

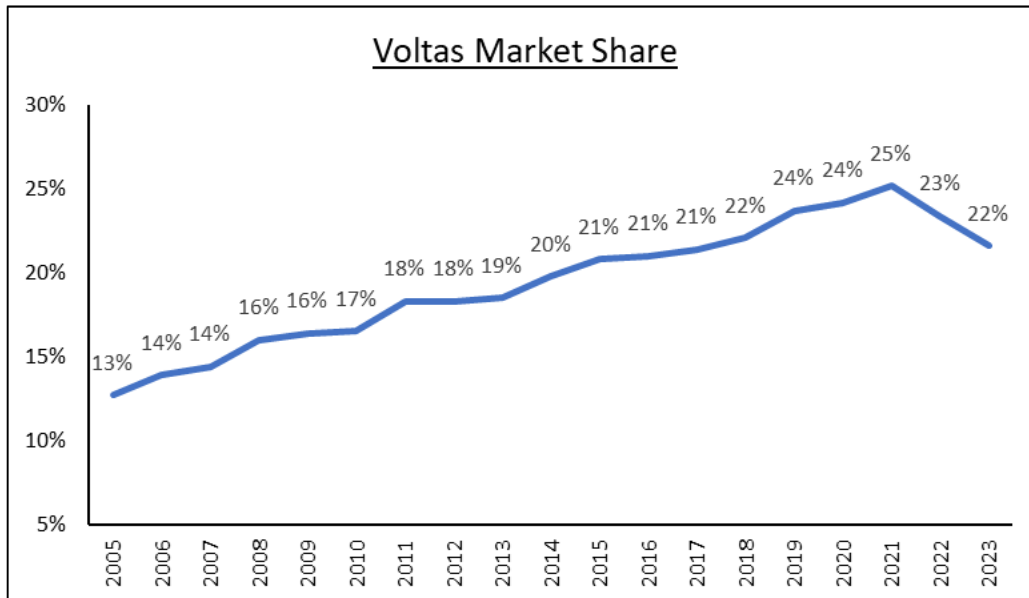
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Why are you so optimistic about Manufacturing when these businesses are lower ROEs relative to Consumer companies and hardly generate any Free Cash Flow?

The 3 key variables that matter in value creation are longevity of profit growth, sustainability of ROE above Cost of Equity (12% in India) and entry prices paid. Traditional investment wisdom is to buy high ROE and high Free Cash Flow businesses. This ignores where a company is in its growth life cycle and entry valuations paid. It also ignores that low reported Free Cash Flow today in many manufacturing businesses is just delayed gratification and that ROCE of many Manufacturing businesses today is understated.

Our threshold of a good business is one that can generate 18% ROE+ with prudent leverage. Hence, a 18-20% ROE business is very attractive and merits consideration over a 40-50% ROE business basis other factors such as growth prospects, disruption, entry prices etc.

Many Consumer businesses which are high ROE today are likely to see greater competitive intensity as competitors attempt to enter adjacencies. This could result in lower margin and hence lower ROE profiles in future vs today. Consider the graph below of how Voltas market share in Air Conditioners has declined due to intense competition (Source: Kotak Institutional Equities). Many FMCG businesses are also seeing their high value customers being targeted by D2C brands and launch of Private Labels by organized retail. Paints has seen the entry of Grasim and JSW.



While Manufacturing businesses tend to be lower ROE than Consumer (they are more capital intensive and have lower pricing power), they could deliver higher and more sustainable growth than some Consumer businesses this decade due to the de-risking tail winds at play and as MNCs should not grudge their Indian partners a 18-20% ROE for reliable supply.

Hence, a manufacturing business that can grow at ~15% PAT growth for 2 decades at 18-20% ROE may be a more attractive investment proposition than a Consumer business than can grow PAT at ~10% for 2 decades at 40%+ ROE.

The low Free Cash Flow of many Manufacturing businesses today is just delayed gratification.

The aim of a business owner needs to be to maximize “long term” Free Cash Flow. Reported Free Cash flow should always be examined in context of where a company is on the growth life cycle and the opportunities it has to re-invest capital. This is not very different from a graduate who goes on to take an advanced degree rather than immediately accepting a job. You are postponing a salary you could earn today, for higher skills and hence better job prospects and a higher salary two years down the road.

Poor FCF in the high growth stage of a company is perfectly normal if the business is re-investing all profits for growth at incremental ROE above Cost of Equity. One is essentially sacrificing dividends today for much higher dividends down the road.

SRF generated no FCF in the period FY2013-2023 because all Operating Cash Flow was reinvested in new capacities. This resulted in SRFs PAT growing from ~250crs to ~2150crs from FY 2013 to FY 2023. They could have been more conservative on investments and paid out higher dividend, but then the profits today would be significantly lower. Focusing on short term Free Cash Flow would have led to the wrong long-term decisions.

The reported ROCE of a manufacturing business that is investing in growing capacity aggressively is understated and not reflective of its true ROCE.

The useful life of many capital-intensive businesses are higher than the timelines on which they are depreciated. Maintenance cap-ex is typically much lower than depreciation. Hence, reported ROCE expands over time as Sales/Net Block expands.

Steep increase in capital expenditure depresses reported short term ROCE as new plants will typically take 3-5 years to reach full utilization. So the reported ROCE of the company is a mix of very high ROCE of old plants and low ROCE of plants that have not reached full utilization.

Finally, a business that is growing rapidly will over-invest to gain credibility with customers. They may choose to build capacity ahead of demand, choose to keep higher inventories to buffer against unreliable raw material supply, keep inventory closer to customers, have higher Work in Process inventory if they are increasing number of SKUs. All these aspects depress reported ROCE which is temporary. These inefficiencies will be eliminated with time.

Manufacturing businesses in India have a great opportunity to capture market share of global supply chains. Leaders with vision will invest ahead of the curve to establish credibility amongst global customers. This will depress reported ROCE but is the right thing for them to do and we will look at such companies with significant interest.