My search for "great" Indian companies

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"Greatness is not a function of circumstance. Greatness, it turns out, is a largely a matter of conscious choice." - ***Jim Collins, Good to Great, 2001***

I moved to India in 2008 to work in the Indian stockmarket. In my first three years in the country, I used to meet at least two or three companies each week. Then, as I came to terms with India's corporate and economic landscape, I realized that very very few companies in India delivered steady financial performance over long periods of time. Whilst I have captured my journey to understand India in my book "Gurus of Chaos: Modern India's Money Masters", my next book "The Unusual Billionaires" delves into the issue of why there are so few Indian companies which deliver reliable financial performance over meaningful periods of time. Thanks to a bit of goading from the editors of The Prime Directory, I am giving you a sneak peek into my next book. Let me begin by being precise about what I define as "reliable financial performance over meaningful periods of time".

Step 1: Define "long periods": A decade in India usually accommodates both the up and down cycles in the economy. For example, the decade from FY06 (i.e. the financial year ending 31st March 2006) to FY15 (i.e. the financial year ending 31st March 2015) coincides with six years of strong economic growth (FY06 to FY11, where average nominal GDP growth was 15.7%) and four years of weak economic growth (FY12 to FY15, where average nominal GDP growth was 12.8%). Hence measuring greatness over a decadal period should not unfairly penalize cyclical companies nor unfairly advantage companies in more stable, steady sectors.

Step 2: Define superior financial performance: At the very basic level, a company doing well would mean that it is profitable and it is growing (by successfully reinvesting its profits). Over very long periods of time, the twin filters of growth and profitability, in my view, are sufficient to assess the success of a franchise. Thus, my stock selection filters are companies that deliver revenue growth of 10% AND Return on capital employed (RoCE) of 15% every year for the past ten years.

Why revenue growth of 10% every year? India's nominal GDP growth rate has averaged 14.5% over the past ten years. However, very few listed companies have managed to achieve this! Therefore, I reduce this filter rate modestly to 10% per annum.

Why Return on capital employed (RoCE)? A company uses capital to invest in assets which in turn generate cashflows and earnings. This capital invested consists of equity and debt and the sum of the cost of equity and the cost of debt (weighted in proportion to their share in total capital) is known more popularly as the Weighted Average Cost of Capital or WACC. A measure of a company's effectiveness in investing its capital is to compare its WACC with the quantum of cashflows or earnings generated by the investment. The latter is known as Return on Capital Employed (RoCE). Companies with low RoCEs keep requiring external infusions of capital to fund their growth. Therefore, this excess of RoCE over WACC is a measure of the excess returns to an investor in the company. It follows therefore that if a company grows without excess returns, it creates no value for equity investors. In general, I have found RoCE is the single biggest factor affecting a company's stock price.

Why minimum RoCE of 15%? The minimum return that one would rationally expect from equities is the risk-free return that you would earn if you invested in the safest investment in India, namely, Government bonds. In early 2016, the Government of India's ten year bonds are giving a return of around 8%. Given that equities carry an element of risk that Government bonds don't, an equity investor would want a premium return for this extra risk. This is the equity risk premium – the extra return an investor expects over and above the risk-free rate for investing in equities. The equity risk premium, in turn, is calculated as 4% (the long-term US equity risk premium) plus 250bps to account for India's rating (BBB- as per S&P). Hence, adding the risk-free rate (8%) and an equity risk premium of 6.5%-7% gives a cost of capital of broadly 15%. Note further that over the past 20 years and 30 years, the Sensex has delivered returns of around 15% per annum thus validating my point of view that 15% is a sensible measure of the cost of capital for an Indian company. Therefore, if a company is to be deemed to be great, it has to deliver an ROCE in excess of 15% per annum over long periods of time.

There are around 1500 companies in India with a market cap of Rs 1 billion (Rs 100 crore) or more. So, if we look at the period of FY06-15, how many of these companies passed the twin filters of 10%+ revenue growth and 15%+ ROCE? The answer is 16 or 1% of our population of the 1500 largest listed companies in India. Amongst this 16, the crème de la crème includes:

ITC: For over a century now, ITC has had market share in the Indian cigarette market in excess of 70%. It has used the free cashflow arising from its dominant position in cigarettes to pay a hefty dividend to its shareholders (over the past decade, ITC's dividend payout ratio has been in excess of 50%) and to build a formidable FMCG franchise (the second-largest in India after HUL).

