

# MARCELLUS



## Investing Through a Crisis

*A Handbook from Marcellus Investment  
Managers*

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## Chapter 1

### Introduction

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The year 2019 ended on a pretty strong wicket for equity markets around the world. Most major indices were up 10-25% during the year. The Dow Jones increased investors' wealth by ~22%, the FTSE, Hang Seng, and India's Nifty by ~12% and the Nikkei by 18%.

However, 2020 brought with it the rumblings of what eventually became a global pandemic, bringing some of the largest economies of the world to a standstill. As Covid19 spread worldwide, stock markets crashed globally, with many indices recording their worst-ever quarter performance and many others seeing the fastest-ever correction in recent history.

In India, the broader markets were anyway appearing shaky due to the weak growth in corporate profits since the past 6-7 years. Then came Covid-19 to add to investors' troubles. And in the middle of all this came the collapse of Yes Bank. In a matter of weeks, the stock markets and the larger economy were dealing with a full-fledged crisis.

Despite the mayhem in the markets, in the first three months of 2020, Marcellus's flagship Consistent Compounders portfolio fell less than half of the broader market fall. In the 12-months to March 2020, the portfolio returned 7.6%, making it the best performing PMS in India. The market in the same period fell by 25%. Taking a longer time horizon, as per data available on SEBI's website, Marcellus' investment technique has beaten the Nifty Index by 19% per annum.

In the chapters that follow, we elaborate on our investment process and emphasize on the techniques that have helped the portfolio navigate through tough markets and a crisis. We hope investors find value in these chapters and can take inputs to build their portfolios that survive future crises and keep compounding wealth for them through bad times as well good.

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## Chapter 2

### India's 'Consistent Compounders' are unique globally

*India is blessed with several companies that have the unique combination of market dominance and return ratios far in excess of cost of capital. The resulting free cash generation enables these companies to reinvest back into their businesses to keep strengthening their dominance and return ratios. This cycle gives an opportunity to invest in these businesses and see your money compound at a steady rate over long periods of time.*

Economic theory dictates that in a competitive market, no firm can consistently earn a return much higher than its cost of capital. This is because the excess returns will attract more competition, which will in turn reduce the profitability of all players operating in that market. By extension, this means that in a competitive market, even a business that has a large or dominant market share in its industry will earn returns on capital employed (ROCE – earnings generated on each unit of capital employed on the balance sheet) or Returns on Equity (RoE – returns on each unit of equity invested in the business) close to its Cost of Equity or Cost of Capital.

It is not hard to find global players who dominate their industries – Walmart dominates US grocery retailing, Carrefour dominates French grocery retailing, Toyota dominates the mid-segment car market in Japan, Hanes dominates Europe's innerwear market. However, none of these companies make ROEs substantially higher than their cost of equity (see Exhibit 1).

#### Exhibit 1: RoE of firms which dominate their sectors in large economies across the world

Company name	2016	2017	2018	2019
Walmart Inc	18.1	17.2	12.7	8.9
Carrefour SA	7.4	NA	NA	11.8
Toyota Motor Corp	13.8	10.6	13.7	9.8
JP Morgan Chase & Co.	10.2	9.9	13.3	14.9

Source: Marcellus Investment Managers, Bloomberg

In India on the other hand, there are several industries where one or two companies not only have a dominant market share, but their RoEs have also remained substantially above the cost of capital (CoC) for decades in a row (see Exhibit 2). The strong pricing power and competitive advantage of these Indian firms is what sets them apart from their global counterparts.

#### Exhibit 2: RoE of dominant Indian firms over 20 years

Company	Avg RoE FY98-08	Avg RoE FY09-19
Asian Paints	32%	36%
ITC	30%	30%
Nestle India	65%	68%
Pidilite	25%	27%
Page Industries	38%	51%
HDFC Bank	21%	19%
Median	<b>31%</b>	<b>33%</b>
Cost of Equity	<b>15%</b>	<b>15%</b>

Source: Marcellus Investment Managers, Companies, Ace Equity

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The gap between RoCE and CoC is the free cash flow that a firm generates for its shareholders. Provided these firms sustain this wide gap whilst also growing their capital employed, they will generate healthy earnings growth consistently over long periods of time, regardless of changes in the internal or external operating environment of these companies. We call these firms ‘Consistent Compounders’.

Once an investor builds a portfolio of such firms, all that she should do is hold them for long periods of time and benefit from the power of compounding of healthy returns, with the volatility in these returns being similar to that of a government bond!

This sounds very simple, but simple is not always easy! You need to first figure out what exactly is a company’s competitive advantage that helps it dominate its industry and generate returns much higher than its cost of capital. Second you need to assess the sustainability of the competitive advantage, which will enable the company to maintain its dominance and free cash generation ability for long periods of time – keeping in motion a cycle of earning returns much above the cost of capital, deploying the resulting large free cash flow to grow its business, profits and market dominance, in turn further strengthening its competitive advantages leading to higher free cash flow.

For example, it is easy to find firms like Maruti Suzuki, which has maintained its industry dominance (>50% market share of cars in India), but its average 10-year ROCE is just 17% – like that of Toyota and Hanes highlighted above. Or take the example of Hindustan Unilever (HUL), which sustains a wide gap between RoCE and CoC, but does not find avenues to grow its capital employed. Despite maintaining an RoCE of over 80% over the past 10-15 years, HUL has generated an annualised earnings growth of just 8% (CAGR) over this period.

Without a thorough understanding of a company’s core fundamental strengths, one may make an initial investment in a portfolio of Consistent Compounders, but may have a less than ideal percentage allocation in the portfolio and/or a shorter than ideal holding period of such stocks in the portfolio. So, let’s use a case study to understand how a company builds sustainable competitive advantages and becomes a Consistent Compounder.

### **Case Study of a Consistent Compounder: Asian Paints**

One of the biggest challenges in running a decorative paints business in India is that being a chemical, paints are highly voluminous products. The average realisation of a decorative paint in India is around Rs 100 per litre – 10-times more voluminous than say FMCG where the average realisation is around Rs 1000 per litre. This characteristic makes it challenging to store and transport 4000+ SKUs of decorative paints to 70,000+ dealers across the country. The easiest way to overcome this challenge is to appoint various layer in the distribution channel – third-party C&F Agents, stockists, wholesalers, distributors etc – and let the voluminous product be on the balance sheets of these channel partners while the supply chain through these distribution layers. This is exactly how paints used to be distributed before the 1960s.

However, as Asian Paints became the market leader, they ended up redefining the supply chain dynamics of the decorative paints industry in two ways. Firstly, Asian Paints reached out directly to the paint dealers on the high-street, without any involvement of a distributor / wholesaler /

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stockist etc. This has meant that decorative paint is perhaps the only mass-market product sold in India directly to 70,000+ dealers on the high-street by the manufacturer. Secondly, although MRP printed on a box of decorative paint gives a healthy margin to the dealer, the price at which these products get sold to customers leaves on average only ~3% margin for the dealer – one of the thinnest margins available to the last-mile distribution layer across all B2C categories. These two changes (direct supply to paint dealers, and only about 3% average margin of the paint dealers) has totally changed the competitive advantage framework for this industry. Let's delve into this further.

The choice of product manufacturer (and hence the driver of market shares) in a paint project is not really done by the homeowner because he chooses products of the company whose shade-card is brought to him by his trusted contractor / painter (i.e. the influencer). The painter, in turn, chooses the shade card based on ready availability of all SKUs on the shade card at all points of time with the nearest dealer – this is because paint inventory has to be replenished few times during a paint project and the painter's team of daily wage workers cannot afford to sit idle due to stock-outs of one of the 4000+ SKUs at the nearest dealer's shop. Hence market shares in the industry are defined by what the paint dealer decides to stock most readily in his shop. Let us now focus on what drives decision-making of the paint dealer.

The largest element of capital employed for a paint dealer in India is real estate. On this real estate, the store economics for the ROCE of a *kirana* (convenience store) are totally different from that of a paint dealer. Firstly, on the same shelf space, a kirana can stock 10x more value of FMCG products compared to the value of decorative paint products, given the voluminous nature of paints (as quantified previously). Secondly, the margin available on each Rupee of sale for a Kirana is 4x higher than that of a paint dealer (12% for a kirana store vs 3% for a paint dealer). Hence, the only way for a paint dealer to generate ROCE similar to that of a kirana, can be by offsetting the 40x differential (10x multiplied by 4x) through inventory turns which are 40x faster for a paint dealer vs inventory turns of a kirana store. If Britannia and Hindustan Unilever deliver once in 10 days to a kirana in a city, then the paint dealer next-door requires delivery of paint products with a frequency of 40 times in 10 days i.e. 4 times in a single day. This is exactly the solution which Asian Paints provides to paint dealers, unmatched by most other decorative paint companies in the industry. Why?

Asian Paints has perhaps been the most pro-active corporate investor in technology across the country over the past 60 years. One of the many benefits of tech investments has been the ability of Asian Paints to forecast demand with a high level of accuracy, for each SKU, each location and for every week of the year. This ensures that without waiting for demand from a paint dealer, the firm optimises the type and quantity of raw material procurement, manufactured products and inventories for each of its depots and delivery trucks. Asian Paints' competitors are not capable of this sort of precise demand forecasting. Furthermore, the firm continues to deepen this capability over time, since its enormous market share brings to it more data on current demand from every location, than what is received by its competitors.

The importance of supply chain efficiency in helping define winners in the decorative paints industry is so high that over the past 3 decades several competitors have failed to gain any market share by offering: a) superior quality of products (e.g. Dulux Velvet Touch); and b) greater

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channel margins to paint dealers (e.g. Jotun and Sherwin Williams – before the latter sold their Indian business to Berger).

Finally, Asian Paints keeps investing in ways to disrupt the industry rather than waiting a competitor to disrupt it. For example, Asian Paints has spent more than a decade in establishing value-added labour-oriented offerings like Asian Paints Home solutions, Water Proofing solutions, Colour consultancies, etc. These services benefit from a transition that the sector has undergone over the past few decades. Asian Paints has limited product price hikes to less than 3.0% CAGR because of incremental operating efficiencies being derived by the firm consistently. This in turn has meant that on average, 65% of the cost of a paint project in India is labour (up from 20-30% two decades ago). This transition calls for a possibility to drive market share in the industry by offering a value-added labour experience to a household in exchange for a labour-intensive composition of the project cost. Such initiatives increase the longevity of Asian Paints' powerful franchise.

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## Chapter 3

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### Prudent Capital Allocation is Critical for Consistent Compounding

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*A characteristic feature of a Consistent Compounder is prudent capital allocation – that is, the choice of what to do with the free cash generated by the business year after year. The smartest management teams reinvest a bulk of the free cash in consolidating their dominance through sustained business growth, without compromising on the returns from the incremental capital deployed.*

If a firm is consistently generating large free cash flows, i.e. the excess of RoCE over the CoC, what should the management do with it? An obvious answer would be to reinvest the free cash into areas in which the firm already possesses deep-rooted competitive advantages (i.e. increasing the capital employed). This would keep the cycle of high RoCE leading to large free cash generation, in turn leading to higher capital employed and strong returns on that, going. However, as the firm grows and deepens its competitive advantages, the quantum of free cash flow available for redeployment tends to far exceed the amount that the business needs in order to keep growing. For example, reinvesting to add manufacturing capacity far in excess of the growth potential of a product will end up depressing the RoCE as the capital employed rises without a commensurate increase in the earnings before interest and tax (EBIT). This then drives the management to explore one of the following two options.

