Tamohara
INVESTMENT MANAGERS

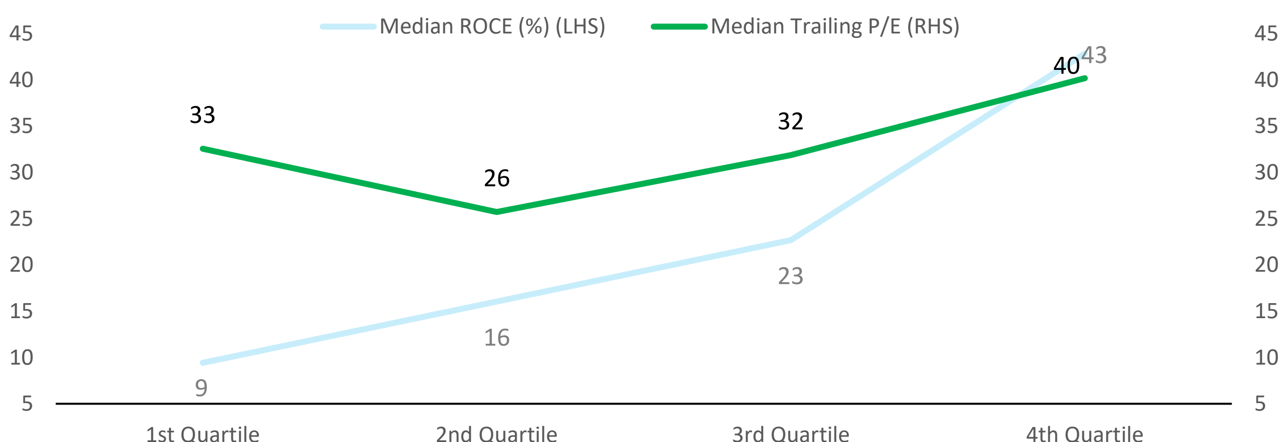
Reinvestment Compounders

Kenneth Mendonca, Tejas Gutka

Last month we argued that Buy Cheap, Avoid Expensive is not necessarily the best strategy. We illustrated this by showing that some of the best wealth creators were not cheap in the past, based on traditional valuation parameters like P/E. Most of the names that we had illustrated, had one thing in common - they were all high-quality businesses, based on their returns ratios (RoCE). This month, we posit that many businesses that currently do not report high returns on capital, but are valued richly on earnings, can also be long term wealth compounders.

Ideally, a plot of the relationship between business quality (as reflected by the returns ratios) and valuations (P/E multiples), should be a straight line, sloping upwards i.e. businesses with low return ratios should have a lower P/E multiple while businesses with higher return ratios should have a higher P/E multiple. However, in reality, the graph is closer to a U-shaped one i.e. both lower and higher return ratios have correspondingly higher P/Es, as illustrated below for the BSE200 constituents:

Figure 1: ROCE vs P/E of BSE 200 companies



Source: ACE Equity, Capitaline, Tamohara

Note: *The population has been adjusted for companies with negative EPS and/or networth, as well as for financial companies to arrive at a sample of 145 companies. The companies have been grouped into four quartiles (each quartile has ~36 companies) based on ascending order of their respective ROCE.*

Intuitively, we may be inclined to dismiss the companies falling the first quartile as speculative. After all, why would the market accord a high earnings multiple to companies with sub-optimal return ratios? In our view, over and above speculation, there could be other reasons to explain such a scenario. We enumerate some of the reasons as follows:

Cyclicals

Cyclical businesses are often directly influenced by change in the economy (e.g. commercial vehicles, capital goods) or change in the demand and supply of their products or raw materials (eg. commodities). These businesses often see sharp and sudden expansion of earnings in favourable periods, leading to normalization of P/Es. However, anticipating a favourable turnaround is a difficult task, especially since cyclical stocks start moving up before an actual improvement happens. Thus, timing of investment is very critical when investing in cyclicals. Nevertheless, in our view, such investments are largely short-term/tactical, rather than long term in nature.

