17th Annual Wealth Creation Study 2007-2012

Economic Moat

Fountainhead of Wealth Creation

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Economic Moat

Fountainhead of Wealth Creation

Moat Quote

"(Great companies to invest are like) wonderful castles, surrounded by **deep, dangerous moats** where the leader inside is an honest and decent person. Preferably, the castle gets its strength from the genius inside; the moat is permanent and acts as a powerful deterrent to those considering an attack; and inside, the leader makes gold but doesn't keep it all for himself. Roughly translated, we like great companies with dominant positions, whose franchise is hard to duplicate and has tremendous staying power or some permanence to it."

– Warren Buffett

What is an Economic Moat?

- **The concept of 'Economic Moat' has its roots in the idea of a traditional moat**

  A moat is a deep, wide trench filled with water, that surrounds the rampart of a castle or fortified place.

- **An Economic Moat protects a company's profits from being attacked by business forces**

  Traditional management theory terms: "Sustainable Competitive Advantage" or "Entry Barriers"

Why Economic Moat?

- **Without Economic Moat, competition from rivals will ensure that high returns of a company are lowered to the level of economic cost of capital … or even below**

  What is happening in the Indian Telecom sector is a classic example of this

Moat Quote

The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns … Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed.” *– Warren Buffett*

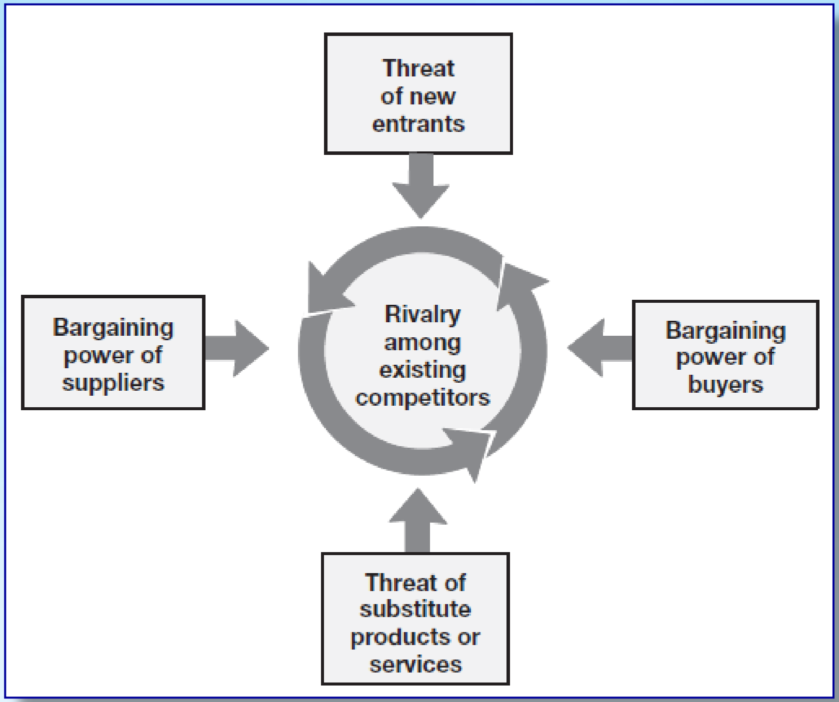
Why Economic Moat?

- **Economic Moat helps sustain superior profitability multiple pulls and pressures**

  Companies do not compete only with rivals for profit, but also with customers, suppliers, potential entrants and substitute products

Porter's Five Forces of Industry

Economic Moat protects profits being eroded by such forces



Economic Moat & investing

- **Much like companies, equity investors too chase high returns on their investments**
  In the long run, equity investors can only make as much money and return as the company itself makes

- **Investing in companies with Economic Moats is the only way to enjoy a share of their high profits and create wealth**

Moat Quote

"A truly great business must have an enduring moat that protects excellent returns on invested capital." – *Buffett*

Economic Moat & investing

- **Companies with "deep, dangerous moats" outperform those without, both in terms of financial performance and stock returns.**
  Markets worldwide are replete with examples similar to cross-sector cases given below in India

1. **Hero MotoCorp v/s TVS Motors**
2. **Bharti Airtel v/s Tata Teleservices**
3. **L&T v/s HCC**
4. **HDFC Bank v/s Central Bank**