- **Diversification, usually inorganic:** Pursuing growth outside their core business, either across geographies or product categories, is usually the most common use of free cash by managements. This can be achieved either organically, or inorganically, through acquisitions. Many firms prefer the inorganic route towards diversification, acquiring companies in related or unrelated businesses, forging joint ventures with other companies, acquiring minority stakes in other companies etc.
- **Returning the surplus cash back to shareholders through dividends or buybacks:** When surplus cash cannot be effectively deployed without dragging down the RoCE sharply, it is prudent to return it to shareholders through special dividends or share buybacks.

Whilst all this sounds straightforward, many firms with a great core franchise that consistently generates high RoCE, have found it difficult to sensibly allocate surplus capital to diversify their business. Consider these examples highlighted below.

#### **M&A and offshore expansion have failed to create substantial shareholder value**

Over the past 3-4 decades, middle-class household consumption in India has grown substantially across several essential products of day-to-day consumption. This has meant that over the past two decades, most dominant firms in these sectors have generated substantial amounts of surplus capital (i.e. capital after meeting the core capex requirements of the firm).

Between 1995 and 2005, there have been various examples of firms deploying their surplus capital towards M&A to acquire businesses in India. Many of these acquisitions have ended up generating substantial value for shareholders with RoCEs of the acquired businesses being well



above their cost of capital. Some examples of these successful acquisitions include: Hindustan Unilever’s acquisitions of TOMCO (Tata Oil Mills Company), Kwality, Brooke Bond, Kissan, Lakme etc. during the 1990s; Dabur’s acquisition of Balsara (2005); Marico’s acquisition of Nihar (2006); and Pidilite’s acquisitions of Ranipal (1999), M-Seal (2000), Dr. Fixit (2000), Steelgrip (2002), Roff (2005) etc. These acquisitions have successfully added sustainable earnings growth drivers for these firms with already high RoCEs.

However, after 2005, several dominant Indian companies have deployed surplus capital towards *international* expansion / acquisitions – for example Godrej Consumer Products Ltd. (GCPL) in Africa, Indonesia, Latin America, Pidilite (Brazil, US, Middle East), Marico (Middle East, Bangladesh, South Africa), Dabur (Africa, US, Turkey, Egypt), Havells (Sylvania), Tata Steel (Europe), Asian Paints (Berger International, 2001), Bharti Airtel (Africa) etc.

Analysing the RoCEs of some of the overseas acquisitions (RoCE of consolidated entity less RoCE of standalone entity, where the India business is housed) shows how these international acquisitions have fared.

The following points are worth highlighting from this analysis:

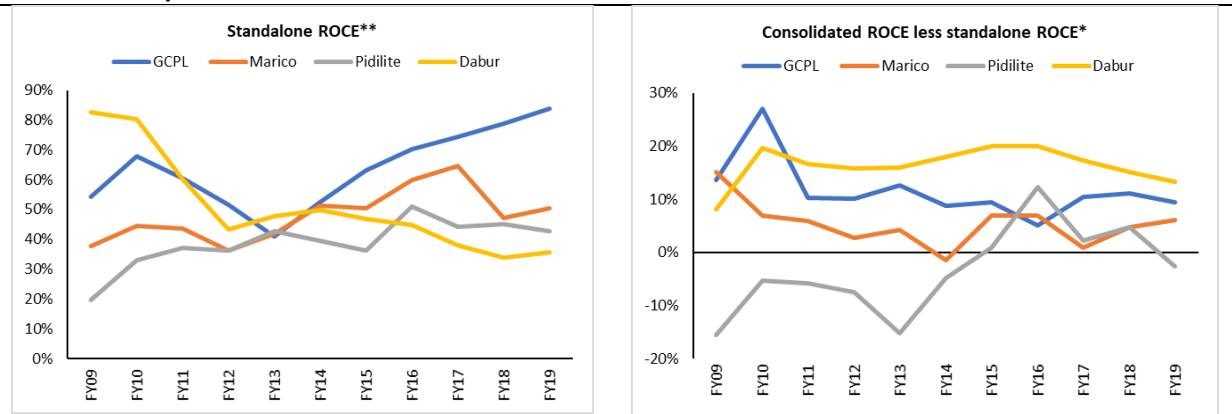
- A substantial part (at times more than 100%) of operating cash flows generated from the standalone business has been deployed towards international acquisitions – see the second column of Exhibit 3.
- Domestic (standalone) businesses of these firms have generated RoCEs substantially higher than cost of capital, many at times even higher than 50% (see Exhibit 4). This is reflective of the strong moats built by these firms in India.
- International (non-standalone) business RoCEs of these firms have been sub-par, many at times substantially below cost of capital (see Exhibit 4). This is reflective of the weak moats existing in these international businesses.

**Exhibit 3: Capital allocation towards M&A, as % of standalone operating cash flows over FY02-19**

Name	Capital allocation to non-standalone businesses as a % of standalone op. cash flows (FY02-19)	Examples of M&A transactions
GCPL	106%	Tura group, Africa (2010); Darling, Africa (2012); SON, Africa (2017) etc.
Dabur	24%	Redrock, Dubai (2004); Hobi group, Turkey (2011) etc.
Marico	28%	Enaleni Pharma, Africa (2008); Int. Consumer Corp., Vietnam (2011) etc.
Pidilite	11%	Pulvitech, Brazil (2008); Jupiter, Middle East (2006); Bamco group, Thailand (2008); Cyclo, USA (2007) etc.

Source: Marcellus Investment Managers; Ace Equity; Non-standalone capital employed is calculated as consolidated capital employed less standalone capital employed less investment in subsidiaries

**Exhibit 4: Implied RoCEs of non-standalone business have been lesser than the standalone business for some companies**



Source: Marcellus Investment Managers, Ace Equity; Wherever a firm has written off intangibles directly against reserves, instead of routing them through P&L, we have added back the intangibles to the capital employed – the largest being Marico’s adjustment of Rs723 crores worth of intangibles against reserves in FY14; Standalone RoCE has been calculated after excluding investments in subsidiaries and associates from the capital employed. This adjustment has been made to get a sense of the RoCE generated by the firm’s standalone business BEFORE the effect of capital allocated towards the non-standalone business.

The analysis above highlights the fact that an inorganic growth strategy might not always be the right use of free cash. There might be many reasons for such a strategy to fail. Managing a business in an unknown (or lesser known) overseas geography may require a different organisations structure than what the acquiring company operates with in its home territory. Or the acquisition might stretch management bandwidth and the lack of attention reflects in the business’ performance.

Whatever the reason for the poor RoCEs of acquired business, it is clear that being a consistent compounder isn’t just about earnings high RoCEs, but also about the prudent use of the free cash generated as a result.

This brings us to another aspect of investment analysis in identifying Consistent Compounders that we have found useful – and that is on capital allocation. Whilst it is difficult to precisely forecast future capital allocation decisions of any firm, it helps to build conviction on the capital allocation approach of our different companies by analysing their long term historical track-record of the same – how / why were certain capital allocation decisions taken in the past, what were the learnings subsequently and how has the approach towards capital allocation evolved for the firm.

We have found that Consistent Compounders usually fall in to two categories.

- **Type 1 – Capital redeployed only in core businesses historically:** Firms such as Page Industries and Relaxo Footwears have reinvested on average, 50% and 90% respectively of their annual operating to expand manufacturing capacities in their core operations, enhance IT systems etc. Moreover, every layer of geographical (within India) or product category expansion has been carried out organically in adjacencies which have a significant overlap with their existing core business. For instance, Relaxo has expanded pan-India into sports shoes, various sub-segments of casual footwear, from being just a north-India based manufacturer of flip-flops 2 decades ago. Page started offering only men’s innerwear in the

1990s, and has subsequently expanded into leisurewear, sportswear and outerwear categories for men, women and kids. For such companies, we focus on building conviction on the runway of growth available to the firm's core business, and the ability of the firm to maintain high RoCE on incremental capital deployment in existing core businesses.

- **Type 2 – Learnt from historical experiences around M&A:** Firms like Asian Paints and Dr. Lal Pathlabs are open to doing acquisitions to grow their product portfolio or geographical presence respectively. However, the promoter and management teams of these firms have demonstrated significant caution and restraint in considering such opportunities in the past. They have executed bolt-on acquisitions which do not risk a large part of the firm's capital employed and have been cautious in deploying incremental capital into these acquired businesses. One exception though is a firm like Pidilite, which has had three distinct phases of large-sized M&A transactions in its history (as summarized below). The firm has acknowledged its mistakes, and implemented course-correction subsequently, which gives us conviction on capital allocation discipline likely to be pursued in future.

### Case Study: Pidilite's capital allocation

It is worthwhile to look at Pidilite's capital allocation track record in a little detail to drive home the point of how crucial prudent capital allocation is to long-term consistent compounding.

- **Phase 1 (1999 to 2005)** – Successful domestic M&A: After having spent five decades in establishing a monopoly in white glue (Fevicol), Pidilite started acquiring and building other adhesive and sealant brands to expand its product portfolio, and to extend the firm's channel presence and intermediary influence. The acquisitions included: a) Ranipal in 1999 for Rs 4 crores; b) M-Seal and Dr. Fixit in 2000 for Rs 32 crores; c) Steelgrip in 2002 for Rs 10 crores; and d) Roff in 2005 for an undisclosed amount. Capital deployed towards acquiring these firms was approx. 11% of total operating cash flows generated by Pidilite over this period. Most of these acquisitions have become monopolies in their respective categories by now and have delivered RoCEs substantially higher than cost of capital for Pidilite. Thanks to this phase of expansion, Pidilite has one of the most diversified distribution networks, with its products reaching the customer through multiple channels, including convenience stores (kiranas), hardware stores, paint shops, modern retail outlets, e-commerce, paanwalas as well as stationery shops.
- **Phase 2 (2006 to 2014)** – Unsuccessful international M&A: Pidilite deployed close to ~Rs 685 crores in international acquisitions (26% of operating cash flows over this nine-year period) in Brazil, Middle East, USA and in acquiring an elastomer manufacturing plant in France. Pidilite bought small companies, some of which were operating in unrelated industries, without any market leadership. In countries like Brazil, the acquisitions were faced with an economic collapse in the country, and issues with the legacy management team of the company. Over the past decade, Pidilite has written off ~Rs 175 crores worth of its investments in subsidiaries in Brazil and Middle East, and ~Rs 300 crores of its investments in the elastomer project. The acquisition made in the USA (Cyclo) has been sold off in 2017 for ~Rs 30 crores.