> *Cyclicals are the most misunderstood of all the types of stocks. It is here that the unwary stock picker is most easily parted from his money, and in stocks that he considers safe.*
>
> \- Peter Lynch

Turnarounds

Turnarounds could be companies who have been financially healthy in the past but have fallen on hard times (Special Situations) or simply businesses that were mismanaged in the past. The turnaround is often a result of change in management, strategy, cost cutting or sale of loss making divisions. Popular examples include Symphony, Ashok Leyland, IndusInd Bank, etc. Investors should consider the following before investing in a turnaround – the probability of the turnaround, and the time horizon needed for the turnaround vis-à-vis the investors investment horizon. Turnarounds can be big money spinners for the long-term investor, however, our experience has been that very few potential turnarounds actually turn around.

Investment phase

In their nascent stages, numerous small businesses are in the investment phase i.e. incurring expenses to grow their brand/network (marketing spend and/or working capital support) or spending on R&D which tend to depress earnings. On the other hand, the company could be in the phase of ramping up its capacities which is not yet contributing to revenues. These businesses inherently have high return on capital on a steady state, however, the upfronted investments impact the company's profitability as well as cashflow in the early years, leading to depressed returns ratios.

Consider the hypothetical case of a restaurant, with the following metrics:

Figure 2: Operating Metric of a Hypothetical Restaurant

Per Restaurant Metrics	
Area (Sq. Ft)	2,000.0
Annual Rent (INR/psf)	1,800.0
Annual Inflation	3.0%
Capex (INR mn)	25.0
Depreciation/Maintenance Capex	10.0%
Revenues (INR mn)	
Year 1	25.0
Year 2	35.0
Year 3	50.0
Steady State SSG	5.0%
RM/Sales	40.0%
No. of Employees	10.0
Salary (INR Mn/Employee)	2.0
Inflation	3.0%
Other Expenses (INR mn)	5.0
Inflation	8.0%
Net Working Capital (days of sales)	-15.0

Source: Tamohara

As a standalone unit, this restaurant turns EBITDA positive in 4 years, as shown below:

Figure 3: Key Financial Metrics of a Hypothetical Standalone Restaurant

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Revenues	**25**	**35**	**50**	**58**	**61**	**64**	**67**	**70**	**74**	**78**	**81**	**86**	**90**	**94**	**99**
y/y change	*N.A.*	*40%*	*43%*	*16%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*
Raw Matertial Costs	10	14	20	23	24	26	27	28	30	31	33	34	36	38	40
% of sales	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*
gross margins	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*
Employee Costs	20	21	21	22	23	23	24	25	25	26	27	28	29	29	30
% of sales	*80%*	*59%*	*42%*	*38%*	*37%*	*36%*	*36%*	*35%*	*34%*	*34%*	*33%*	*32%*	*32%*	*31%*	*31%*
Rentals	4	4	4	4	4	4	4	4	5	5	5	5	5	5	5
% of sales	*14%*	*11%*	*8%*	*7%*	*7%*	*7%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*
Other Expenses	5	5	6	6	7	7	8	9	9	10	11	12	13	14	15
% of sales	*20%*	*15%*	*12%*	*11%*	*11%*	*12%*	*12%*	*12%*	*13%*	*13%*	*13%*	*14%*	*14%*	*14%*	*15%*
Total Expenses	**39**	**44**	**51**	**55**	**58**	**60**	**63**	**66**	**69**	**72**	**75**	**79**	**82**	**86**	**90**
% of sales	*154%*	*125%*	*102%*	*95%*	*95%*	*94%*	*94%*	*93%*	*93%*	*93%*	*92%*	*92%*	*91%*	*91%*	*91%*
EBITDA	**-14**	**-9**	**-1**	**3**	**3**	**4**	**4**	**5**	**5**	**6**	**6**	**7**	**8**	**8**	**9**
ebitda margin	*-54%*	*-25%*	*-2%*	*5%*	*5%*	*6%*	*6%*	*7%*	*7%*	*7%*	*8%*	*8%*	*9%*	*9%*	*9%*
Depreciation	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3
% of sales	*10%*	*7%*	*5%*	*4%*	*4%*	*4%*	*4%*	*4%*	*3%*	*3%*	*3%*	*3%*	*3%*	*3%*	*3%*
EBIT	**-16**	**-11**	**-3**	**0**	**1**	**1**	**2**	**2**	**3**	**3**	**4**	**4**	**5**	**6**	**7**
ebit margin	*-64%*	*-32%*	*-7%*	*0%*	*1%*	*2%*	*2%*	*3%*	*4%*	*4%*	*5%*	*5%*	*6%*	*6%*	*7%*
return on capital employed	*-75%*	*-53%*	*-16%*	*1%*	*3%*	*5%*	*8%*	*11%*	*14%*	*17%*	*20%*	*24%*	*27%*	*31%*	*35%*
Pre-tax Cash From Operations	-13	-7	1	5	6	6	7	8	8	9	10	10	11	12	13
% of ebitda	*N.A.*	*N.A.*	*N.A.*	*190%*	*181%*	*173%*	*167%*	*163%*	*159%*	*155%*	*153%*	*150%*	*148%*	*147%*	*145%*
Capex	25	3	3	3	3	3	3	3	3	3	3	3	3	3	3
Pre-tax Free Cash Flow	**-38**	**-10**	**-1**	**3**	**3**	**4**	**4**	**5**	**6**	**6**	**7**	**8**	**9**	**10**	**11**
% of pre-tax CFO	*N.A.*	*N.A.*	*N.A.*	*50%*	*55%*	*60%*	*63%*	*67%*	*70%*	*72%*	*74%*	*76%*	*78%*	*79%*	*81%*