Hero MotoCorp v/s TVS Motors

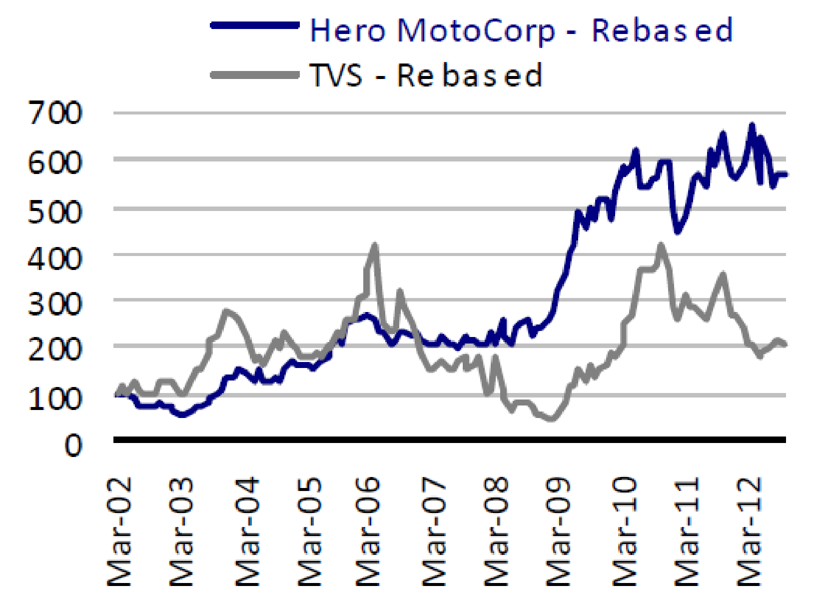
The facts …

- ❑ Both started business around the same time in the 1980s
- ❑ Both were Indo-Japanese JVs – Hero Group with Honda and TVS Group with Suzuki

The figures

FY12	Hero MotoCorp	TVS Motor
Volume (m)	6.2	2.2
Mkt share (%)	40	14
Sales (INR b)	236	74
PAT (INR b)	22	1
RoE (%)	66	15
FY02-12:		
Sales CAGR (%)	18	14
PAT CAGR (%)	17	11
Avg RoE (%)	56	14

The picture: 363% outperformance (10-yr)



MOAT IMPACT:

- ❑ **Hero MotoCorp: World's largest two-wheeler company**
- ❑ **TVS Motor: Struggling to retain its hitherto No 3 spot in India**

Bharti Airtel v/s Tata Teleservices

The facts …

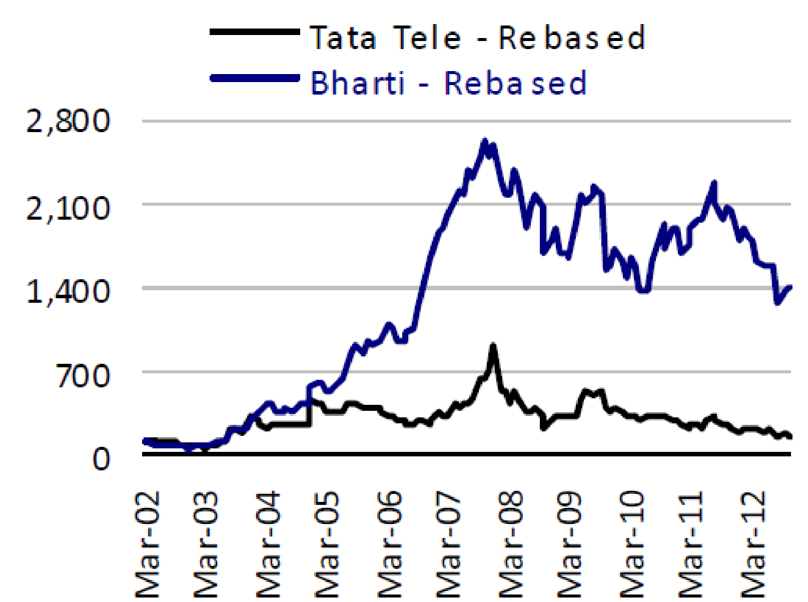
- Both incorporated in 1995 on the eve of India's telecom boom. In fact, Tata Tele had the rich Tata legacy

The figures

FY12	Bharti Airtel	Tata Tele
Sales (INR b)	715	25
PAT (INR b)	43	-5
RoE (%)	8	-ve
FY02-12:		
Sales CAGR (%)	47	25
PAT CAGR (%)	Loss to Profit	Loss to Loss
Avg RoE (%)	23	-9

- Both journeyed India's wireless explosion – massive value migration from wired telephony.

