The magic formula to identify multi-bagger stocks

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Bull markets are always decked with stories of compounders and multi-bagger stocks, pushing investors to hunt for multi-bagger stocks in every investment they make. But as many of us know, very few companies end up delivering such high returns, over a sustained period.

Barring the momentary multi-bagger stocks (that typically burst at the end of a bull market) the recipe for real long-time compounders can be summed up with the following formula:

Returns = Strong net earnings (PAT) growth + Good return on equity (RoE) + Good cash flows + Governance

When all these factors are together at play, a stock delivers high compounded returns. While the first three are quantitative, the fourth is qualitative. Sounds pretty simple, right? But their confluence is not that simple! And if one of the factors is not present, it can result in poor returns or result in the stock price even collapsing, like it does with bull market multi baggers.

We will first discuss the importance of each of these factors and then go through few illustrations to understand how these factors play out.

#1 Growth, quality of growth and re-rating

Growth: Growth is the one factor that makes stocks attractive over other asset classes. It is a prerequisite for a stock to deliver returns. Growth here refers to growth in net earnings (profit after tax).

Growth, when seen with the price that the market places for a stock's earnings (price to earnings ratio)– tells you whether you are buying a stock at the right price. This is called the PEG ratio.

As a formula, this is a stock's price-to-earnings (P/E) ratio divided by the growth rate of its earnings for a specified time period. So if a company's price earnings ratio is say 18 and its earnings is expected to grow at say 18% every year for the next 3 years, its PEG is 1. Is this attractive valuation?

Now, let us understand how a stock is termed attractive in relation to its growth. You may know the rule of 72. A company growing profit at 15% every year is doubling its profits every 5 years while one growing at 25% is doubling profits every 3 years. Anyone buying such a company's stock at around a PEG ratio of 1 is theoretically getting a great price to invest since he or she will theoretically be at least doubling their wealth in 3 or 5 years (in the above examples).

Quality of growth: The market does not reward just growth. It rewards the quality of growth – meaning the ability of a company to steadily grow its profits for an extended period with great capital efficiency (RoCE).

What is Return on Capital Employed (RoCE)?

The ratio is used to measure how much returns a business is generating on the total capital employed. It gives a primary indication of the capital efficiency of a business.

RoCE = Earnings before interest and taxes/ total capital employed (equity + debt)

A high RoCE should eventually translate to high RoE if the debt capital is put to good use. Even here, the debt capital should have come at attractive interest rate. If a company has a high debt component at high interest rate, then it can have a high RoCE that may not finally translate into high RoE.

RoCE is a better indication of capital efficiency and future potential of a business in cyclical sectors or capital-intensive sectors. In those companies, RoE will improve only with debt reduction as the initial debt capital results in profit growth that helps generate sufficient cash flows to repay the debt.

How RoE is different from RoCE

ROE measures the return on your equity capital. RoE gives primary indication of whether a business is worth investing at all. In simple terms, unless RoE is above the cost of capital for a business, the business is not going to generate any shareholder returns.

In the Indian context, sectors such as IT services and consumer goods, where companies typically grow their profits with high capital efficiency for extended period, can be classified under the category of 'quality growth'.

Some investors look at quality of growth from the perspective of high margins. In other words, they believe that high margin means high quality of return or high RoCE. This is not really the case at all times! Here's why looking at margins alone can be deceptive at times.

Certain high margin businesses in sectors like engineering & capital goods, pharmaceuticals & chemicals, auto ancillaries, textiles, etc. have high capital intensity (high investments in both fixed assets as well as working capital). Here margins MUST compensate for capital intensity to generate decent RoCE. On the other hand, many low margin businesses from sectors such as retail, consumer durables or consumer electronics/electricals generate similar/ superior RoCE to high margin businesses, despite thin margins of 5-15%, due to low capital intensity. (lower investments in fixed assets and low working capital needs).

So, looking at businesses based on based on capital efficiency (RoCE) than margins can lead you one step closer to identifying multi-bagger stocks.

PE re-rating: Growth leads to returns yes. But how does it cause price earnings (PE) multiple to go up – that is, how does PE re-rating happen? Let us theoretically try to understand this:

A company growing its earnings (PAT) at 25%, is doubling its earnings every three years. In other words, it should theoretically deliver 16X returns in 12 years if bought at a PE Ratio of 25 or PEG Ratio of 1.