Source: Tamohara

However, if this was a restaurant chain, it wouldn't stop at just one restaurant. In that case, the company would continue to add new restaurants every year. Consequently, the reported numbers would reflect losses for an extended period with suboptimal return ratios. Enterprising investors, however, would appreciate that as the base of existing restaurants grows, it more than absorbs the losses of the newly opened restaurants. Therefore, the currently depressed earnings do not truly reflect the earning power of the business, and thus, the high multiple accorded by the market is meaningless.

The following chart depicts that financial journey of a restaurant chain based on the metrics highlighted earlier (other costs have been assumed to be higher as a significant amount of corporate resources would be needed to manage a chain of restaurants compared to a standalone restaurant).

Figure 4: Key Financial Metrics of a Hypothetical Restaurant Chain

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
No. of Stores Outstanding	10	20	40	60	80	102	124	147	172	199	227	257	287	318	350
Addition in Current Year	*10*	*10*	*20*	*20*	*20*	*22*	*22*	*23*	*25*	*27*	*28*	*30*	*30*	*31*	*32*
Added Last Year	*0*	*10*	*10*	*20*	*20*	*20*	*22*	*22*	*23*	*25*	*27*	*28*	*30*	*30*	*31*
Added Year before last	*0*	*0*	*10*	*10*	*20*	*20*	*20*	*22*	*22*	*23*	*25*	*27*	*28*	*30*	*30*
Steady State Stores	*0*	*0*	*0*	*10*	*20*	*40*	*60*	*80*	*102*	*124*	*147*	*172*	*199*	*227*	*257*
stores added/stores outstanding	*100%*	*50%*	*50%*	*33%*	*25%*	*22%*	*18%*	*16%*	*15%*	*14%*	*12%*	*12%*	*10%*	*10%*	*9%*
Revenues	250	600	1,350	2,279	3,416	4,803	6,340	8,073	10,065	12,318	14,867	17,789	21,069	24,727	28,827
y/y change	*N.A.*	*140%*	*125%*	*69%*	*50%*	*41%*	*32%*	*27%*	*25%*	*22%*	*21%*	*20%*	*18%*	*17%*	*17%*
EBITDA	-586	-686	-819	-882	-862	-790	-677	-528	-341	-123	168	538	1,036	1,633	2,359
ebitda margin	*-234%*	*-114%*	*-61%*	*-39%*	*-25%*	*-16%*	*-11%*	*-7%*	*-3%*	*-1%*	*1%*	*3%*	*5%*	*7%*	*8%*
EBIT	-611	-736	-919	-1,032	-1,062	-1,045	-987	-895	-771	-621	-400	-104	319	838	1,484
ebit margin	*-244%*	*-123%*	*-68%*	*-45%*	*-31%*	*-22%*	*-16%*	*-11%*	*-8%*	*-5%*	*-3%*	*-1%*	*2%*	*3%*	*5%*
Gross Block	250	525	1,075	1,675	2,325	3,075	3,880	4,765	5,758	6,863	8,060	9,378	10,770	12,263	13,858
gross fixed asset turnover	*1.0*	*1.1*	*1.3*	*1.4*	*1.5*	*1.6*	*1.6*	*1.7*	*1.7*	*1.8*	*1.8*	*1.9*	*2.0*	*2.0*	*2.1*
Capital Employed	215	425	845	1,256	1,660	2,098	2,529	2,976	3,456	3,971	4,497	5,051	5,592	6,139	6,690
return on capital employed	*-285%*	*-173%*	*-109%*	*-82%*	*-64%*	*-50%*	*-39%*	*-30%*	*-22%*	*-16%*	*-9%*	*-2%*	*6%*	*14%*	*22%*
Pre-tax Cash From Operations	-576	-662	-763	-789	-722	-593	-416	-196	73	383	779	1,269	1,902	2,650	3,543
% of ebitda	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*464%*	*236%*	*184%*	*162%*	*150%*
Capex	250	275	550	600	650	750	805	885	993	1,105	1,198	1,318	1,393	1,493	1,595
Pre-tax Free Cash Flow	-826	-937	-1,313	-1,389	-1,372	-1,343	-1,221	-1,081	-920	-722	-419	-48	510	1,157	1,948
% of pre-tax CFO	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*27%*	*44%*	*55%*