The picture: 1240% outperformance (10-yr)



MOAT IMPACT:

- **Bharti: India's No1 telecom co with global aspirations**
- **Tata Tele: Yet to report a single quarter of profit**

L&T v/s HCC

The facts …

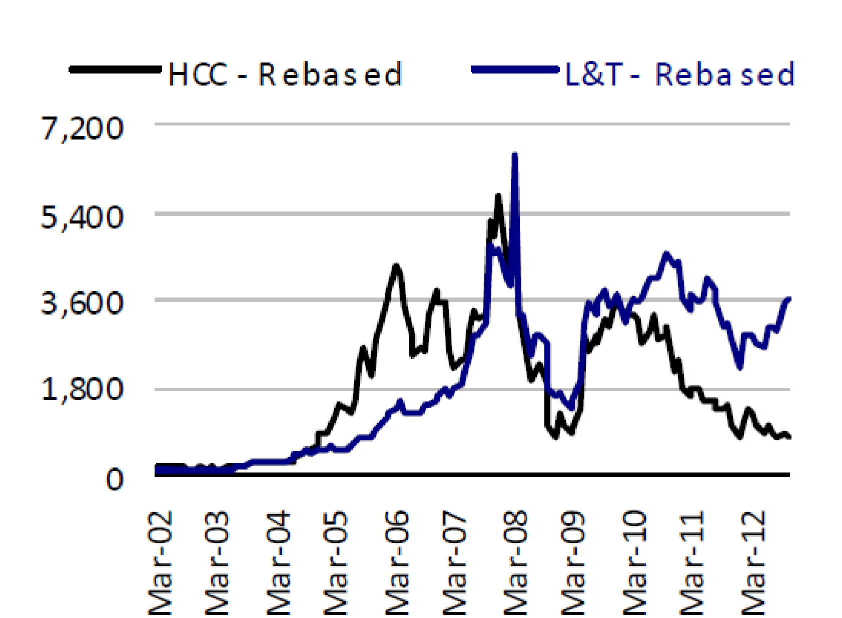
- Both long standing construction players in India. In fact, HCC was incorporated in 1926, earlier than L&T (1946)

The figures

FY12	L&T	HCC
Sales (INR b)	643	82
PAT (INR b)	45	-4
RoE (%)	16	- ve
FY02-12:		
Sales CAGR (%)	22	32
PAT CAGR (%)	32	Profit to Loss
Avg RoE (%)	22	11

- Both have benefited from India's exponential growth in infra, construction, real estate

The picture: 2800% outperformance (10-yr)



MOAT IMPACT:

- **L&T: Arguably India's answer to General Electric**
- **HCC: Struggling to make profit plus issues like BOTs, Lavasa**

HDFC Bank v/s Central Bank

The facts …

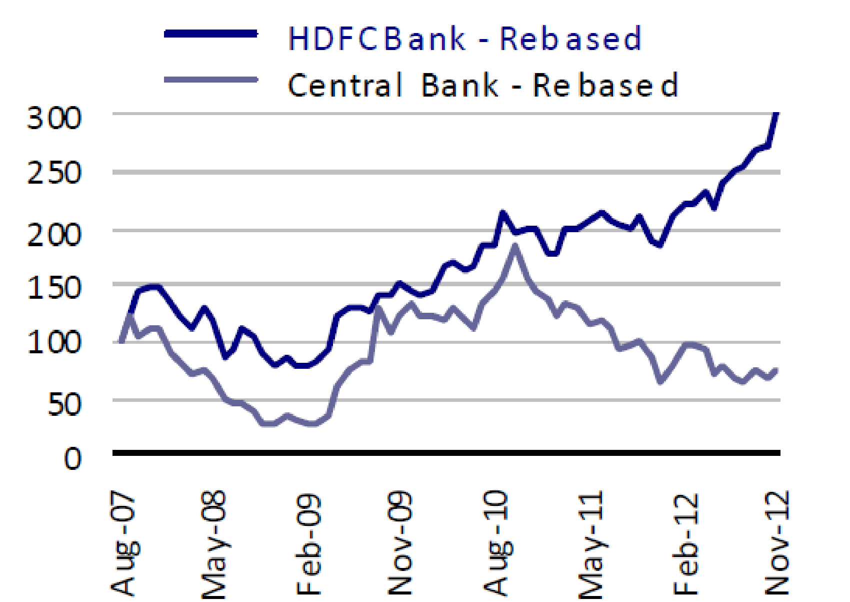
- Central Bank has recently completed 100 years. HDFC Bank, in contrast, is less than 20 years old.