- **Phase 3 (2014 to 2019)** – Successful domestic acquisitions: Having learnt from its mistakes made in the preceding phase of international acquisitions, Pidilite resumed its focus on frequently acquiring smaller domestic competitors in its core business. For example, Bluecoat has been acquired for ~Rs 260 crores (6% of FY14-19 operating cash flows) and Suparshva for an undisclosed consideration. These acquisitions have turned out to be substantially RoCE accretive for Pidilite. The firm has also deployed ~Rs 300 crores over FY14-19 (~7% of operating cash flows and ~2-3% of capital employed over this period) to acquire businesses in adjacent categories (CIPY – floor coatings; Nina and Percept – waterproofing contractors) and has formed JVs with MNCs like ICA for niche products like wood finishes. These businesses have shown significant improvement in financial performance post acquisition. In addition to disciplined capital allocation towards M&A in this phase, Pidilite also announced (and completed) a share buyback of Rs 500 crores in FY18 at Rs 1,000 per share, a 12-13% premium to the prevailing market price. This share buyback amounted to 14% of capital employed and 63% of operating cash flows in FY18.

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## Chapter 4

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### Crushing Risk is the key to Surviving a Crisis

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*Some of the biggest corporate frauds in history have come to light during an economic crisis and a tanking stock market. Drying up of liquidity, and constricted access to capital makes it increasingly difficult for managers to hide the unsustainability of their business or revenue models. To avoid the resulting permanent damage to portfolio values, it is imperative to be cognisant of the risks involved in investing and taking preventive steps to mitigate them.*

#### Traditional investing theories can be detrimental to portfolio returns

The Efficient Markets Hypothesis (EMH), one of the more popular investing theories, contends that since stock prices efficiently discount all the available information in the market, it is impossible to beat the market. On the other hand, there is the Capital Asset Pricing Model (CAPM), which says that it is possible to increase portfolio returns is to increase systemic risk – i.e. buying high beta stocks.

Whilst Warren Buffett's rubbishing of the EMH is well-known ([click here](#)), the CAPM still remains popular, both in classrooms and in practice. The contention that returns are proportional to risk makes many investors invest in products without adequately appreciating the risks involved.

Investors need to minimise four types of risks if they want to generate steady and healthy investment returns in the Indian stock market:

- **Accounting risk:** We all now know how prominent public and private sector banks in India fudged their NPA figures for years on end until the RBI's Asset Quality Review forced them to come clean. The same problem exists with several housing finance companies (who don't come under the RBI's purview). The accounts of a leading cement manufacturer don't stack up. Neither does the annual report of high-flying retailer make sense. Ditto with a prominent petchem company and a prominent pharma company. In fact, many companies in the BSE500 have annual reports which do not pass scrutiny. Using a few accounting ratios and a financial model which contains time series data on 1300 of India's largest listed companies, we seek to identify that 20% of listed Indian companies whose books can be readily relied upon.
- **Top-line risk:** At US\$2,000, India's per capita income is still very low (less than half the level of Sri Lanka and a quarter of the level of South East Asian countries like Thailand and Malaysia). As a result, beyond the basic essentials of life – FMCG products, pharma products, basic apparel – most other products in India are luxury items for most Indians. As a result, even for small cars or entry-level two-wheelers, demand in India fluctuates wildly. E.g. Maruti Suzuki typically experiences 5-6 years of strong demand growth (growth well above 15% per annum) followed by 3-4 years of famine (growth well below 5% per annum). Whilst its cross-cycle average growth tends to be around 12%, the stock price volatility reflects the volatility of Maruti's top-line growth. In contrast, a company selling essential products like Asian Paints or Marico, tends to see steady revenue growth – between 10-20% per annum – pretty much every year. Investing in companies selling essential products in India therefore reduces risk.

- **Bottom-line risk:** As the cost of capital is still pretty high in India, it is rare to find Indian companies who spend heavily on genuine R&D. Understandably therefore, the Indian economy is characterized by rapid imitation – a company spots a niche (say, gold loan finance) and within a decade it has 100 imitators. This rapid new entry squeezes the profitability of the first mover and thus creates risk for its shareholders. In order to reduce such risk, we look for sectors where over extended periods of time, 1 or 2 companies cumulatively account for 80% of the sector’s profit pie. Such monopolies have lower volatility in their profit margin.
- **Liquidity risk:** India is the least liquid of the world’s top ten stock markets largely because promoters own more than half of the shares outstanding. As a result of this, beyond the top 30 odd stocks, liquidity – measured by average daily traded volume (ADV) – drops rapidly. By the time you are in the lower reaches of the BSE100, ADV is well below \$5m per day. Such low liquidity creates stock price gyrations as investors go through their cycles of euphoria and panic. Tilting the portfolio towards liquid stocks reduces this risk.

The advocates of the CAPM argue that investors who take any of the four risks outlined in the preceding section should be rewarded by the market for taking that extra risk. That line of thinking does not work in India.

In the book “Coffee Can Investing: the Low Risk Route to Stupendous Wealth” (2018), it’s been shown that identifying stocks with low accounting, top-line and bottom-line risks, using a simple quantitative filter (double-digit revenue growth and over 15% RoCE every year for ten years in a row) consistently generates returns in the vicinity of 20% p.a. with half the volatility of the Nifty. Even without adjusting for risk (volatility), you are far better off investing in this portfolio rather than in the Nifty. In fact, you are far better off investing in this portfolio relative to almost every other asset class in India (including real estate, private equity and government bonds). You do NOT have to take extra risk in India (or load up on beta) to get healthy returns.

Why does this simple filter-based approach to creating a CCP work so consistently? Because the CCP basically seeks to minimise the four risks outlined in the preceding section. If a company is able to grow revenues at double digits every year for ten consecutive years, it is almost certainly selling an essential product which will be in demand in both economic booms and busts. Secondly, if a company is able to generate ROCE above 15% every year for ten consecutive years, it is highly likely to be a dominant/moated franchise. (The vast majority of the Nifty companies have not generated an RoCE of 15% even once in the past ten years.)

It makes imminently more sense to crush risk rather than embracing unwarranted risk.

### Crises expose corporate frauds

*“In many ways, capital markets are designed to circulate good news. Financial services firms...typically make more money when share prices rise. Corporate issuers are incentivized to announce good news...and investors to believe it. This dynamic is part of what occasionally creates asset bubbles and boom/bust cycles. Investors who remain objective and sceptical, while the herds echo and amplify each other’s excitement, have a better chance of profiting from the more blatant disconnects from reality.” – Howard Schilit, Financial Shenanigans (2018)*

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The risks highlighted above assume critical importance during a crisis. The most spectacular accounting frauds usually come to light when the stock market is tanking and the access to capital starts drying up. For example, Satyam Computers imploded in January 2009, four months after the Lehman Bros bust triggered a liquidity freeze in India; the Enron scandal came to light in October 2001, 15 months after the dotcom bust and a month after 9/11 had pushed the US stock market further into the mire; WorldCom filed for bankruptcy in July 2002 after having cooked its books frenetically in the wake of the dotcom bust; and Bernie Madoff confessed to his sons in December 2008 – three months after Lehman went under – that his wealth management scheme was in reality a massive Ponzi scheme.

This happens for three reasons. Firstly, the central driver of accounting fraud is the promoter's need/desire to siphon cash out of the company. When liquidity is easily available, he can either cover his tracks by borrowing money in his own name and infusing it in the company (say, through short-term loans) or the company itself can avail of short-term loans. The surfeit of liquidity sloshing around the company creates an impression that everything is alright. However, when liquidity tightens, these short-term loans dry up and staff/suppliers/creditors raise the alarm that the company is out of cash. By then, the promoter has taken typically flight.

Secondly, the money that the promoter borrows is usually collateralised by either his properties or his shares. A liquidity crunch typically hits the value of both of these asset classes. That in turn leads lenders to issue margin calls to promoters. Thus, the promoter – who has already pilfered money from his listed entity – now finds himself being chased by his lenders. It wasn't a coincidence we think that two prominent Indian jewellers took flight six months after wholesale money market rates started rising in India (from August 2017 onwards). Unless a miracle shores up the value of real estate and shares in India, we should expect more promoters to take flight rather than taking the trouble to meet margin calls.

Thirdly, in a growing economy, corporates can show genuine growth in revenues and hence justify the growing working capital needs. Hence in a booming economy everyone – shareholders, auditors, lenders – buys the logic of rising short term borrowing to finance working capital needs (even though the actual driver of higher borrowing might be the promoter's pilferage of cash). When the economy then slows – in the wake of rising interest rates – that fig leaf is removed. The auditors, with their professional reputation on the line, now become less willing to sign off on growing pile of receivables. Given that from 2018 onwards, the Ministry of Corporate Affairs has oversight of the audit profession in India, we expect an increasing number of auditors to pull the plug on promoters who are cooking the books.

### **The importance of accounting quality**

*“It has been far safer to steal large sums with a pen than small sums with a gun” – Warren Buffet*

The annual churn in the BSE500 Index is as high as 12% p.a. – 60 new companies become part of the Index every year, replacing 60 incumbents. This high churn ratio signifies that most existing incumbents are unable to sustain their place in the index and, over the course of time, make way for more deserving candidates. A closer analysis of the stocks exiting the BSE500 over the last 5

to 10 years indicate that most exits had little to do with business downturns but were mainly due to corporate governance/accounting lapses and capital misallocations at these firms.

**Exhibit 5: High churn in BSE500, with many Index constituents seeing enormous market cap erosion**

BSE 500 constituents			Distribution of Returns (CAGR over Dec '09-'19)			
As of Dec, 2009	Of which, exited by Dec 2019	Remaining as of Dec 2019	> 15%	0% to 15%	0% to (-) 15%	< (-) 15%
500	226 (45% of total)	274	83	146	101	136
	Of these, 34 exited due to corporate actions	55% of total	Only 46 delivered over 20% CAGR			Nearly 109 lost over 20% and many ceased to exist

Source: Marcellus Investment Managers, Ace Equity

If one were to look at BSE500 as it stood in December 2009, out of the total 500 member stocks then, only 274 stocks continue to remain in the index. In other words, nearly 45% of the stocks have exited the index over the last ten years. On their way out, most of these stocks saw significant erosion in their shareholders' wealth (on an average, the companies which exited the index have lost 40% of their December 2009 market cap). Hence, for every Bajaj Finance and Eicher Motors which significantly enriched their investors, there has been an Educomp and Lanco Infratech which left their minority shareholders high and dry.

While the number of companies which have generated enormous wealth for their shareholders are bound to be a handful, the number of companies which have destroyed shareholders' wealth would be much more. Hence, the ability to stay away from dubious names is equally if not more important than the ability to discover a great company.

**Marcellus' forensic framework to evaluate accounting quality**

Evaluating the accounting quality of a company is a cornerstone of the investment at Marcellus. We have developed a set of 12 financial ratios that help us grade companies on their accounting quality. The selection of these ratios has been inspired by Howard M. Schilit's legendary book on forensic accounting, "Financial Shenanigans" (first published in 1993 and currently in its fourth edition).