Source: Tamohara

The detailed financial working can be accessed at http://bit.ly/QSRTamo.

The above only proves that once a quality business exits the investment phase, the profitability, cash flows, and return ratios improve significantly. However, would such a business be an attractive investment at seemingly high P/Es?

Let us explore this with the following illustration:
Assume all profits are cash profits and there is no incidence of tax. Company A is a growing company. It has lucrative re-investment opportunities and thus has decided not to declare any dividends. Company B is a mature company. Its profit margins are stable, and the re-investment needs are low. As excess cash is likely to build up in the company, it has implemented a 50% dividend pay-out. Company C is similar to Company A. Except that either due to lower availability of re-investment opportunities or pressure from shareholders, the company distributes 25% of profits as dividends. Consider the companies' wealth creation journey for its shareholders after 10 years.

Figure 5: Comparative Financial Performance of Three Hypothetical Companies

Company	A	B	C
Current Profits	100	100	100
Multiple	25	10	20
Current Market Value	2,500	1,000	2,000
Reinvestment Rate	100%	50%	75%
Return on Invested Capital	25%	10%	25%
Cumulative Dividends	-	660	725
Profits, 10 years hence	931	163	558
Multiple	15	15	15
Market Value	**13,970**	**2,443**	**8,364**
Returns Multiple	5.6	3.1	4.5
IRR	**19%**	**14%**	**17%**

Year	A			B			C		
	Profits	Dividends	Cashflow	Profits	Dividends	Cashflow	Profits	Dividends	Cashflow
0	100		(2,500)	100		(1,000)	100		(2,000)
1	125	-	-	105	53	53	119	30	30
2	156	-	-	110	55	55	141	35	35
3	195	-	-	116	58	58	167	42	42
4	244	-	-	122	61	61	199	50	50
5	305	-	-	128	64	64	236	59	59
6	381	-	-	134	67	67	280	70	70
7	477	-	-	141	70	70	333	83	83
8	596	-	-	148	74	74	395	99	99
9	745	-	-	155	78	78	470	117	117
10	931	-	13,970	163	81	2,525	558	139	8,504
IRR			19%			14%			17%

Source: Tamohara

While companies B and C have consistently paid dividends to their shareholders, company A, by choosing to completely re-deploy its retained earnings, has delivered a 5.6x return to its shareholders over a 10-year time period. It is important that your investment choices be guided by your investment goals and risk appetite, and if dividends are a source of income, then Company B or C would be the appropriate choice. However, the true power of compounding (returns on invested capital) is observable in Company A. Notice that the power of compounding withstands a fall in the valuation multiple of company A. The following table illustrates that the relation continues to hold at even higher entry and lower exit multiples.