The figures

FY12	HDFC Bank	Central Bank
Deposits (INR b)	2,465	1,962
Advances (INR b)	1,988	1,477
PAT (INR b)	52	6
RoE (%)	19	5
RoTA (%)	1.7	0.3
FY02-12:		
PAT CAGR (%)	33	14
Avg RoE (%)	18	17

- Central Bank's has 60% more branches than HDFC Bank (4,000+ v/s 2,500)

The picture: 230% outperformance (5-yr)



MOAT IMPACT:

- **HDFC Bank: FY12 PAT 10x of Central Bank, Mkt Cap 24x**
- **Central Bank: Lagging on most metrics – NPA, RoE, RoTA, etc**

Economic Moat: Two factors

1. **INDUSTRY STRUCTURE**

   Interplay of Buyer power, Supplier Power, Threat of new entrants/substitutes, etc

2. **COMPANY STRATEGY**

   5 elements – (1) Distinct value proposition
   (2) Tailored value chain (3) Trade-offs (4) Fit
   (5) Continuity over time

Moat Quote

"Why are some companies more profitable than others? … First, companies benefit from (or are hurt by) the structure of their industry. Second, a company's relative position within its industry can account for even more of the difference."

– **Joan Magretta**, in her book *Understanding Porter*

Economic Moat:
Applying in equity investing

1. The Economic Moat hypothesis

Investing in a portfolio of EMCs (Economic Moat Companies) should lead to sustained outperformance over benchmark indices across years, irrespective of market conditions.

2. Backtesting the hypothesis

Step 1: The backtesting framework

1. Arrive at a list of EMCs as on March 2002 and invest in them
2. Monitor price performance from March 2002 to March 2012

Economic Moat: Applying in equity investing

Backtesting the Economic Moat hypothesis (contd)

Step 2: Deciding Economic Moat criteria

2A. The principles:

1. Economic Moat ultimately reflects in financials, with RoI significantly superior to peers
2. Competitive advantage is relevant only within sectors

2B. The practice:

1. For each of the last 8 years, calculate for all sectors RoE of companies and sector average RoE
2. A company is an EMC if for at least 6 years, its RoE exceeds industry average
3. Discretionary adjustment to the final list based on then known facts and figures

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Backtesting the Economic Moat hypothesis (contd)

Step 3: The findings

#1 – EMCs handsomely outperform

#2 – EMCs’ outperformance is earnings and valuations agnostic

#3 – EMCs’ outperformance is sector agnostic

#4 – Future not too meaningful for EMCs, but critical for non-EMCs

Backtesting the Economic Moat hypothesis (contd)

Finding #1: EMCs handsomely outperform

- Over 2003-12, overall return of 177 companies was 18%
- EMCs returned 25% whereas non-EMCs returned 12%
- Sensex return was 18%, implying 7% Alpha for EMCs and negative 6% Alpha for non-EMCs

2003-12 Avg Price CAGR (%)

