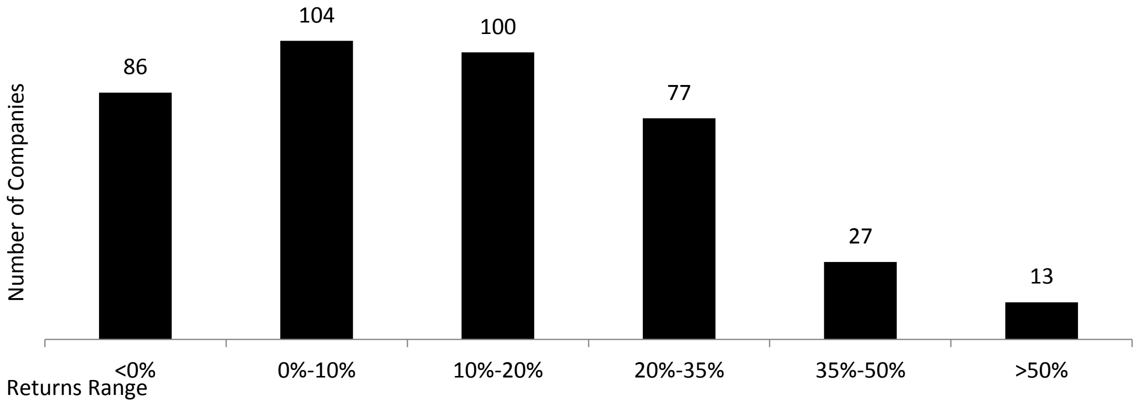
Tamohara Investment Managers - Monthly Newsletter **May 2015**

As we discussed in our last Newsletter, real risk in investments is a permanent loss of capital and not just volatility. We concluded that with an increase in the investment horizon, investors can significantly reduce the risk of a permanent loss of capital. Having secured the downside, the next logical step is to appraise the upside. In the current Newsletter, we attempt to determine the key drivers of long term equity returns.

What drives Long term Sustainable Equity Returns?

To understand the broad attributes of companies which have delivered long term sustainable returns in past, we looked at the return profile of companies in BSE 500 Index (roughly covers the entire universe of liquid, investible companies in the market) between year 2005-2013. We shortlisted companies which delivered a compounded annual return of 20% or more during this period (excluding financials companies and non-financial companies with a limited history) to arrive at a set of 109 companies

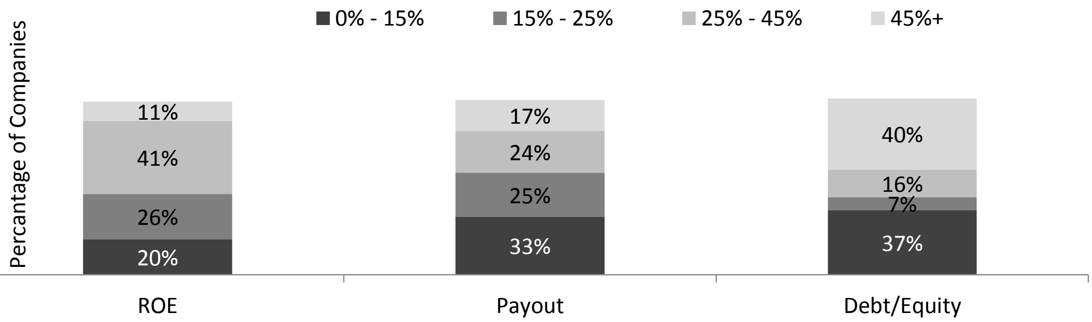
Returns Distribution of BSE 500 Companies



Source: Capitaline, Tamohara

On further analysing the key financial parameters of the shortlisted companies, we came across some striking similarities. Around 80% of these companies had Return on Equity (ROE) of more than 15%, about 65% of the companies had a dividend payout ratio of more than 15% while 60% of these companies had a leverage of less than 45%. In a nutshell, most of these companies had some superior financial parameter, or in common parlance, Quality

Select Financial Parameters of BSE 500 Companies (Ex- Financials) that have compounded at 20%+ over the last 6-9 yrs



Source: Capitaline, Tamohara

What constitutes Quality?

The primary objective of any business is to earn an economic profit i.e. generate returns in excess of its cost of capital. Long term value creation in a business is driven by its ability to sustainably and consistently generate returns in excess of the cost of capital. Quality, thus, in the investment parlance, is the ability of a business to generate superior returns on its capital.

A number of parameters - both quantitative and qualitative - collectively contribute towards building a quality business. Some of the key determinants of quality, in our view, are: Competitive landscape, Investment intensity, Technological dependence, Brand pull, Entry/exit barriers, and so on. For instance, lower competitive intensity renders a better pricing power while conversely, a high competitive intensity is more often than not harmful for profitability. Similarly, an investment heavy business usually takes much longer to overcome its cost of capital whereas a low investment business typically generates superior returns. This list is long, and probably the subject of a future newsletters; currently, our focus is on highlighting the importance of quality.

