Here are 12 ways to spot a multibagger among thousands of companies

by Shashank Khade, 27th June, 2017

Investment Advisory

The moot question remains, is it easy to buy into multi-baggers? If yes, then all of us should have been wealthy by now. Let's try to address the burning question in the mind of an investor.

It's natural for the ultra-wealthy to get attracted to Equities have been widely acknowledged as a vehicle for wealth creation. But, investing in equity stocks have a different connotation to investors based on the stage of the lifestyle of understanding equity investing.

Different types of investors take a dip in the stock markets every day. Some are traders, looking to be smarter than the market and aspiring to make profits out of short term trading.

Trading techniques could include news-based trading, gut-based trading, self -developed strategies, quant-based and driven by chart patterns. Some are medium term investors, aiming to build capital out of booking profits periodically in stock markets.

Few finally graduate to being long-term investors who understand a particular business and wait patiently for the company to deliver earnings growth and markets to take cognizance of it.

Naturally, the term multibagger, would mean differently to these market participants. To a trader, it may mean high annualised returns driven by summation of returns generated through short-term trades.

Most investors evaluate multibagger stocks with a rear-view mirror approach. They may not try to understand why a stock multiplied and what situations led to such great returns.

In an aspirants' mind, generally, multibaggers are essentially stocks which can give phenomenal returns in a shorter time span e.g. Mad rush for IPO stocks expecting a newly listed stock to provide considerable returns in a short time span.

These are looked at as necessary steroids for portfolio returns. Some investors look forward to multibaggers as means to build capital to a respectable level and hence are ready to take higher risks in this quest.

In other cases, investors invest in equities after a lag of 2-3 years of strong stock market performance and then aspire to play catch-up. For a long-term investor, it may mean creating sizeable wealth through participation in the business journey of a company.

We are referring to 'multibaggers' as stocks which multiply or provide avenues for phenomenal wealth creation. The wealth creation could happen over a long horizon of time through compounding gradually and necessitates a patient investors' mindset.

The panacea for an investor earning out of a multibagger stock is when he has put serious capital at work. However, serious investing happens only when the investor has understood the company' business model, risks to growth, market potential thoroughly, has invested at sane entry valuations and is willing to wait for a business to grow its earnings in the future years.

The moot question remains, is it easy to buy into multi-baggers? If yes, then all of us should have been wealthy by now. Let's try to address the burning question in the mind of an investor.

How do you get multi-baggers? For this, we will need to understand why do stocks multiply and which type of stocks become multi-baggers?

There can be different approaches to this quest. We believe the most common formula for stocks becoming multi-baggers is to identify companies with underlying components, viz. (Consistent EPS growth accompanied with free cash flow growth) + (Ample cope for PE expansion at the entry valuation of the stock) can translate into a multi-bagger opportunity

Stocks which multiply may have some of these underlying characteristics:

Growth at attractive price GAAP

Consistently strong earnings growing company available at an attractive valuation. E.g. Market situation in 2003, 2009, 2013.

Mispriced opportunities

Business is grossly undervalued due to investor ignorance or being out of flavour. Ex. Some of the consumer stocks in 2007

Change in Investor Communication

Company which did not communicate regularly has focussed on transparency in last few quarters/years. e.g many of the mid cap stocks

A chance to participate in a large market potential opportunity at an early stage

In a large market opportunity, the company has a first-mover advantage in a new business which is extremely scalable. Ex. housing finance.

Balance sheet transition

Companies executing high to low leverage transformation, working capital cycle reduction, lowering capital intensity in a business.

Turnarounds/Cyclical opportunities

Company has undergone severe strain before completing business/financial restructuring and now looking to realign business & balance sheet correctly. Most investors dislike a company which has gone through a rough patch. Risk perception being high such stocks are ignored and available at unassuming valuations

A market opportunity whose time has come

Company' business opportunity becomes ripe for building scale.

Capability to expand free cash generation

Most important feature of sustainable multi-bagger stocks has been the ability to generate free cash flows consistently and the ability to grow them. Ex. IT, Pharma, Cement, Capital goods, consumer product companies which have demonstrated a steady increase in a free cash flow generation have become large cap stocks.

One of its kind

One of its kind business with strong entry barriers, could lead to unprecedented scarcity premium.

Change in Management/Focus

Promoters remaining status-quo, next-gen induction could bring in fresh thinking & positive changes in business strategy & investor perception.

High ROE/ROI

A business which can demonstrate high ROE/ROI for extended periods is available at attractive valuation due to negative business/promoter intent perception.

Rising trend in ROE/ROI

A cyclical business changes its characteristics to become a secular business due to changing business dynamics and starts to expand its ROE/ROI to healthy levels and sustains it.

Most important question is when do you seek such opportunities? Interestingly, most multi-bagger stocks have provided an adequate margin of safety for investors at early stages. The highest margin of safety in multi-baggers is in over pessimistic situations.

Markets being driven by human behaviour swing between over pessimistic and optimistic market levels. The period from 2008-09 and 2012-13 have been most recent examples of over pessimism.

These are times when investors need to be greedy and seeking multibagger returns. However, being governed by human psychology normally just the reverse takes place.

In 2013, most investors sought the safety of capital and in 2017 are scouting for multibagger opportunities. Most investors who invested in 2016 and beyond have been aspiring for multi-baggers. Why?

Precedence has shown that a large number of small & mid cap stocks multiplied from Aug'13 lows. The BSE Small Cap index has multiplied 2.75x from 5100 to over 14000 from 2013 until now.

From Nov'10 to Aug'13, the BSE Smallcap index had more than halved from 11000 to 5100. Why did the investors not participate in stocks then?

The fear of capital loss amongst investors with regards to small cap stocks was the highest then, leading to mispriced stock valuations across the board by 2013.

The pendulum has swung to the other side now with such aversion having changed to attraction to small cap stocks. The market always has cycles in a long-term trend.

Multi-bagger opportunities need to be sought in pessimistic times against the crowd.

The risk-adjusted returns are in investors' favour then. In most small cap stocks presently, the potential for PE expansion has reduced, leaving upside only from EPS growth.

Given this, it is evident that multibagger opportunities are going be scarce in such situations. Aspirants need to temper their returns expectations. It defies logic to take a high risk to capital to generate high returns.

Investors need to keep their risk allocation low by investing in companies available at reasonable valuations with an expectation for moderate returns rather than searching hard for the next multi-bagger opportunity.

In a quest for such opportunities, there is no need to risk capital by investing in a company, with poor business credentials, backed by unknown management. Neither does too much of blue sky thinking needs to be done to buy into futuristic or thematic bets.

In the present market conditions, investors should not allow expectations of wealth multiplication to translate into wealth division.