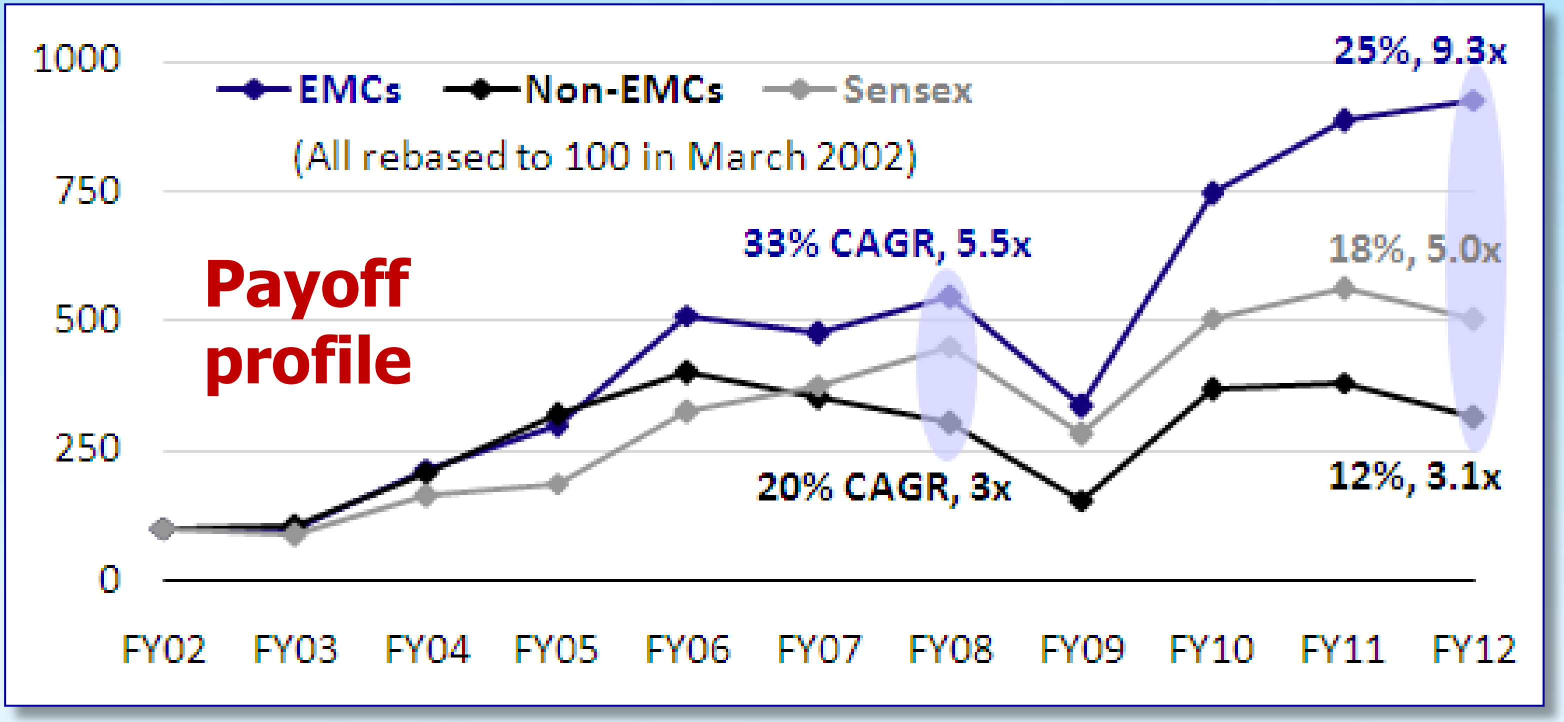
	EMCs	Non-EMCs	Overall
Return	**25%**	**12%**	**18%**
Sensex	18%	18%	18%
Alpha	**+7%**	**-6%**	**0%**

Economic Moat:
Applying in equity investing

Backtesting the Economic Moat hypothesis (contd)

Finding #1: EMCs handsomely outperform (contd)

- Besides point-to-point outperformance, EMCs outperformed the Sensex in every year over the 10 years
- Also, after 3 years, EMCs outperformed even non-EMCs



Backtesting the Economic Moat hypothesis (contd)

Finding #2: EMCs' outperformance is earnings and valuations agnostic

The most plausible explanation for this:

- **Earnings agnosticism**
  EMCs' strong competitive advantage which ensures that they enjoy a more-than-fair share of the growth inherent in most sectors in India

- **Valuation agnosticism**
  Continuous rollover of EMCs' competitive advantage period (CAP)

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Backtesting the Economic Moat hypothesis (contd)