On the other hand, a risk free (@6% return) instrument takes 12 years to just double your money. 16X in 12 years versus 2X in 12 years. Get the hang?

This huge difference in returns offered by a high growth stock versus a risk-free investment forces investors to shift to such stocks, settling for even lower returns than the initial potential – say for 8X or 4X returns. And this pushes prices higher. Consequently, PE ratio goes up. Such re-rating happens typically in growth companies where earnings are forecasted to grow steadily for extended period of time. We will see examples of such companies later in this article.

#2 Return on Equity (RoE)

Return on equity is the most important determinant of how much return an investor can make from a company. Textbooks recommend that a company should make returns (RoE) above its cost of capital to qualify as an investment candidate.

In India, where cost of capital (especially for companies outside of bluechip firms) is relatively high (9-13%) compared to developed markets, companies are expected to generate a RoE at least >13-15% to qualify as investment candidates. Higher the RoE above cost of capital, higher the potential stock returns. So, companies that can generate RoE significantly above cost of capital for extended periods of time turn out to be significant wealth creators.

A high RoE is an outcome of the efficiency with which a business is run. Imagine a company generating a RoE of 20% and seeing opportunity to invest all its profits back in the business. The re-invested profit will also generate 20% and have a compounding effect. On the other hand, excessive cash accumulation by companies depresses their RoE while also giving signal of low future growth prospects. For more insights on RoE, we recommend reading MOSL 18th Wealth Creation Study titled "Uncommon Profits".

The myth around high RoE: Unlike earnings growth, which is a pre-condition for high stock returns, we cannot categorically say that all high RoE companies deliver high returns. This is because much depends on the price to book value at your entry point. Let us suppose you buy ITC today when its RoE is is 25%. A RoE of 25% is true only for someone who buys the stock at its book value. Or in other words, the ROE is at a P/BV of 1. For a buyer at say 4.5x book value, the RoE is actually 6%. This is nothing more than a risk-free return. To conclude, high RoE will lead to high returns only if the entry point, that is the price to book value is low OR the company is growing fast.

#3 Cash Flows

There is an adage that says revenue is vanity, profit is sanity and cash is reality. A company must realize the profit on the full amount it has booked as revenue without the money being stuck as long outstanding receivables or being written off as debt. Healthy cash flows are critical to paying back dividend to shareholders or to re-invest in the business itself for growth.

A strain in cash generation is the first sign of trouble for any company. It can be due to ambitious expansions or acquisitions or decline in margins or execution delays or change in business environment or any other factors. Then debt, either in the form of adverse working capital or longer-term debt starts piling up threatening the ability of a business to continue. So, it is important to understand the cash flow pattern (operating & investing) of each business and industry as that will help you decide when to cash out.

From an investor's point of view, regular dividends and periodic buy-backs are a positive indication of cash flows. But at the same time excessive focus on dividend yield can be counter-productive. For non-financial companies the focus should be on the Operating cash flows (OCF) and how companies utilize it. Just to provide an example, MRF, the priciest stock (absolute price) known for paltry dividend pay-out, has delivered 13X return in the last decade while re-investing almost all of its cash flows back in the business.

On the other hand, Coal India, which pays out high dividend and re-invests less for growth delivered negative returns since 2015. There was NO growth in PAT in the last 10 years.

Cash flows assume more significance in this period of new-age IPOs where valuation is based on multiple of sales and not profits. Whatever be the story, growth needs capital and if companies run out of cash for growth, you know it can be a slippery slope.

#4 Governance

"You cannot make a good deal with a bad person" said Warren Buffett. Whether it is a new-age company or old-world commodity or consumer plays, good governance is an essential ingredient for good shareholder returns.

These 2 articles below from PrimeInvestor are a must read if you are relatively new to the world of equities:

- Why corporate governance matters
- The many roads to mis-governance

Governance issues generally crop up in family-owned businesses or where the promoters are involved in multiple businesses. So, it is extremely important to have an understanding about promoters, board composition, ownership structure and about group companies, if any. In such cases, the section on "Related party transactions" in annual report should be given due importance.

You can also read our article on "Reading an Annual Report" and the 6 sections to look for relevant information in it.

Some of you may have been equity investors when the Sathyam Computer saga happened. The top tier IT company's promoters had significant interest in an infrastructure company called MAYTAS (reverse of Satyam). Financial transactions, engineered for personal gains, to the detriment of equity investors, led to the collapse of bluechip IT company Sathyam You can read more about the scam here.