The book draws upon case studies of accounting frauds, including not just well-known cases such as Enron and WorldCom but also as numerous lesser known instances of accounting trickery. The author then goes to draw lessons from these cases to create techniques for detecting misreporting and frauds in financial statements.

The 12 forensic accounting ratios we use cover the balance sheet (correct representation of assets/liabilities), income statement (revenue/earnings manipulation), cash flows and audit quality checks.

Exhibit 6 elaborates on a few of these ratios. We look at the historical consolidated financial statements for the universe of firms. We first rank stocks on each of the twelve ratios and give a final decile-based pecking order on accounting quality for stocks. The top 7 deciles are generally indicative of a company with good accounting quality/practices – these are in what we



call, the ‘Zone of Quality’ whereas the bottom 30% generally represent companies with questionable accounting practices – we call this the ‘Zone of Thuggery’.

**Exhibit 6: Accounting ratios used by Marcellus to evaluate accounting quality**

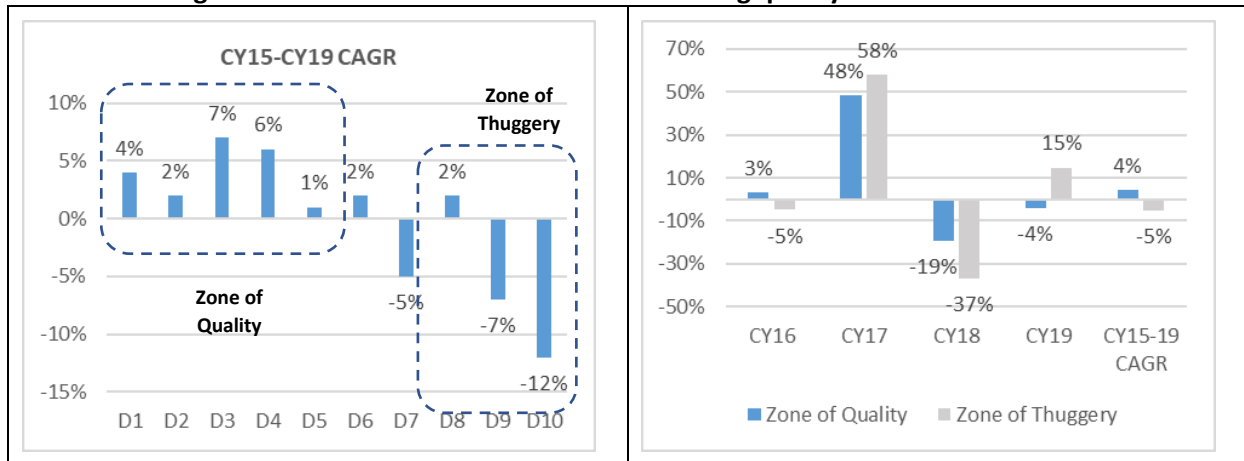
Category	Ratios	Rationale
Income statement checks	Cashflow from operations (CFO) as % of EBITDA	To check aggressive revenue and earning recognition practices
	Provisioning for debtors	To check aggressive provisioning policies
Balance sheet checks	Yield on cash and cash equivalents	To check cash balance misstatement or cash mis-utilisation
	Contingent liabilities as % of Net worth (for the latest available year)	Indicative of the extent of off-balance sheet risk
Cash theft checks	CWIP to gross block	High ratio would indicate unsubstantiated capex
Auditor checks	Growth in auditors' remuneration to growth in revenues	Faster growth in auditors' remuneration vis-à-vis company's operations raises concerns surrounding auditors' objectivity

Source: Marcellus Investment Managers

**Our forensic framework has proven to be an effective predictive tool**

Over the longer term, there has been a strong correlation between the accounting quality as suggested by our forensic model and the shareholders returns. For instance, the ‘Zone of quality’ has outperformed the ‘Zone of thuggery’ by a whopping 9% p.a. over CY16-19.

**Exhibit 7: Strong correlation between returns and accounting quality**



Source: Marcellus Investment Managers; Ace Equity

There is another way to understand the effectiveness of this forensic model – there are around ~53 companies (out of the BSE 500) which constantly featured in D8 to D10 rankings in our accounting model for the years FY2015-18. Over CY16-19, these companies have on an average delivered negative CAGR of 13% compared to benchmark BSE 500’s 10% i.e. an underperformance of nearly 23% p.a.

## Beyond the forensic screens

Our forensic framework helps us to weed out companies with dubious accounting quality. It also helps us identify the key accounting red flags for a company. However, our quest for accounting quality does not end there. There are several qualitative aspects of accounting and corporate governance which our forensic model may not be able to pick up due to lack of data uniformity across companies or where there are subjective judgements involved. Such areas can only be evaluated through a deep dive into historical financial statements and primary data checks around management integrity.

We have developed the following checklist for further accounting and corporate governance checks beyond the forensic model. This checklist forms an essential part of the qualitative assessment of stocks.

### Exhibit 8: Forensic accounting and corporate governance checks

Further Accounting checks	Corporate governance checks
Comparative common-sized income statement vs peers to analyse any significant divergence in key expense items vs peers	Related party transactions and its significance
Comparative Dupont analysis vs peers	Other business interests of promoters (any significant stress in those business, how is it getting funded etc)
R&D capitalisation vs charge to P&L	M&A with promoter owned entities
Goodwill as % of Net worth	Significant litigation surrounding the promoters
Frequent changes in auditors	Promoter family structure, succession, disputes etc.
Any significant adverse comment in the auditor's report	Pledge of promoter shareholding
Any significant portion of company's operations (such as subsidiaries) not audited by the principal statutory auditor	Insider buying and selling
Quality of audit committee (whether dominated and chaired by an independent director)	Remuneration to promoters
Frequent changes in accounting periods	Frequency and necessity of Equity Dilution

Source: Marcellus Investment Managers

## Case study – Amtek Auto

We produce below our first-hand experience of analysing Amtek Auto's financial statements a few years ago. The stock looked extremely cheap on valuation multiples with very high margin profile but a very weak balance sheet. Our analysis pointed towards multiple glaring issues in its financials. We went on to be proved right on most of these things.

**Exhibit 9: Amtek Auto's financials raised multiple red flags**

Area	Remarks
Much higher working capital days vs peers	Amtek Auto's working capital days were significantly ahead of peers (such as Bharat Forge and Mahindra CIE) averaging 148 days over FY11-14 vs just 38 days for Bharat Forge and 14 days for Mahindra CIE.
Significantly higher margin vs Bharat Forge	Amtek Auto's standalone EBITDA margin averaged ~29% over FY12-14 higher than Bharat Forge's 24% over the same period. Amtek Auto's margin premium over Bharat Forge appeared unjustified particularly given latter's better product profile (high tonnage CV forgings, higher exports share), market leadership and higher margin non-auto revenues. This raised concerns over earnings recognition practice and quality.
Lower depreciation rate vs peers	Amtek's standalone depreciation rate over FY12-15 averaged 4.5% vs Bharat Forge's 6.6% and Mahindra CIE's 8.3%. This was particularly worrying given Amtek's gross block turnover vs peers.
Significantly lower gross block turnover/high capex levels	At the standalone level, Amtek generated average gross block turnover of 0.41x over FY13-15 vs Bharat Forge's 0.99x and Mahindra CIE's 1.5x. At the same time, Amtek Auto's capex totalled Rs74bn over FY12-15 - but revenues increased by only Rs14bn over the same period.
Consistently negative Free cash flow and unsustainable debt levels	Amtek never generated any positive free cash flow from FY08-15. Cumulative consolidated CFO generated over FY08-15 was Rs99bn but capex (Rs227bn) and investment in subsidiaries Rs14.2bn resulted in massive negative free cash and consequent increase in debt levels (Amtek's debt-equity at FY15 had shot up to 2.2x by September 2015-end).
Quality of auditor	Amtek's accounts were audited by a small unknown Delhi based firm, for several years.
Group structure	The group had several companies engaged into auto ancillary business which included a couple of listed companies besides Amtek Auto. This created conflicts of interests between these companies. Besides the holding structure of the group was complicated with several investment holding companies in the link to owning the ultimate operating companies.
Related party transactions	The company had strangely NO disclosure of related parties at the consolidated level. At the standalone level, loan/advance given to related entities (the financials did not specify the exact name of the party to whom loan given) accounted for nearly 25% of standalone net worth at September 2015-end.

Source: Marcellus Investment Managers

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## Chapter 5

### Why Consistent Compounders are the best bet in a crisis?

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***A portfolio of Consistent Compounders offers the most optimised risk-reward for an investor in the Indian markets – healthy returns with the volatility close to that of a government bond. This makes them an investment for all seasons, and more so in times of market stress and crisis where investors are especially worried about large drawdowns in their portfolios. Consistent Compounders not only fall less in a crisis, but also recover much sooner and sharper.***

*“Only when the tide goes out do you discover who’s been swimming naked’. This insight from Warren Buffett has repeatedly proven to be correct when it comes to investing in stocks. When the broader market is undergoing a euphoric or bullish phase, most stocks do well regardless of the quality of their underlying fundamentals. However, when the euphoria ends, stocks with poor underlying fundamentals are decimated, leading to significant capital erosion for investors who did not adequately understand the weak fundamentals of their portfolio companies.” – from ‘Coffee Can Investing: The low risk route to stupendous wealth’ (2018) by Rakshit Ranjan, Saurabh Mukherjea & Pranab Uniyal.*

Investors desire not just healthy returns on their portfolio, but also for the returns to be steady or consistent. Most of all, no one likes large drawdowns (declines) in their portfolios. However, when the broad markets decline during a crisis, it is rare for a portfolio of stocks not to do so. A sharp fall in stock prices often leads to panic among investors and they end up selling their holdings at or near market bottoms. Unless an investor is extremely lucky, it is nearly impossible to exactly time the market and exit at a pre-crisis peak to avoid the heartburn of large drawdowns and then buy at a post-crisis bottom to maximise returns from the rally that follows.

It is here that Consistent Compounders emerge as the best allies of an investor. Not only does a portfolio of Consistent Compounders fall less during a crisis, it also recovers sooner and sharper on the other side of the crisis.

#### **Why Consistent Compounders are the best bet in a crisis?**

In simple terms, the stock price can be expressed as a function of two variables – the P/E valuation multiple and Earnings. The P/E is a function of many factors external to the company (macroeconomic variables, political uncertainty, global commodity market trends, geopolitical dynamics etc.) as well as factors internal to a company (expectations of future earnings growth sustainability). The external factors are nearly impossible to predict and by extension, so is their impact on the earnings multiple of a stock. Therefore, at a time when market P/E compresses due to external factors, individual stock prices take a hit too. But for a company with strong fundamentals, the impact is limited due to its strong earnings growth (which offsets the P/E compression) as well as the longevity of these earnings (which restricts the P/E compression). As we have seen earlier, such strong fundamentals are the essence of consistent compounders.

Taking the case of Asian Paints as an example. In FY03 and FY16 (see Exhibit 10), Asian Paints managed to maintain healthy earnings growth even in a disruptive external environment. Hence,

the ripple effect of a stressed stock market's P/E multiple de-rating was more than offset by Asian Paints' earnings growth during the same period. In FY12, Asian Paints' P/E multiple expanded by 9% with an EPS growth of 17%, in a year when the Sensex's P/E multiple deflated by 16% and Sensex's earnings grew by 6%.