Why quality matters

As we have highlighted at the beginning of this communiqué, quality is a primary driver of investment returns. As Charlie Munger once famously observed *“We’ve really made the money out of high quality businesses. In some cases, we bought the whole business. And in some cases, we just bought a big block of stock. But when you analyze what happened, the big money’s been made in the high quality businesses. And most of the other people who’ve made a lot of money have done so in high quality businesses.*

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 6% on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you’ll end up with a fine result."

Thus, a long term investment horizon (as highlighted in the April 2015 communiqué) and a high quality business (as we discuss in this communiqué) are the essential building blocks of a successful investment.

Durability - Hidden Value vs. Value Traps

When you have a long term investment horizon, it is very important that the quality of the business that you invest in remains sustainable throughout your investment horizon. So far, we have looked as historical data to determine the importance of quality; however, successful investment requires that the quality benefit remain durable. If the quality benefit is not durable, then the business will keep generating lower returns on its capital each year, and eventually the stock price will start catching up with the gradual deterioration in value.

Consider the Indian Telecommunications industry for instance. With a very low cellular penetration the industry went through a very large boom in the initial years where increasing user base dwarfed the incremental capital costs. However, soon competition intensified, leading to price wars. Further, huge capital outlays in the form of towers and airwaves had to be incurred and incremental customer acquisitions slowed - partly due to higher competition and partly due to increased penetration. Thus, revenue growth slowed, profitability dipped but balance sheets continued to expand, impairing the returns on capital and increasing the leverage. Tellingly, shares prices plummeted/lagged other better businesses.

Share Price Movement of Bharti Airtel Ltd from Mar'02 to May'15

Share Price Movement of Reliance Communications Ltd from Mar'06 to May'15

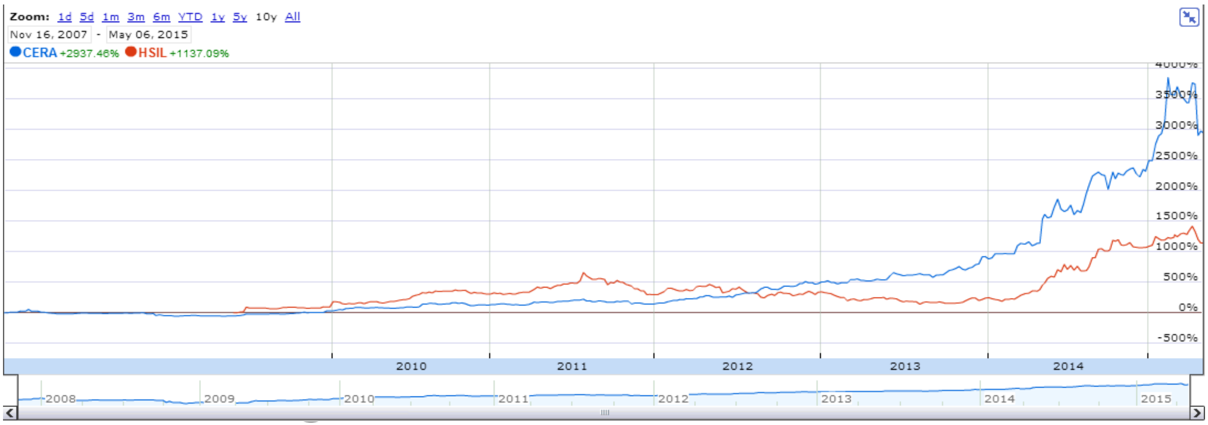
Share Price Movement of Idea Ltd from Mar'07 to May'15

Source: Google Finance

Even the best performing stock in the sector has returns 84% in 8 years!!. Thus, the quality, its durability, and the earning power of a business are very important factors in assessing the margin of safety of the investment. As Warren Buffet put it "The ideal business is one that generates very high returns on capital and can invest that capital back into the business at equally high rates. Imagine a $100 million business that earns 20% in one year, reinvests the $20 million profit and in the next year earns 20% of $120 million and so forth...".

The Sanitaryware companies listed in India are a perfect illustration of this. There used to be very little competition in the branded sanitary ware business, with two large players listed in India - Cera Sanitaryware Ltd (Cera) and HSIL Ltd (HSIL). Both these businesses had strong brands and enjoyed superior growth and profitability, generating high returns on capital from the business. However, HSIL also had a glass manufacturing business which was highly capital intensive and generated lower returns. Therefore, at a corporate level, Cera continued to reinvest capital at a constant rate while HSIL's reinvestments did not earn such high rates. Over a ten year period, this difference was reflected in the share price performance of the two companies as follows:

Relative Returns of Cera Sanitaryware and HSIL; Nov'07 - May'15



Source: Google Finance

To conclude: Successful investing is not only about long term investment horizon and focus on quality, it also involves a continuous evaluation of the durability of the factors that collectively impact the quality of business. Monitoring and re-evaluating an investment is, thus, as important as investing in a good business at the first place. We believe that wealth creation is a function of ability to invest in a quality businesses which has a durable competitive advantage and inherent ability to reinvest capital at superior rate of return for a longer period of time.

We look forward to your feedback.

Team Tamohara

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