Marico: Over the last 25 years, Marico has built a strong consumer franchise by: (a) focusing on its core categories - hair oil and edible oils; (b) building a positive work culture based on values such as empowerment, meritocracy, innovation, openness and integrity; and (c) prudent capital allocation which balances deepening of competitive moats in India – for example through installing best-in-class inventory management systems for its dealers - with expansion overseas.

Asian Paints: Asian Paints is a rare example of a large Indian company, held by multiple promoters and yet run by a high caliber, professional, management team. Over the last fifty years no Indian company has been able to match Asian Paints' consistent delivery of growth in revenues, earnings and returns on capital employed. With over 50% share of the Indian paints market, in my framework, Asian Paints stands out as the best amongst the best.

Berger Paints: In post-1991 India, Berger Paints has cemented its position as India's second largest paint firm. Its current promoter and management team are nurturing the key factors that have defined its success since 1970s, around quality of talent, a refreshingly enlightened employee work culture and prudent capital allocation.

Page Industries: Leveraging on their experience of successfully operating Jockey's master franchise in Philippines, Page's promoters have delivered a unique product proposition in India's the fast growing innerwear segment – comfort and durability with an aspirational brand at an affordable price – a combination that nobody else has been able to replicate.

Astral Poly: In the last decade and a half, Astral has emerged as India's strongest Chlorinated poly vinyl chloride (CPVC) pipes franchise, despite facing stiff competition from much larger peers such as Supreme and Finolex. The company maintained focus on prudent capital allocation, which manifested in strong earnings growth (41% CAGR) and average RoCE of 23% over FY05-15.

HDFC Bank: Right from its inception in 1994, HDFC Bank has delivered clock-work like execution with a high focus on low cost funds, conservative lending and technology driven solutions. Thus, HDFC Bank's stable financial performance has been driven by a balanced set of underlying drivers: net interest margins, operational efficiency and super asset quality.

So why do we have only 16 companies in India which have over the past decade passed the basic twin filters of at least 10% revenue growth per annum and 15% ROCE per annum? There are three reasons why the number of reliable Indian companies so small:

1. **Focus on the long term (more than 10 years) without being distracted by short-term gambles:** For 99% of Indian promoters, the "opportunistic" gene is so deeply embedded that as soon as they spot a new sector they can venture into, they go "off-strategy". As the leading market strategy consultant, Rama Bijapurkar, says, "Most companies tend to focus on short term results and hence that makes them frequently do things that deviate away from their articulated strategy…these diversions take them away from the path they have to travel on to achieve their long term goals…the willingness to resist the temptation of short term 'off-strategy' profits for long term sustainable gain is not there in most Indian companies."
2. **Constantly deepen the moat around the core franchise using the IBAS: (Innovation, Brands, Architecture and Strategic Assets) framework:** The IBAS framework was created by the legendary British economist, John Kay, and captures neatly how great companies strive over many decades to create sustainable competitive advantages (which, in turn, allow them to pull away from their competitors). Examples of this theme include Asian Paint's use of IT as early as the 1970s to help forecast sales patterns. Similarly, Astral Poly Technik has innovated with its CPVC pipes and fittings by launching products that are lead-free, soundproof, bendable, etc. As Mr. Sandeep Engineer, Promoter of Astral PolyTechnik, told me: "We grew at 40% plus CAGR for more 7-8 years up to 2014 while the economy wasn't that strong; where was the slowdown? Slowdown is in the mind! If you create new product segments, if you create leadership, if you create brand, growth will be strong and ahead of industry." The challenge for most successful Indian companies is that once the first generation promoter exits the business, his progeny rarely have the stomach for the amount of work required to further deepen the competitive moats. As a result, second generation promoters usually oversee the slide to mediocrity of what their ancestors built.
3. **Sensible allocate capital whilst studiously avoiding betting the balance sheet on expensive an unrelated forays:** As successful companies grow, they throw off ever increasing amounts of cash. The challenge then becomes to allocate this cash in such a way that ROCE does not suffer. Beyond a point, the best way to protect ROCE is to return large amounts of money to shareholders, something that most promoters find hard to stomach. ITC stands out as an example of a firm that has always returned large amounts of money to shareholders whilst making modest (by the standards

of its large balance sheet) investments in new businesses. Similarly, Asian Paints has forayed overseas but never stretched its balance sheet for this purpose. In a chat with me in November 2015, KBS Anand, MD and CEO of Asian Paints, had this to say on the impact of the home improvements business on RoCE: “At the moment, the home improvements business is too small to have any significant impact on the overall firm’s RoCE. But if you are talking about building long-term strength with your channel partners, then whatever RoCE we lose in the new business will be more than offset by increase in RoCE of the paints business”.

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