**Exhibit 10: Drivers of Asian Paints share price returns in years when Sensex reported a decline**

	FY03	FY16	FY12
Asian Paint's EPS growth	31%	25%	17%
Asian Paint's P/E rerating	-23%	-14%	9%
Asian Paint's share price growth	1%	7%	28%
Sensex EPS growth	13%	-10%	6%
Sensex P/E rerating	-22%	1%	-16%
Sensex share price growth	-12%	-9%	-10%

Source: Marcellus Investment Managers, Ace Equity

The observations for Asian Paints hold true for all Consistent Compounders. As seen in Exhibit 11, Consistent Compounders not only give returns in absolute terms as well as relative to the broader market, they do so on a steady basis over long periods of time.

**Exhibit 11: Stock prices of Consistent Compounders have been remarkably resilient over 20 years**

Analysis for the 20-year period '99-19	Sensex	Asian Paints	HDFC Bank	Pidilite	Marico	Relaxo
Share price CAGR - 20 years (1999-2019)	12%	28%	29%	27%	20%	38%
Number of years when the stock delivered...						
– A positive return	14	18	17	16	16	16
– Positive return when Sensex was negative	-	4	3	2	4	3
– Negative return when Sensex was positive	-	0	0	0	2	1
– Over 20% absolute return	5	13	14	11	10	12

Source: Marcellus Investment Managers, Ace Equity

Even during periods of a wider economic or financial system crisis, Consistent Compounders tend to sustain their fundamental strengths and their stocks fall less and recover sooner and sharper after the stock market crisis. In most cases, these companies emerge stronger from a crisis. A portfolio of Consistent Compounders thus addresses the investor's worry of large drawdowns in her portfolio in times of a crisis.

**Exhibit 12: Impact of timing entry into Sensex and CCP during 2008 crash**

Investment type*	Entry price	Exit price (10 yrs later) ***	Performance (CAGR)
SENSEX (Pre 2008 crash)	100	165	5%
SENSEX (bottom of the crash)	39	165	16%
CCP (Pre 2008 crash **)	100	483	17%
CCP (bottom of the crash **)	75	483	20%

Source: Marcellus Investment Managers; \*Date of pre-crash = 7th Jan'08 & Date of bottom of the crash = 9th Mar'09; \*\*Equal weighted portfolio of six companies: HDFC Bank, Asian Paints, Cipla, HDFC Ltd, Hero Motocorp and Infosys; \*\*\*Date of exit price = 7th Jan'18

During the global financial crisis of 2008-09, the BSE Sensex declined by 61% over the period January 2008 to March 2009. As against this, the average drawdown of all Large-cap CCP portfolios constructed based on principles laid out in Coffee Can Investing: The low risk route to stupendous wealth' (2018) (refer to 'Maximum drawdown' of 'Large-cap CCP' portfolios which were active during the 2008 crash i.e. portfolios shown from Exhibit 90 and Exhibit 111 of the book) was **only 35%**. Some of the most common stocks amongst these active Large-cap CCP portfolios from the book 'Coffee Can Investing' included HDFC Bank, Asian Paints, Cipla, HDFC Ltd, Hero Motocorp and Infosys. An equal weighted portfolio (let's call it the Consistent Compounders portfolio) of these six stocks, for instance, fell by only 25% between January 2008 and March 2009.

Now let's analyse the data shown in Exhibit 12 above, to quantify the benefit / futility of timing entry at the bottom of the stock market crash of 2008, for investment in Sensex vs the Consistent Compounders portfolio.

Entry into a mediocre quality stock/portfolio just before the 2008 crash delivered a meagre 5% CAGR over the next decade, in-line with weak earnings growth potential of the underlying asset as well as a compression in the valuation multiples for the stocks as a reflection of deteriorating fundamentals due to the crisis. However, if an entry in the mediocre portfolio was timed exactly at the bottom of the crash, the 10-year CAGR achieved would have increased to 16%! The difference between 5% (without timing) and 16% (with perfect timing) is not only large, it also changes the relevance of compounding for such a portfolio consisting of mediocre stocks. At a 5% CAGR, an investor is perhaps not even beating inflation in his cost of living. However, at 16% CAGR, the investor would have created substantial wealth over a ten-year period.

On the other hand, timing entry / exit from the Consistent Compounders portfolio (as shown in Exhibit 12) during the global financial crisis does not materially change the decadal returns. The returns for the Consistent Compounders portfolio increase from an already healthy 17% to 20% if entry into such a portfolio is perfectly timed at the bottom of the stock market crash. Hence, the conclusion that emerges from Exhibit 12 is that Resilience of the Consistent Compounders portfolio makes timing of entry and exit redundant. Meaning that staying invested in a portfolio of Consistent Compounder stocks eliminates the need to time the buying or selling of stocks to avoid large drawdowns in a portfolio.

The resilience of companies with strong fundamentals in a crisis is evident from the performance of Marcellus' Consistent Compounders Portfolio through the recent market meltdown led by the Covid-19 pandemic. As seen in Exhibit 13, the portfolio has delivered a positive absolute return of 7.6% over the past 12 months, unlike the -25.0% return of Nifty 50 over the same period. And this holds true when we back-test returns for a portfolio of CCP companies.

**Exhibit 13: Marcellus' Consistent Compounders Portfolio has been resilient in the Covid-19 crisis**

	FY20	Q4FY20
Marcellus CCP	7.6%	-12.9%
Nifty 50	-25.0%	-29.1%
Difference	32.7%	16.2%

Source: Marcellus Investment Managers

Even on the way up, CCP portfolios recover much sooner and sharper compared to the broader stock market. After a 14-month long fall in the stock market during the 2008 global financial crisis, the market bottomed out on 9th March 2009. As shown in Exhibit 14, CCP stocks recovered back to their pre-crash levels much sooner compared to a long drawn 20-months recovery period for the Nifty 50.

**Exhibit 14: Consistent Compounders recover sooner, and sharper compared to the broader market**

CCP 2007	% fall between Jan'08 to Mar'09	Time to recovery (in months)
Asian Paints	-41%	4
Cipla	-5%	1
HDFC bank	-52%	7
HDFC Ltd.	-60%	18
Infosys	-27%	3
Hero Motocorp.	+35%	N.A.
<b>SENSEX</b>	<b>-61%</b>	<b>20</b>

Source: Marcellus Investment Managers, Ace Equity

As explained earlier, this rapid recovery in share prices of CCP portfolios after the market has bottomed out is because of a combination of the following factors:

- CCP companies might strengthen their fundamentals during such crisis and come out stronger on the other side of the crisis
- Before the stock market crash, share price performance of CCP companies is fully supported by their earnings and fundamentals.

In addition to the challenges highlighted in Exhibit 12 and Exhibit 14 above, an investor trying to time entry / exit during a stock market crash will also incur costs involved around a) risk of getting the timing wrong; b) transaction costs; and c) intense focus on share prices rather than on fundamental research (or your day job) during such times of stock market crash.

**What do Consistent Compounders do differently during a crisis? A look at non-financial companies in the ongoing Covid-19 crisis**

The Consistent Compounder companies sell products and services which are small ticket, day-to-day essentials consumed by Indian middle-class households. Unlike spends on tourism / entertainment / leisure / luxury categories, demand for products and services of our portfolio companies is highly utility oriented and hence cannot be cancelled easily. For instance: a) you cannot defer the purchase of packaged foods like baby milk, Covid tests, essential medicines etc; b) you can delay by few weeks, the purchase of innerwear, footwear, diagnostic tests, etc; and c) you can delay by few months, the repainting or furniture repair in your home. Moreover, no matter how our lifestyle changes after such a crisis, habits and consumption patterns of these products are not likely to change or get substituted in the foreseeable future.

So, what do Consistent Compounders do differently?

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- **Support offered to channel partners:** Addressing the concerns of and managing the interests of the network of distributors and other partners in the supply chain in mind is a common trait among Consistent Compounders. For example, during a crisis like demonetization or the ongoing Covid crisis, Page extends an extra 60 days of credit to distributors. Such support from Page helps strengthen the firm’s relationship with their channel over the longer term”. What is so unique about this? Page’s competitive advantages have allowed it to build a strong balance sheet, which can support a short-to-medium term pressure on working capital due to an extended credit period. Most of its competitors cannot as their RoCEs remain close to their CoC and hence restrict the business’ ability to generate sufficient free cash to build a resilient balance sheet. Another such example is of Dr. Lal Pathlabs, where the firm helps their franchisees by trying to renegotiate downwards rentals for collection centres’ laboratories.
  - **Potential benefits of in-house labour force:** Footwear and innerwear are the two most labour-intensive manufacturing industries. Relaxo and Page not only do their manufacturing in-house (no outsourced manufacturing), but they do so with a full-time permanent workforce (no contract labour). On a normal day, this helps these companies maintain quality of their products, but in crisis it makes it easier for them resume normalcy in their manufacturing setups much sooner than that of their competitors, who rely on contract labour and can take time in mobilizing the required workforce.
  - **Benefits of owning / controlling the supply chain:** Once a crisis that affects operations abates, supply chains of different companies come back to normalcy at different speeds. For instance, distributor-based supply chains will come back sooner than wholesaler-based supply chains due to the unorganized/indirect nature and greater stress on working capital of a wholesaler vs a distributor. Firms which have fewer layers in their channel compared to others will get back to normalcy quicker. Firms like Page Industries and Relaxo are unique relative to their competitors due to their reliance only on distributors rather than wholesalers. Others like Pidilite and Nestle have a greater proportion of direct distributors compared to their competitors who are more dependent indirect distribution channels. Firms like Asian Paints and Berger do NOT have any channel partners in their supply chain barring the paint dealers on the high street. Dr. Lal Pathlabs, with its B2C business model (direct control on franchisees, lab technicians and equipment used by these lab technicians) will be better placed than competitors like Thyrocare which are more B2B in nature and do not such direct control on their supply chain infrastructure.
  - **Market share shift from unorganized to organized players, and from small/weak players to large/stronger players:** Crises bring out the evolutionary equivalent of business, where the fittest or strongest businesses survive and the weak get weaker. Several Consistent Compounders have been massive beneficiaries of events like demonetization and GST implementation due to the shift of market share from unorganized to organized players after these events. And in all likelihood, such shifts will continue with every business disruption, be it the Covid-19 pandemic, or other domestic or global calamities that may come in the future. The opportunity to consolidate market share will be most seen in industries like footwear, paints, innerwear, packaged foods, adhesives where the competition tail is long.



- **Utilise benefits from the recent corporate tax rate cuts to suffocate competition:** Consistent Compounders have been the biggest beneficiaries in their respective industries, of the corporate tax rate cuts announced in 2019. At a time when competitors struggle due to the cash flow implications of the ongoing crisis on their balance sheet, the incremental cash flow available to Consistent Compounders from tax rate cuts is likely to be used to gain market share through product price cuts, higher employee benefits, accelerated capex, support to channel partners and vendors, etc.