Such collapse of governance can lead to equity erosion in no time. One such recent case is DHFL. At its peak, the stock traded at a Market Cap of Rs.21,000 crore while having debt of Rs.82,000 crore. While equity shareholders lost the entire value of shares, the debt holders also took a a massive 60% hit.

But companies do survive bad corporate governance at times if the underlying business is good. As Warren Buffett famously said; “When a manager with a reputation for brilliance tackles a business with a reputation for bad economics, the reputation of the business remains intact”.

The survival of Satyam under Tech Mahindra, Crompton Greaves (renamed as CG Power) under Murugappa group and Eveready under Dabur are testimony to this.

Bottomline – look for good businesses run by good management.

How the above factors play out in multi-bagger stocks

Let us look at some illustrations of how the above factors played out in the case of some of the multi-bagger stocks.

#1 Multi-bagger stocks where all three factors worked

Eicher Motors

CAGR	2007-09	2009-18	2018-21
Sales	21.73%	13.19%	-0.92%
PAT	25.76%	42.02%	-11.75%
M Cap	58.56%	52.33%	-2.69%
Avg RoE	10.01	27.56	19.92
Avg PE Ratio	20	35	28
Stock	2.5X Return	44X Return	8% decline

Britannia Industries

CAGR	2007-13	2013-21
Sales	18.20%	9.87%
PAT	16.25%	27.95%
M Cap	13.13%	39.01%
Avg RoE	33.39	42.68
Avg PE Ratio	33	46
Stock	2X Return	12X Return

Page Industries

CAGR	2007-14	2014-21
Sales	36.29%	13.22%
PAT	36.94%	12.03%
M Cap	55.41%	24.66%
Avg RoE	48.96	48.96
Avg PE Ratio	36	73
Stock	22X Return	5X Return

V Guard Industries

CAGR	2008-18	2018-21
Sales	22.68%	5.30%
PAT	22.60%	14.35%
M Cap	47.74%	4.65%
Avg RoE	24.36	19.23
Avg PE Ratio	47	49
Stock	43X Return	14% return

Table: PrimeInvestor.in • Created with Datawrapper

Above are some of the wealth creators in the last decade. Except Page Industries, the other stocks had their periods of outperformance and sluggish phases. In other words, growth and returns were not linear, as is the case with equity as an asset class. But in all cases, you can see that the companies delivered very high returns during their high growth phase, emphasizing the direct correlation of returns to earnings growth..

Page Industries IPO was in 2007 at 24 PE while the stock witnessed re-rating up to 100 PE. V Guard came in next with an IPO in 2008 at 20 PE. Eicher Motors and Britannia also witnessed PE re-rating during their high growth phase. (We have written earlier about the twist in Eicher Motors' growth story)
Apart from growth, these companies have been generating humungous cash flows and are all cash rich.

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These are just few illustrations on how a combination of high growth with good return ratios and cash flows can lead to significant wealth creation. Some of the IPOs in recent years such as Avenue Supermart, Dr Lal Path labs, Dixon Technologies, IRCTC, CDSL, etc that turned out to be wealth creators share similar characteristics as well.

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#2 Stocks with high RoE and cash flows, but low growth

ITC

CAGR	2007-17	2017-21
Sales	13.01%	5.89%
PAT	14.08%	8.94%
M Cap	19.66%	-5.74%
Avg RoE	30.21	23.23
Avg PE Ratio	33	23
Stock	6X Return	22% decline

CASTROL India

CAGR	2007-15*	2015-20*
Sales	7.20%	-1.90%
PAT	17.71%	-1.07%
M Cap	23.49%	-11.03%
Avg RoE	73.77	60.30
Avg PE Ratio	37	22
Stock	7X Return	45% decline

Hero Motocorp

CAGR	2007-16	2016-21
Sales	12.45%	1.61%
PAT	15.59%	-1.27%
M Cap	17.58%	-4.93%
Avg RoE	45.96	27.90
Avg PE Ratio	21	16
Stock	4X Return	33% decline

*Calender Year
Table: PrimeInvestor.in • Created with Datawrapper

This is a different scenario wherein companies mentioned above delivered multi-fold returns to shareholders in the past, but have seen a slowdown in growth in recent years. The companies continue to generate superior RoE and cash flows. But with growth tapering off, PE de-rating followed. Although the management of these companies awarded shareholders' patience with liberal dividend payouts, the absence of growth pushed valuations lower as can be seen in the table.