Figure 6: IRR comparison at Various Exit Multiples

Company:		A	B	C
Entry Multiple		25	10	20
Exit Multiple	10	14%	10%	13%
	15	**19%**	**14%**	**17%**
	20	22%	17%	20%

Source: BSE, Tamohara

What can be observed is that for all exit multiples, Company A emerges as the best investment. Thus, in the long run, the ability of a business to consistently re-deploy its earnings into its business and generate high rates of returns on such re-invested capital determines its wealth creation capacity rather than the earnings multiple at which one invested in such a business. Only if Company B's exit multiple expands to 20 and Company A's exit multiple drops to 10 (highly unlikely in the real world), Company B is a viable investment choice.

So far, our discussion has focused on companies which have re-invested successfully, however this is not always the case. There is no guarantee that all such ventures will succeed. For instance, some capital-intensive businesses are often accompanied by low pricing power which leads to an un-ending cycle of re-investments and sub-par returns. Similarly, beware of companies that 're-invest' capital through mergers and acquisitions

which the management claims will be earnings accretive. The acquisition may not have the same earnings power as the acquirer, thus leading to a dilution of returns of the overall business over time.

To sum it up, long term investment success is materially driven by the ability of the investor to identify high quality businesses and purchasing them at a reasonable discount to its future cash flows. Popular valuation shortcuts like earnings multiples, book value multiples etc do not correctly reflect the true worth of a business. The long-term investor may not see immediate returns in case she purchases a high-quality business at a seemingly high multiple, however, over a period of five-ten years, such an investment will outperform any investment made purely because of low valuations, without any consideration for quality. The same holds true for a business that has the potential to generate high returns on capital but is currently not reporting such returns on account of heavy investments being made for the growth of the business. We refer to such businesses as ‘reinvestment compounders’ as they have the capability to reinvest their cash flows at high rates of return. We will cover them and others in more details in a future communique.

Disclaimer

This document has been prepared by Tamohara Investment Managers Private Limited ("Tamohara") and is provided to you for information only. This document does not constitute a prospectus, offer, invitation or solicitation and is not intended to provide the sole basis for any evaluation of the investment product or any other matters discussed in this document. This document is made available to you because Tamohara believes that you have sufficient knowledge, experience and/or professional advice to understand and make your own independent evaluation of the risks and rewards of the investments and/or other matters discussed in this document and to make your own independent decision whether to implement the same. Any view expressed in the document is generic and not a personal recommendation and/or advice. It does not consider your risk tolerance, financial situation, knowledge and experience. Please discuss with your investment advisor if you seek advice on whether the proposed investment products are appropriate for you. The investments discussed in this document may not be suitable for all investors. Investments are subject to market risk. There can be no assurance or guarantee that any investment will achieve any particular return. Unless expressly stated, products are not guaranteed by Tamohara or their affiliates or any government entity. Past performance is not necessarily an indicator of future performance. Actual results may vary significantly from the forward-looking statements contained in this document due to various risks and uncertainties, including the effect of economic and political conditions in India and outside India, volatility in interest rates and the securities market, new regulations and government policies that may impact the business of Tamohara as well as its ability to implement the strategy. The information contained in this document has been obtained from sources that Tamohara believes are reliable but Tamohara do not represent or warrant that it is accurate or complete, and such information may be incomplete or condensed. Neither Tamohara, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any upon this document or its contents, or for any omission. The views in this document are generally those of Tamohara and are subject to change without notice, and Tamohara has no obligation to update its views or the information in this document. Tamohara or its affiliates may have acted upon or have made use of material in this document prior to its publication. Tamohara does not provide legal or tax advice and should you deem it necessary to obtain such advice, you should approach independent professional tax or legal advisors to obtain the same. This document is confidential and may not be reproduced or disclosed (in whole or part) to any other person without our prior written permission. The manner of distribution of this document and the availability of the products may be restricted by law or regulation in certain countries and persons who come into possession of this document are required to inform themselves of and observe such restrictions. This document is not directed to, nor intended for distribution or use by, any person or entity in any jurisdiction or country where the publication or availability of this document or such distribution or use would be contrary to local law or regulation, including for the avoidance of doubt the US. The contents of this document have not been reviewed by any regulatory authority in India or in any other jurisdiction. If you have any doubt about any of the contents of this document, you should obtain independent professional advice. The product strategies mentioned in the document may change depending upon the market conditions and the same may not be relevant in future. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and Tamohara or its directors, officers, partners or employees may or may not have any position in these sector(s)/stock(s)/issuer(s).