year Average

Step1: Average Relative Price-Earnings Ratios:

2.50 = Two-year high Relative Price-Earnings Ratio

1.00 = Two-year low Relative Price-Earnings Ratio

1.75 = Two-year average Relative Price-Earnings Ratio

Step 2: Current relative PE

13.31 = Current stock price-earnings ratio

16.36 = Current sector median price-earnings ratio

0.79 = Current relative PE

Step 3: Price-Earnings Ratio, based on average relative ratio and current relative ratio:

= 0.79/1.75

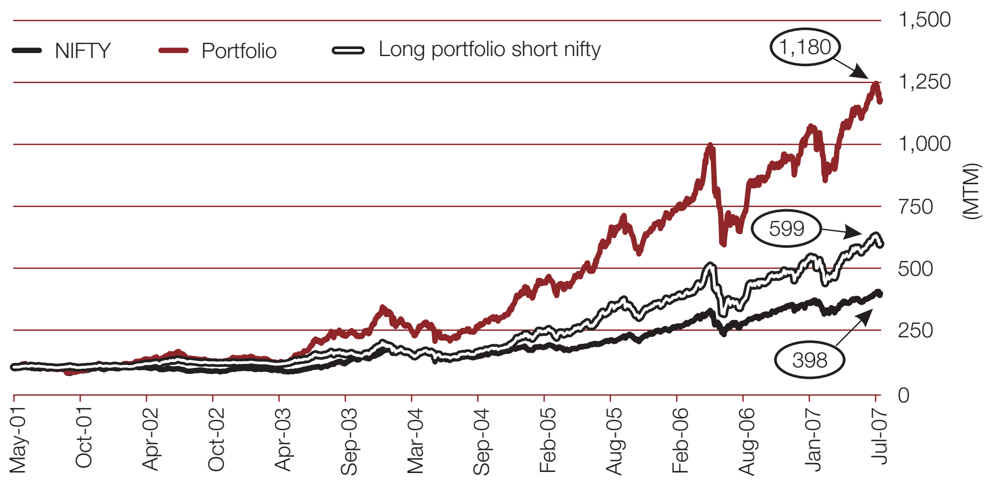
= 0.45

Based on this score, companies are ranked; the lower the better.

Historical performance

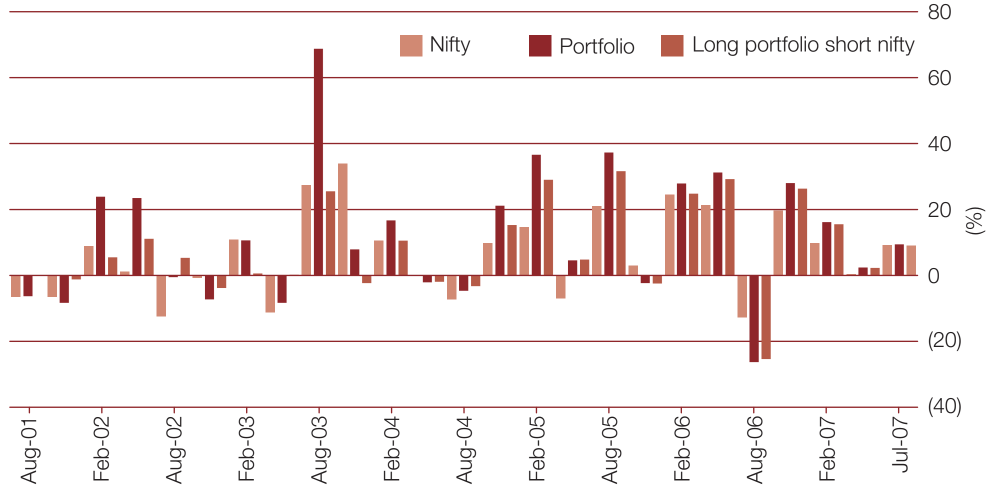
The graph below depicts the historical performance of the stocks based on our selection criteria for the screen. On an average, there are 15 companies in a quarter which meet these crtieria.

Chart 8: Performance (May'01 - Jul'07)



Source: Edelweiss research

Chart 9: Quarterly performance



Source: Edelweiss research

Assumptions

The relative price-earnings valuation model assumes the following

- The long-term growth and risk profile of the firm has not fundamentally changed over time.
- The sector is currently fairly valued and the company's relationship to the sector will return to its norm.

A careful evaluation of each firm's relative price-earnings ratio must be undertaken before investing to determine if it represents a reasonable relationship to the market going forward.

