Margin of safety

Let's say Rajan owns a house that he rents out. He gets a monthly rent of Rs 25,000, i.e., a yearly rent of 3 lakhs. He knows that a house will reasonably sell for 20 times its yearly rent. The value of his house will be 20*3 lakhs = 60 lakhs.

Let's look at Rajan's sources of value and how that can impact his overall wealth.

1. Rental yield: 3 lakhs a year
2. Earning appreciation: Current valuation is 20 times the yearly rent = 20*3 = 60 lakhs. If the rent goes up by 10% to 3.3 lakhs – the value of the house will be 20*3.3 = 66 lakhs. If the rent goes up by 20% to 3.6 lakhs the value of the house will be 20*3.6 = 72 lakhs. **The buyer is paying the same valuation multiple but the rental income has gone up – hence the value of the house has gone up.**
3. Change in valuation multiples: Current valuation is 20 times the yearly rent. If this changes to a higher multiple like 22 times the yearly rent, then the value of the house will be 22*3 = 66 lakhs. If the multiple goes up 25 then the value of the house will be 25*3 = 75 lakhs. **The rental income is same but the valuation multiple has gone up hence the value of the house has gone up.**

Let's say that you are looking to buy this house from Rajan only from an investment perspective (you are not going to live in this house, but will be renting it out for income or selling it for a profit).

Let's say you believe that the current valuation multiple is of 20 times the yearly rent is reasonable as this has been the multiple at which houses were sold over the last 15 years.

If you are paying Rajan Rs 60 lakhs.

- It could be because are interested in a rental yield of 5% (3*100/60=5%) as this still better than the bank rate you are getting.
- Or that you expect the rentals to go up and thus giving you a better rental yield and an opportunity to sell at slightly better price. For example if you believe that rents will go up by 10% then the rental yield will be 3.3*100/60 = 5.5%. And the value the house will fetch will be 20*3.3 = 66 lakhs. This is a profit of 6 lakhs.
    - This will expose you to the down side if the rental incomes decrease by 10% to 2.7 lakhs. Then the rental yield will drop to 2.7*100/60 = 4.5%. And the value the house will fetch will be 20*2.7 = 54 lakhs. This is a loss of 6 lakhs
- Or you expect the valuation multiples to go up thus giving you an opportunity to sell at a slightly better price. For example if you expect the multiples to go up to 22 then the house will fetch 22*3 = 66 lakhs. Resulting in a profit of 6 lakhs.
    - This will expose you to the downside of decrease in the valuation multiple. For instance if the valuation multiple goes down to 18 then the house will fetch 18*3 = 54 lakhs. A loss of 6 lakhs.

Moral of the story so far: If you are buying at fair valuation, you are either happy with the rental yield or you are betting on an increase in the earnings or the valuation multiple. If your bet is incorrect then you stand to lose.

Let's say Rajan was in a rush to sell the house as he needed to leave the city for a better opportunity elsewhere – and sells it to you for 50 lakhs.

- This means you can now enjoy an earning yield of 3*100/50 = 6% based on the rental.
- Or you can wait till you find a buyer who will pay the "correct" multiple of 20 and buy the house for 60 lakhs. Thus making a profit of 10 lakhs.
    - This price also gives you protection if the rentals decrease to upto 2.5 lakhs a year. As you will still be able to sell the house for Rs 50 lakhs.
    - This price also gives you a bit of protection against the drop in price multiple to say 17, you can still sell the house for 17*3 = 51 lakhs and still make a profit of 1 lakh.

Moral of the story so far: If you are buying at a price that is lower fair valuation, you get a slightly better rental yield. Also there is a bit downside protection for a decrease in earnings or valuation multiple or both.

Connecting this analogy to the stocks.

- Rental income = Earnings per share
- Valuation multiple = P/E ratio

For a stock there are 3 source of value.

1. Dividend yield – income received through dividends
2. Earnings increases- the value of the stock is expected to go up if the earnings go up (with the valuation multiple or P/E remaining the same)
3. P/E expansion – the P/E multiple at which the stock is traded going up (with the earnings reaming the same)

When you are buying a stock you have to analyse earnings per share and stock P/E, (stock price as a multiple of its earnings).

If you are paying less than the "fair" P/E for that stock then you stand to gain even when you are able to sell at fair multiple. You have a bit of safety margin if the earnings or P/E multiple drop and will benefit by increase in the earnings or increase in P/E multiple.

If you are paying more than the "fair" P/E for that stock you are taking a bet on either an increase in earing or increase in the P/E multiple. You are exposed to a loss if there is fall in the earnings or the P/E multiple.

If you would like to calculate fair price of a stock - Pl refer our article on source of value and time value of money. You can also analyse the industry valuation over a long term to get a perspective on the fair P/E for stocks in that industry.

In summary

- Price of a stock in itself has no meaning and one should look at it relation to the earnings.
- For having a margin of safety one should be paying less than the fair price. This gives a cushion against a drop in earnings or decrease in valuation multiple – while letting one enjoy the upside if there is an increase in earnings or valuation multiple.
- If one is paying fair price or higher than fair price, one is taking a bet on earnings increase or an increase in multiple. This is risky as one is trying to predict the future. One needs to remember that predictions have a high chance of being incorrect.