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## Chapter 6

### CCP Lenders Gain from A Crisis

*The lending business is, by its very nature, cyclical in nature and tends to be widely impacted in times of an economic crisis. However, the scale of the impact, and the post-crisis recovery vastly vary between lenders. High-quality lenders, through prudent underwriting, are able to contain their non-performing assets during a crisis and with their ability to access capital, are able to bounce back sharper and quicker than peers.*

#### Lessons from historical financial crises

As highlighted in Exhibit 15, a few years of high loan book growth, low NPAs and economic boom are inevitably followed by low credit growth, high NPAs and recessionary fears. Good quality banks and NBFCs manoeuvre through these economic and financial cycles with razor-sharp focus on capital allocation, execution and underwriting and they do not get swayed by the emotions of greed and fear.

**Exhibit 15: Financial and economic cycles over the years**

Banking Sector				
Financial Year	Advances growth (%)	Gross NPAs (%)	Economic environment	Comments
97-98	17%	14%	Crisis	CRB Capital goes bust, hundreds of NBFCs shut down
98-99	13%	15%		
99-00	19%	13%		
00-01	18%	11%		
01-02	22%	10%	Recovery	As economy recovers CCP lenders rapidly gain market share
02-03	14%	9%		
03-04	16%	7%		
04-05	29%	5%	Boom	Phase of high growth and low NPAs – all lenders flourish
05-06	32%	3%		
06-07	30%	3%		
07-08	25%	2%		
08-09	21%	2%		
09-10	8%	3%	Crisis	GFC – poor quality lenders suffer most
10-11	22%	2%		
11-12	16%	3%	Recovery	As economy recovers CCP lenders rapidly gain market share
12-13	28%	3%		
13-14	15%	4%		
14-15	10%	4%	Boom	Cycles of crisis, recovery and boom keep repeating
15-16	8%	8%		
16-17	4%	9%		
17-18	9%	11%	Crisis	
18-19	13%	9%		

Source: Marcellus Investment Managers, RBI

Three key metrics are essential to the success of a lending business – their loan book growth, their Net Interest Margins and their Non-Performing Assets ratio. Good quality lenders aim to

keep these ratios in a calibrated range, avoiding excesses during a boom, which can prove disastrous in a crisis. But what do great lenders really do, and how do they do it? Let us see two examples of how financial institutions navigated a crisis in the past and what makes them Consistent Compounders in the lending business.

### Case Study: HDFC Ltd. during the NBFC crisis of the late 1990s and early 2000s

The Indian NBFC crisis in the 1990s was marred by fraudulent behaviour of large NBFCs, changing regulations, and eventually a shakeout in the NBFC sector. In 1997-98, CRB Capital, a financial Services conglomerate with a net worth of over Rs. 400 Cr and an asset base of Rs. 1,000 Cr (this was as big as ~15% of HDFC Limited's loan book size then), which was even granted a provisional banking licence, duped millions of small investors of their investments in its mutual fund and in its fixed deposits.

Even though CRB had a AAA credit rating (just like IL&FS did before the ongoing crisis started), the auditors never pointed out any problems and CRB had 133 subsidiaries before the crisis. As the crisis deepened, the Government infused Rs. 2,550 Cr into three public sector banks, IFCI had to be bailed out with a Rs. 1,000 Cr package, NPAs of IDBI increased to 18% and Global Trust Bank's net worth turned negative (it had to be eventually merged with the Oriental Bank of Commerce). Subsequently, as the RBI tightened NBFC regulations, the number of NBFCs dropped to 7,855 in March 1999 from 55,995 in March 1995 i.e. over 80% of the NBFCs were shut down.

Exhibit 16 shows how HDFC Ltd. reported an increase in GNPA's (Gross NPAs) by ~50% i.e. from 0.7% in FY98 to 1% in FY99. Growth in PAT and loan book moderated, and the P/E ratio compressed by ~40% in FY99. However, after the crisis, HDFC Ltd.'s loan book growth accelerated from 18% in FY99 to 31% in FY01 and 30% in FY02, and its PAT growth went back to over 20% CAGR after the crisis, from as low as 14% during the crisis. As a result, despite a 40% cut in its P/E multiple in FY99, over the five year period from March 1998 to March 2003, HDFC Ltd. delivered a share price CAGR of +16%, while the Sensex delivered a -5% CAGR (negative) during the same period.

**Exhibit 16: Performance of HDFC Ltd. during the NBFC crisis of the late 1990s**

Financial metric	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04
PAT growth%	34%	27%	18%	14%	20%	18%	22%	19%	23%
Loan book growth (%)	27%	20%	<b>22%</b>	<b>18%</b>	22%	31%	30%	26%	29%
NIM (%)	3.3%	3.7%	<b>3.0%</b>	<b>2.4%</b>	2.2%	2.4%	2.8%	3.0%	3.2%
GNPA (%)	-	0.5%	<b>0.7%</b>	<b>1.0%</b>	0.9%	0.8%	0.9%	1.0%	1.2%
P/E ratio	20.1	13.6	<b>13.1</b>	<b>8.1</b>	11.3	13.8	14.4	11.7	18.7
RoE (%)	17%	16%	17%	18%	20%	21%	23%	24%	27%

Source: Marcellus Investment Managers, Ace Equity

### Case Study: HDFC Bank during the 2008-09 global financial crisis

During the 2008-09 crisis, Indian NBFCs had a massive ALM mismatch (asset-liability-management) – over 50% of the NBFCs had borrowings which matured within one year while average asset duration was 3 years. Disbursements for several NBFCs were down by 50-70% due

to lack of funds. In September 2008, NBFCs' borrowings from mutual funds had increased to 45% of total borrowings vs. 30% in March 2006. ICICI Bank, the largest private sector bank at that time, saw large delinquencies on its retail book – GNPA's for ICICI Bank rose 100bps from 3.3% in FY08 to 4.3% in FY09. Immediately after the Lehman crisis subsided, as part of its attempt to deal with inflation, the RBI changed the policy rate a record 13 times between Apr'10 and Oct'11, increasing it from 3.25% to 8.50% during the period.

In an uncertain and volatile environment with the lending system afflicted by rising NPAs, HDFC Bank continued to cautiously grow its retail loan book. HDFC Bank suffered the same fate as HDFC Ltd. in the previous crisis: its NPAs as a % of loan book increased by ~50% and P/E ratio compressed by ~40% in FY09 (see Exhibit 17). Then, in the years following the crisis, HDFC Bank was able to rapidly gain market share and its asset quality became better than the pre-crisis years. As competition reduced, yields increased and HDFC Bank was able to offset the asset quality risk with better pricing. PAT growth was sustained at ~30% CAGR both before as well as after the crisis. As a result, despite a 40% cut in its P/E multiple in FY09, over the five year period of Mar'08 to Mar'13, HDFC Bank delivered a share price CAGR of +26%, while the Sensex delivered a +4% CAGR during the same period.

**Exhibit 17: Performance of HDFC Bank during the 2008-09 global financial crisis**

Financial metric	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
PAT growth (%)	31%	31%	39%	41%	31%	33%	32%	30%	26%
Loan book growth (%)	37%	34%	35%	56%	27%	27%	22%	23%	26%
NIM (%)	3.6%	4.0%	4.1%	4.2%	3.9%	4.1%	4.1%	4.2%	4.0%
GNPA (%)	1.5%	1.4%	<b>1.4%</b>	<b>2.0%</b>	1.4%	1.1%	1.0%	1.0%	1.0%
P/E ratio	27.8	26.6	<b>29.4</b>	<b>18.3</b>	30	27.8	23.6	22.1	21.2
RoE (%)	16%	19%	18%	17%	17%	17%	19%	21%	19%

Source: Marcellus Investment Managers, Ace Equity; Note: Adjusting for the CBOP merger, FY09 PAT growth would have been 34% and advances growth would have been 38%

## What differentiates Consistent Compounders in the lending business from their competitors?

*“With little differentiation in finished products (loans and services) and no aspirational value attached to these products, low raw material cost (as measured by the cost of funds) and superior execution are the only two key competitive advantages for a top-quality retail bank. Moreover, a hugely leveraged balance sheet (10x leverage is normal for banks) means that below-par credit selection usually has a disproportionately large adverse impact on the bank’s profitability.” - ‘The Unusual Billionaires’ by Saurabh Mukherjea (2016) – (see chapter 7 on HDFC Bank).*

Apart from having their own individual strengths, the common factors that differentiates a great lender from competition are:

- Prudent credit underwriting: During good times, poor quality lenders usually relax their credit underwriting norms, aggressively foray into new products, rapidly expand to newer geographies and have a focus on the P&L rather than on the balance sheet. On the other

hand, good quality lenders tend to be consistent in their underwriting standards. For example, HDFC Bank's competitors had aggressively forayed into retail loans during the high growth period of 2005-07 (pre global financial crisis of 2008-09). On the other hand, HDFC Bank had held back and stuck to its stringent processes at the cost of growth in the short term. Further, HDFC Bank usually tests a new product on a small set of existing customers, then offers it to all eligible existing customers and only then is it widely launched to outside customers. This enables it to modify its credit processes based on the initial underwriting experience and then grow with much lower risk. Following this calibrated approach over long periods of time has held HDFC Bank in good stead across the multiple credit cycles that India has seen.

- **Management teams with an innate sense of capital allocation:** Lending businesses are necessarily highly leveraged businesses with a high reinvestment rate. This unique characteristic of financial businesses further amplifies the impact of capital allocation decisions made by the CEOs of these organisations. Good capital allocation can lead extraordinary results while poor decisions can pose an existential threat to a bank or NBFC. To cite an example of a CCP lender, Kotak Mahindra Bank (KMB) has shown admirable capital allocation skills, whether it is in terms of distributing dividends, acquisitions, entering into joint ventures, buying stakes of JV partners or timing of QIPs. KMB's capital allocation skills are best reflected in their dividend policy. KMB has had an average dividend pay-out ratio (i.e. % of profits paid out as dividends) of 2.9% over the last decade (FY09 to FY19). Since capital is the raw material of a financial services business, rather than distributing it as dividends, KMB has redeployed capital and generated an average return on equity of 14.5% on that capital over FY09 to FY19. As a result of the bank being able to redeploy 97% of its profits and consistently earn a decent RoE on it, KMB's EPS grew at a ~23% CAGR during this time. This EPS growth has played a key role KMB's share price growing at a CAGR of 34% over FY09-19.
- **Disciplined asset-liability management:** Bajaj Finance excels at asset-liability management, a critical issue for NBFCs. BAF is one of the only Indian NBFCs that has longer-dated liabilities (borrowings etc.) and short-dated assets (loans). Most NBFCs end up doing the exact opposite – a very high risk when liquidity dries up in a crisis. Over F12-19 only ~8% of BAF's liabilities were in the form of short-term borrowings. This insulates BAF in times of a crisis when short term rates usually spike.