Screening criteria

- The average price-earnings ratio is less than or equal to 90 and is greater than 3
- The companies with percent rank below 50% of the entire data base of average price earning ratio are selected.
- The earnings per share for the current quarter is greater than earnings per share for the same quarter last fiscal
- The current TTM earnings is greater than average TTM earnings for the last three years

Table 5: Consolidated performance*

	Long portfolio	Long portfolio short Nifty	Nifty
May' 01-Jul'07			
CAGR(%)	48	47	20
Standard Deviation (%)	29	23	23
For last 3 years			
CAGR(%)	68	54	40
Standard Deviation (%)	38	33	24
Quarterly			
Average (%)	12	11	6
Best (%)	69	36	34
Worst (%)	(26)	(25)	(16)
Standard Deviation (%)	20	16	14
Monthly			
Average(%)	4	4	2
Best (%)	26	25	15
Worst (%)	(22)	(19)	(18)
Standard Deviation (%)	11	8	7

Source: Edelweiss research

* *Quarterly and monthly statistics are for the entire back-tested period and not just for the last three years.*

Portfolio for the current quarter (1st Aug '07 - 31st Oct '07)

Aban Offshore Ltd.	Aptech Ltd.	Bharti Airtel Ltd.
Birla Ericsson Optical Ltd.	Bombay Dyeing & Mfg. Co. Ltd.	Crisil Ltd.
Glenmark Pharmaceuticals Ltd.	H D F C Bank Ltd.	Indiabulls Financial Services Ltd.
Kopran Ltd.	Kotak Mahindra Bank Ltd.	Mahindra Gesco Developers Ltd.
Micro Inks Ltd.	N E P C India Ltd.	Reliance Capital Ltd.
Samtel Color Ltd.	Zee Entertainment Enterprises Ltd.	

Performance for the last quarter = 9.4%; Nifty returns = 9.1%

Please note:

Each of the four screens/ portfolios above is updated quarterly.

The impact of factors such as commissions, bid-ask spreads, dividends, time-slippage and taxes is not considered. This overstates the reported performance, but all approaches are subject to the same conditions.

Sell rules are the same as the buy rules: The screens are simply reapplied using each subsequent month's data. Thus, a stock is "sold" if it ceases to meet the initial criteria, and new stocks are added if they qualify.

The universe for these screens is CNX 500.

For each of these screens, we have taken a month's lag to allow for the earnings to be declared for the universe under consideration.For a June ending quarter, the investment period is August - October quarter

Edelweiss Securities Limited, 14th Floor, Express Towers, Nariman Point, Mumbai – 400 021, Board: +91 22 2286 4400, Email: *research@edelcap.com*

Naresh Kothari	Head	Institutional Equities	naresh.kothari@edelcap.com	2286 4246
Vikas Khemani	Head	Institutional Equities	vikas.khemani@edelcap.com	2286 4206
Shriram Iyer	Head	Research	shriram.iyer@edelcap.com	2286 4256

Alternative Research

Regular Products

- Derivatives Daily (DD)
- Earnings Strength Comparison (ESC)
- Edelweiss Corporate Action Tracker (e CAT)
- Edelweiss Fund Insight (EFI)
- Edelweiss Market Scan (EMS)
- Edelweiss Technical Reflection (ETR)
- F&O Crossover
- hEDGE
- Insider Trades
- Pair Strategy
- Rollovers Analysis
- RSC Tracker (RSC)
- Screens

Special Situation Trades

- ADS Conversion
- Alpha Trades
- Buy Back
- Delisting
- De-Merger
- Directional (Long / Short)
- Merger
- Open Offer
- Option Trading
- Restructuring (Value Unlocking)
- Rights Arbitrage
- Secondary Offerings
- Spread Trade

Date	Reports
01-Jan-07	IPO Radar; A Snapshot of IPOs in CY06
08-Jun-07	Master Moves; Opportunities from open offer, buyback, de-listing
03-Aug-07	hEDGE: The alternative insights monthly
03-Aug-07	RSC: Power gains gliter; Sugar still bitter
06-Aug-07	Earning Strength Comparison
03-Aug-07	Enhanced Nifty; Nifty with an edge

Edelweiss

Ideas create, values protect

Edelweiss Securities Limited, 14th Floor, Express Towers, Nariman Point, Mumbai 400 021
Tel: +91 22 2286 4400. Email: research@edelcap.com