Basics of capital expenditure

What’s capital expenditure

- Adding plant/machinery/equipment that can aid in generating revenues :
  - Computers/printers/office equipment
  - Plant/machinery
  - Allied infrastructure
  - Land/building/factories etc.
- The key principle in understanding is 3 E’s : End Use, Efficiency and EPS accretion.

What we will learn together ?

- How do you identify good/bad/grey capex ?
- How does one understand the improving/decreasing efficiency of assets ?
- How do we benchmark asset sweating with competitors ?
- How do we know if the capex is additive to EPS/ROCE or not in the long run ?

Understanding capital

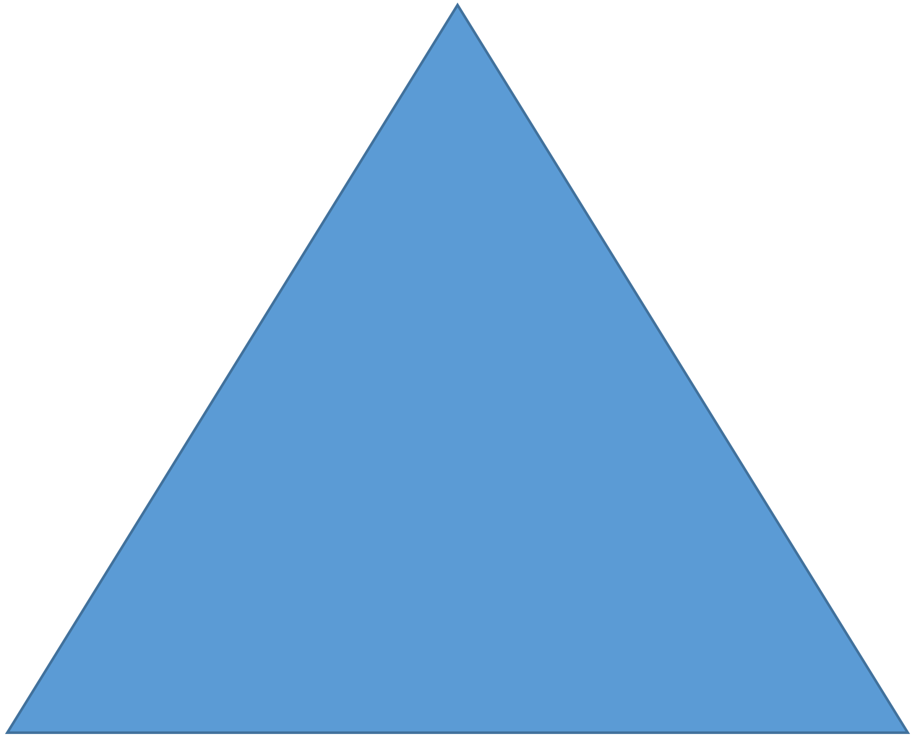
There are fixed asset intensive industries and/or working capital intensive industries

Fixed asset heavy industries are :

- Steel
- Textiles
- Auto – auto components

Some good mental models to ascertain capital intensity

Value to weight ratio



Technological obsolescence
And value addition

(intangibles like brand, software, IP, patent lessen FA intensity)

Transportation costs to MRP ratio

(higher it is, the more local the produce)

Preliminary diligence

- Is the company adding capacity in products/services that will be ROCE accretive ? For eg., sintex, orient paper and industries
- Is the capex being done ahead of time ? For eg., sintex doing phase II of textiles even before phase I of textiles is “sweated”
- How does the capital intensity and EBTIDA margin compare with the other peers in the industry ? If FA turnover is lower and EBTIDA is lower than industry average, what’s the end purpose to pursuing this capital expenditure

Sample checks

- Look for RPT, increase in LT debt (in INR/FC) and capital WIP to see the extent of capex
- Read the commentary in MD & A to see the end purpose and
  - When the capex will be completed
  - What will be the revenue generation potential
  - How will it improve FA turnover or otherwise and capital efficiency
- Good managements under promise and over deliver (eg: OCCL commissioned their capacity expansion ahead of time and also succeeded in "Sweating" the capex by winning customers simultaneously)

Sample checks

- Look for periodicity of capex addition over the last 10 years and if the company has been able to play the industry cycle well. Eg: suzlon adding massive capex in 2008 got them into a spiral
- Companies that don’t dilute equity and yet expand capacity organically are typically astute capital allocators
- Check for focus areas in MD & A:
  - Is the company focussed on bottomline or on empire building ?
  - Is the company focussed on achievements over 5-10 years or tom-tomming yoy achievements alone ?
  - Is the company focussed only on macros and industry or on execution and detailing ?
  - Is the company acknowledging internal and external challenges or using awards/recognition as a Trojan horse
  - Is the company conscious of the bottomline and the balance sheet – for eg., increase in debt, increase in equity or are they merely talking of topline growth ?

Grey areas

- Big capital into new far flung areas where company does not have any management bandwidth
- Unrelated diversification – typically that adds big revenues but requires huge capital outlay and is low on margins and cash flows (eg., sintex expanding into textiles, OPIL expanding into paper)
- Capex funded by equity dilution and debt; much worse if it is convertible debt – company gets exposed on downside to interest payments and if there is an upside, convertible bond holders might drag down the EPS post conversion.

Investing wisdom

"Indian promoters often use gold plated capex as a means to siphon out money or reduce their equity contribution into the business or both"

Easy checks

- Go to www.ratestar.in
- Check the financial ratios
- Improving FA turn over plus shrinking debtors/cash conversion cycle is a big plus
- Be watchful of companies that have a depleting FA turnover consistently along with worsening ROCE – law of diminishing returns eventually does catch up

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"That's torn it, now we're BOTH out of gas!"

Mungerilal wisdom

"If you treat cash like a jasmine seller and focus on quick and fast cash flows without creating a lot of capex, you will never run into a problem. The big moat is not in P & L but is in the BS and cash flows"

Recommended books

Creative Cash Flow Reporting

Uncovering Sustainable Financial Performance

Charles W. Mulford
and
Eugene E. Comiskey