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## Chapter 7

### The futility of timing

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***Investing in a portfolio of consistent compounders makes the timing of entry and exit redundant. We show that trying to finetune the purchase price of a stock is not worth the time and effort. The reason for the same is that stock price movements are largely driven by growth in earnings and hence for healthy long-term returns, what is most important is the assessment of the long-term earnings potential of a business.***

#### **Investing in Consistent Compounders makes timing redundant**

*“I can’t recall ever once having seen the name of a market timer on Forbes’ annual list of the richest people in the world. If it were truly possible to predict corrections, you’d think somebody would have made billions by doing it.” – Peter Lynch*

In this handbook on investing through a crisis, our discussion so far has largely revolved around assessing a company’s core fundamentals and the strength and long-term sustainability of these fundamentals which enables businesses to keep growing earnings while maintaining a return on capital in excess of its cost of capital. These companies not just survive a market crash or a crisis, but emerge stronger from them, in turn consistently compounding an investor’s wealth.

However, when markets crash, all stocks tend to first correct, before investors start factoring in the differing fundamentals between the weaker companies and their consistent compounder counterparts. Should investors then try and take advantage of the market-wide correction by exiting their holdings of consistent compounders and buying them later at lower levels? We touched upon this question in Chapter 5 and will delve further into it in this one.

Assume we have two investors, who both invest Rs 1 crore annually in shares of Asian Paints. The first investor, Mr. Gifted, is skilled at perfectly timing his stock purchases, and each year buys Rs 1 crore worth of Asian Paints shares at the stock’s lowest price point for that year. The second investor, Mr. Mortal, believes he cannot time share price movements. As a result, he buys Rs 1 crore worth of Asian Paints shares on the 1st of April each year, regardless of the prevailing price.

Mr. Gifted and Mr. Mortal start investing in Asian Paints from April 2010.

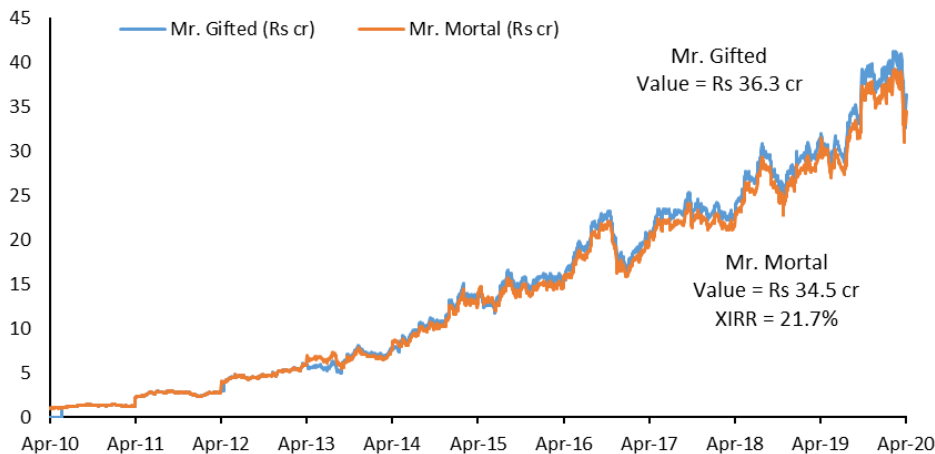
In their first year of investing, Mr. Mortal invests Rs 1 crore in Asian Paints at Rs 203 per share on 1st April 2010. Mr. Gifted on the other hand, using his timing skills, invests his Rs 1 crore on 21st May 2010, when the Asian Paints’ stock price is at its lowest during the fiscal year (Apr-Mar) 2011. Both our investors repeat this exercise annually for a period of ten years, including years in which their purchase prices differ materially. For example, in FY2014, Mr. Mortal’s investment on 1st April 2013 is at a price of Rs495 per share whereas Mr. Gifted waits to buy on 28th August 2013 at Rs392 per share. Mr. Gifted’s purchase, at the lowest price point during FY4 is 21% lower than Mr. Mortal’s – inarguably a material difference.

At the end of their ten-year investing cycle, the two investors compare their portfolio values and the compounded return they have earned (XIRR).

Mr. Gifted’s portfolio is worth Rs 36.3 crores, an XIRR of 22.6%! Mr. Mortal’s portfolio is worth Rs 34.5 crores, an XIRR of 21.7%!

Mr. Mortal’s portfolio value is only 5% lower than that of Mr. Gifted!! Mr. Gifted has surely done better than Mr. Mortal, but his relative outperformance is not material enough to see significant benefit from market timing. The chart below shows the progression of their portfolio values during the 10 years investment period. Note: These portfolio values DO NOT include dividends – they are based only on share price movements. Including Dividends will increase the XIRR numbers by 1-2% for both investors.

**Exhibit 18: Portfolio values of Mr. Gifted and Mr. Mortal for investment Asian Paints (FY11-20)**



Source: Marcellus Investment Managers, Ace Equity; Note: Portfolio values do not include dividends - they are based on only share price movements

Moreover, FY11-20 was not the only 10-year period when Mr. Gifted failed to add much value via his skills of timing his annual investments into Asian Paints share price. The table below shows that no matter when the two investors started this exercise, the most Mr. Gifted ended being ‘wealthier’ than Mr. Mortal was 15% at the end of their ten-year investment cycle.

**Exhibit 19: Portfolio returns for various investment periods in Asian Paints**

Investment period	Portfolio value after 10 yrs (Rs cr)		XIRR		Mortal as a % of Gifted (B/A)
	Mr. Gifted (A)	Mr. Mortal (B)	Mr. Gifted	Mr. Mortal	
1 <sup>st</sup> Apr'01 - 31 <sup>st</sup> Mar'11	73.0	67.6	34.8%	33.5%	93%
1 <sup>st</sup> Apr'02 - 31 <sup>st</sup> Mar'12	74.6	67.7	35.2%	33.5%	91%
1 <sup>st</sup> Apr'03 - 31 <sup>st</sup> Mar'13	89.6	81.7	38.4%	36.8%	91%
1 <sup>st</sup> Apr'04 - 31 <sup>st</sup> Mar'14	75.5	67.1	35.4%	33.3%	89%
1 <sup>st</sup> Apr'05 - 31 <sup>st</sup> Mar'15	83.7	73.9	37.2%	35.0%	88%
1 <sup>st</sup> Apr'06 - 31 <sup>st</sup> Mar'16	67.6	58.3	33.5%	30.9%	86%
1 <sup>st</sup> Apr'07 - 31 <sup>st</sup> Mar'17	63.8	56.5	32.5%	30.3%	89%
1 <sup>st</sup> Apr'08 - 31 <sup>st</sup> Mar'18	52.7	45.0	29.1%	26.4%	85%
1 <sup>st</sup> Apr'09 - 31 <sup>st</sup> Mar'19	46.5	44.9	26.9%	26.3%	97%
1 <sup>st</sup> Apr'10 - 31 <sup>st</sup> Mar'20	36.3	34.5	22.6%	21.7%	95%
<b>Average</b>			<b>32.6%</b>	<b>30.8%</b>	<b>90%</b>

Source: Marcellus Investment Managers, Ace Equity

### **Other variants of this analysis**

- If we consider investing in the Sensex (instead of Asian Paints) over any 10-year time period after 1991, the outcome would not have been dissimilar. Mr. Mortal's 10-year portfolio value would have been 80-95% (average of 83%) of Mr. Gifted's portfolio value.
- If we increase the time frame of investment of each portfolio from 10 years to 20 years for any year after 1991, the outcome would still be the same! Mr. Mortal's 20-year portfolio value would have been on average 82% of Mr. Gifted's portfolio value if invested in Sensex, and an average of 85% if invested in Asian Paints.

### **Why does this happen?**

The simple reason why Mr. Mortal isn't too far behind Mr. Gifted in all these portfolio iterations discussed above is that – earnings drive 80-90% (if not higher) of the stock returns generated over the long run. As a result, provided the underlying asset (company or an index) delivers a modest or healthy earnings growth, it does not matter whether the entry point of one investor was 20% higher or lower than another investor.

Most investors have free cash to invest each year. Many of these spend a lot of effort trying to be Mr. Gifted and waiting for the 'right' opportunity to deploy their funds. And as we have seen above, not only is it difficult being Mr. Gifted in market timing, it is also not worth the effort.

The philosophy we follow for Consistent Compounders PMS aims at investing in companies whose earnings we believe, will compound consistently at health rates over long periods of time. Instead of worrying about how best we can time the market volatility and entry valuations for these investments, we spend all our efforts trying to understand and build high conviction on their fundamental strengths which are likely to drive their earnings in future.

### **The other aspect of timing – trying to buy when stocks are 'cheap'**

*“Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for that forty years, you're not going to make much different than a six percent return — even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you'll end up with one hell of a result.” – Charlie Munger in “The Art of Stock Picking” (2013) [[Source](#)]*

### **The “fundamentalists” at Marcellus**

Over the past couple of years, we have reiterated time and again the folly of using P/E multiples as a gauge of which stocks one should invest in. For instance, as shown in the charts below, for both the time periods FY09-14 and FY14-19, the companies which delivered the highest PBT growth also ended up delivering the highest share price returns.

In our July 2019 newsletter for our Consistent Compounders Portfolio, we explained that: “A weak franchise trading at 10x P/E multiple appears cheap, when its fair value P/E might actually be 5x. On the other hand, a consistent compounder trading at 50x appears expensive, when its

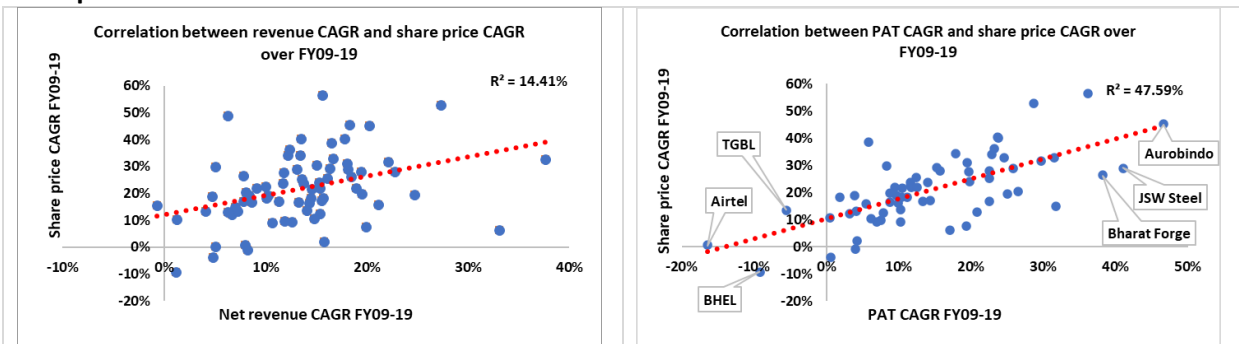


fair value P/E could be higher than 100x. Conviction on the ability of a firm (competitive advantage) to deliver sustainable RoCEs as well as growth (which requires capital reinvestment) is often underappreciated in a P/E multiple based valuation methodology.” In fact, in that newsletter we demonstrated that, in 1994 Nestle’s fair P/E multiple was 290x! [\[Source\]](#)

**The futility of P/E multiple based investing**

In this note, we assess the relative power of a variety of metrics which explain stock price movements. In the three charts shown below we have illustrated the ability of three different fundamental metrics – revenue growth, profit growth and Free Cash Flow (hereafter called FCF) growth – to explain stock prices of the BSE100 constituents over the last 10 years.