#3 Stocks with poor cash flows

This is one metric where an error can prove to be expensive for you as an investor. Here are two illustrations to throw light on how growth without cashflows can lead to collapse of companies.

USHA MARTIN

CAGR	2007-15	2015-18	2018-21
Sales	11.13%	-23.20%	0.51%
EBIDTA	7.44%	-800.00%	673%
M Cap	-3.25%	-23.20%	69.95%
Fixed Assets	18.94%	-23.00%	-0.98%
Debt	19.45%	-87.00%	7.04%
	4X increase		
Avg RoE	7.00	0.00	12.93
Stock		-80%	5X Return
(2010-2018)			

JAIN IRRIGATION

CAGR	2007-18	2018-21
Sales	16.31%	-10.4%
EBIDTA	16.39%	-30.9%
Margin%	12.81%	6.54%
PAT	9.21%	-9.32%
M Cap	6.79%	-28.00%
Fixed Assets	9.83%	5.14%
Debt	15.48%	15.89%
	5X increase	
Avg RoE	11.71	-5.86
Stock	2X Return	-63%

Table: PrimeInvestor.in • Created with Datawrapper

Usha Martin is a company that just escaped from going to NCLT post severe cash crunch and high debt. The company went for a high debt-led expansion. Revenue contracted and margins slipped to negative when the commodity cycle turned negative. The company got into a debt trap and the stock price collapsed. Usha Martin was lucky to stitch a deal with Tata Steel group and come out of the debt trap though. Not all companies get lucky!

Jain Irrigation on the other hand, highlights the danger of running a low margin manufacturing business while requiring huge investment in working capital. The sub-par RoE also led to poor shareholder returns between 2007-18 when sales went up 5 times. But debt was silently mounting, as sales expanded. Other manufacturing companies that collapsed include Amtek, Sintex, Suzlon Energy and BGR energy as the companies pursued ambitious growth using debt.

This problem of debt trap also happens to order-book driven companies where sales growth starts diminishing, receivables pile up and debt increases during a downcycle.

Another business that is even more sensitive to cash flows is the lending business. As it is a business with many times borrowings (8 to 10X) on net worth. We have also seen many ambitious companies from this space permanently destroying shareholder wealth; Yes Bank being one of them.

To sum it up, growth with capital efficiency, cash flows and governance is a recipe for high returns. If your growth estimates do not pan out too well, it may yield slower/lower results if other factors remained intact but miscalculations on governance and mis-reading of cash flows can destroy wealth.

Is it easy to hunt for multi-bagger stocks?

It is certainly not an easy exercise to find out multi-bagger stocks that can grow at high rates and with high capital efficiency for prolonged periods. But our discussion above can point to the following:

- Whether a company is sound in cash flow and governance is a must check before you understand its prospects. These will lay the foundation for building wealth. Don’t compromise on those when you are taking long-term positions.
- Sometimes, we may recognize the potential of companies only half-way past their journey and by that time they might have already become expensive in valuation. This happens because the companies may not have all the required attributes in their early stages. As long as the growth story has not tapered off and the foundation (we mentioned above) remains sound, you may still look at such opportunities.
- External factors or significant changes internally can change the course of journey for many companies. Therefore, it is necessary to periodically review your thesis and see if it holds good in the changed circumstances.
- For picking companies that are lesser known, the starting point is 'Growth' followed by Capital efficiency'. Without growth, no other factor can contribute to meaningful returns. In smaller companies, often times, minor corporate governance issues are not uncommon. But if such companies do not get their act together as they grow, then you would have to take a call before the market discovers the 'bluff'.

- While commodity and cyclicals are generally considered outside the category of compounders, companies that do prudent and timely capital allocation through cycles emerge as big winners as well. This has been discussed in detail in our article on Investing Approaches.
- Companies with huge capital investments, borrowings or acquisitions require a different level of evaluation and if you have not studied the equity landscape for long, these might be risky calls to take and often exposes you to high volatility as well.

Use our Stock screener to filter stocks with the above discussed metrics. You can also check our video on how to select growth stocks using our Stock Screener. Alternatively, you can use our Stock Rankings tool to check for high growth and high-quality stocks.