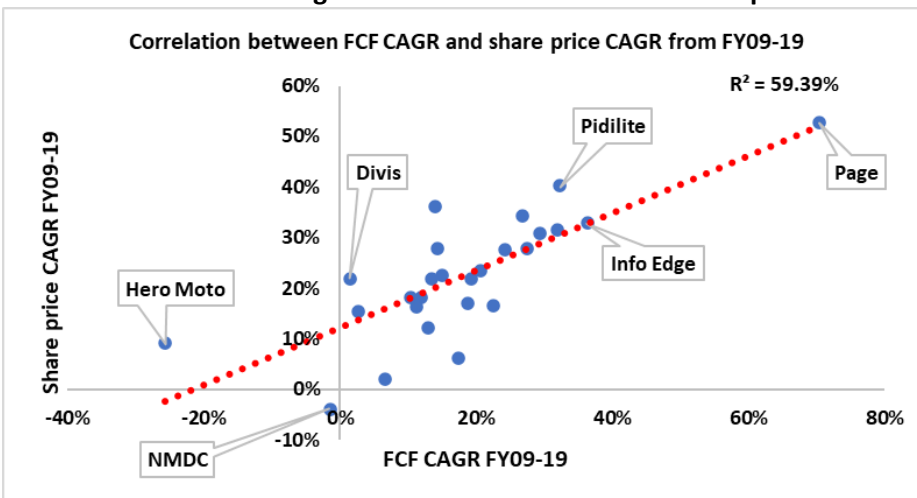
**Exhibit 20: Correlation of growth in net revenue (chart on left) and growth in profit after tax with share price CAGR over FY09-19**



Source: Marcellus Investment Managers, Ace Equity

As you can see from the charts, whilst revenue growth can explain only 14% of the stock price movement seen over the past decade, profit growth can explain a healthy 48% of the stock price movement. But the star of the show is FCF growth – it can explain nearly 60% of the movement in BSE100 stock prices over the past decade. That is truly extraordinary, and it suggests that amongst all fundamental metrics FCF growth is by far the biggest driver of shareholder value.

**Exhibit 21: Correlation of growth in free cash flow with share price CAGR over FY09-19**

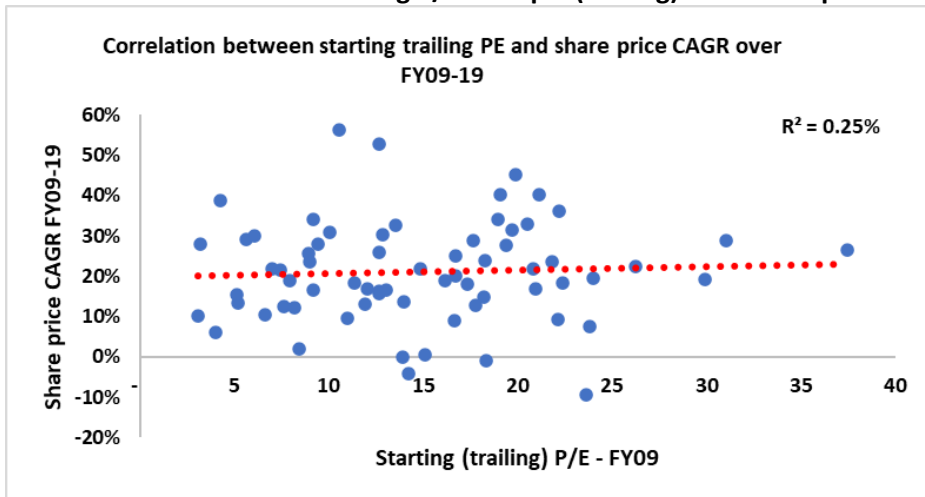


Source: Marcellus Investment Managers, Ace Equity

So, what is FCF? Technically speaking it is the operating cashflow that a company generates less the monies that it spends on investing in property, plant, equipment and other assets that it acquires. The formula for FCF we have used is “Operating cash flow – (Capex+ Advances for capex) – Investment in subsidiaries & intercorporate deposits”. In plain English, FCF is a true measure of how much money a company makes after paying not just for its expenses but also paying for various assets & equipment that it needs to run the show.

In contrast to the potency of FCF growth in explaining stock price movements, it is worth seeing a visual illustration of the irrelevance of P/E multiples in explaining stock price movement – P/E explains around 0% of the movement in stock prices. (Yes, 0%.) In plain English, whether BSE100 constituents’ share prices rose or fell over the past decade had NOTHING to do with the P/E multiples of these stocks. If you want to see how useless P/E, P/B and EV/EBITDA multiples are in India over horizons such as 1 year, 3, 5 and 10 years, please refer to Appendix 5 of our bestselling book “Coffee Can Investing: The Low Risk Route to Stupendous Wealth” (2018).

**Exhibit 22: Correlation of starting P/E multiple (trailing) with share price CAGR over FY09-19**

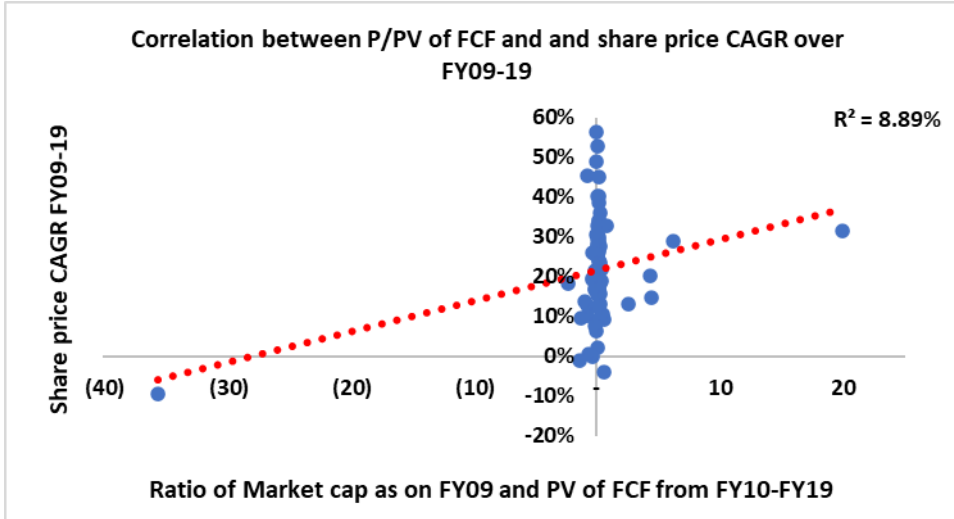


Source: Marcellus Investment Managers, Ace Equity

**The God-like simulation**

Since we know the FCF of the BSE100 constituents over the past 10 years, we can pretend that we are sitting in Mumbai in March 2008 and with God-like prescience forecast FCF over the next 10 years. Armed with these FCF forecasts, we then use a discount rate of 15% to calculate the Present Value (PV) of these free cashflows as in March 2008. That gives us PV of FCF. Using this metric, we calculate P/ PV of FCF for each of the BSE100 constituents. Now, we can test whether this new God-like metric is better than P/E multiples in explaining stock price movements.

**Exhibit 23: Correlation of P/PV of FCF as explained above, with share price CAGR over FY09-19**



Source: Marcellus Investment Managers, Ace Equity

As shown in the chart above, P/PV of FCF explains 9% of the movement in BSE100 stock prices over the past decade. Since 9% is > 0%, P/ PV of FCF appears to have greater potency than P/E multiples in explaining stock price movements. However, the relative impotence of P/ PV of FCF (compared to a metric like FCF growth) underscores the insignificance of stock prices in forecasting future stock price movements. This counterintuitive fact seems to confound many investors in the Indian stock market – why the stock price of a company today tells you next to nothing about how the company’s stock price will perform going forward.

**Investment implications**

As highlighted in the quote from Charlie Munger at the beginning of the chapter, how much money an investor will make from an investment depends fundamentally on just one thing – what is the RoCE generated by the investee company. If the company’s pre-tax RoCE is below 15% (which is the case for just over a third of the BSE100 constituents in FY19), it will be very difficult for an investor to generate a healthy return from buying shares in such a company even if the P/E of the stock is low. Conversely, as Mr Munger explains, if we buy shares in, say, Pidilite – a company with a pre-tax ROCE of 34% in FY19 – we are likely to make a very healthy return from the investment even if Pidilite’s P/E is optically high.

FCF growth captures this aspect of investment success far better than P/E does because FCF is nothing more than ROCE less the cost of capital. Therefore, healthy growth in FCF necessarily implies equally healthy growth in ROCE. That is why, as shown in Exhibit 23, FCF growth is able to explain nearly 60% of the change in the share prices of BSE100 constituents.

Therefore, it is better to focus on the P/PV of FCFE multiple rather than the P/E multiples for evaluating the long-term investment returns.

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## Chapter 8

### Conclusion

When stock markets crash, the move to the bottom is usually so fast that investors seldom get a chance to react in a rational manner. In fact, panic is usually the more common response to a crisis in the markets, and many end up exiting their investments at or near the bottom.

A market crash during a crisis should in fact be viewed by investors as an opportunity to build a sound portfolio for healthy and steady long-term returns. The Covid-19 related crisis in early 2020, although serious in nature as well as its far-reaching impact, wasn't the first such major correction to hit the Indian stock market (major corrections took place in 1993, 2000, 2008, 2013 and 2016) and very unlikely it will be the last.

In order to navigate the vicissitudes of the market, investors need to build a portfolio of stocks which is not only resilient in times of crises but is also capable of seizing opportunities that arise when conditions normalise. Consistent Compounders possess these highly desirable twin characteristics.

Fortunately for us, India is blessed with a large number of firms dominant in their industries and earning returns on capital far higher than their cost of capital. Identifying the Consistent Compounders among these requires a thorough exploration of the sustainable competitive advantages of these companies. An understanding of how these companies create barriers to entry around their businesses and acquire pricing power is crucial. This understanding is the key to assess how long a business can keep turning the cycle of large free cash flow generation being deployed back in to the business for higher growth and strengthening of competitive advantages, which in turn leads to even higher free cash flows.

As proponents and practitioners of long-term investing, we have seen that a portfolio of 12-15 Consistent Compounders delivers market-beating results on a consistent basis – both in bull and bear markets. Investors desirous of further exploring how to build such a portfolio will do well to read the book “Coffee Can Investing: The Low Risk Route to Stupendous Wealth”.

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**Disclaimer:** *The following stocks mentioned in this handbook are part of one or more of Marcellus' PMS and/or advisory portfolios*

Asian Paints	Pidilite	Relaxo	HDFC Bank	Relaxo Footwears
Divis Labs	Info Edge	Kotak Bank	Bajaj Finance	Dr. Lal Pathlabs
Berger Paints	ITC	Nestle India	Page Industries	

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