Explaining EMCs' valuation agnosticism: CAP

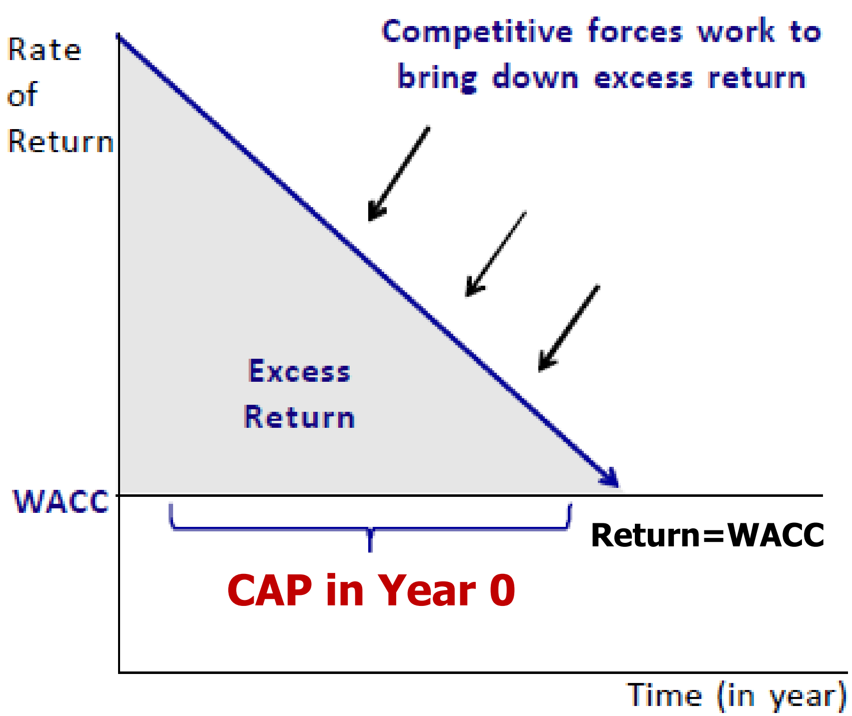
- **Competitive advantage period (CAP)** is the time during which a company is expected to generate returns on incremental investment that exceed its cost of capital.
- **Markets do assign premium valuations to EMCs**, given their reasonably accurate assessment that such companies enjoy a very long CAP.
- **Where the markets fail** is in recognizing that barring a low mortality rate of less than 15%, EMCs leverage their moat and sustain high return even with passage of time.
- **The CAP of EMCs simply rolls over** with each passing year, creating incremental excess return for investors.

Economic Moat:
Applying in equity investing

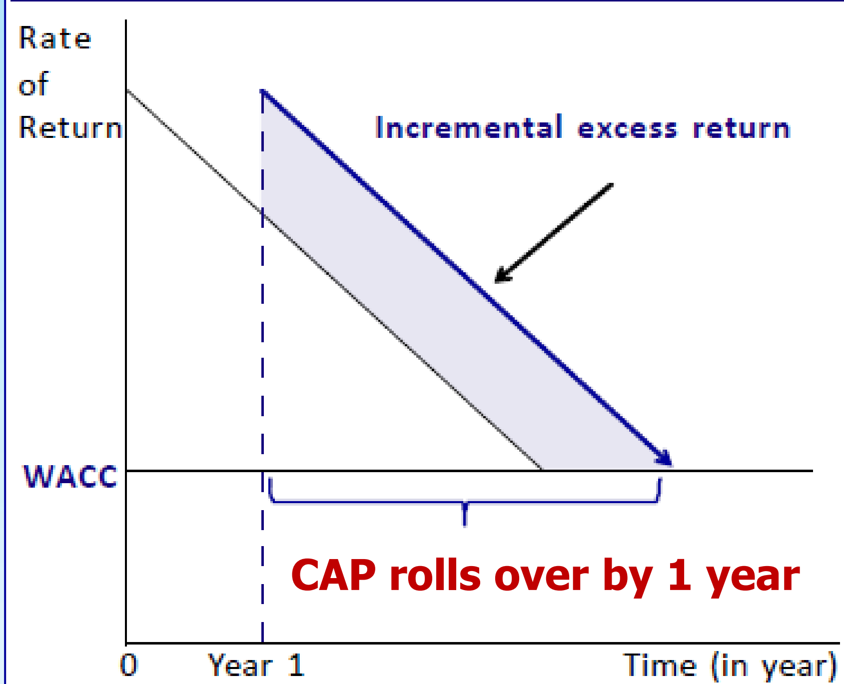
Backtesting the Economic Moat hypothesis (contd)

CAP rollover plausibly explains EMCs’ valuation agnosticism

Markets intuitively value companies based on CAP …



… but markets are unable to appropriately value EMCs whose CAP rolls over with every passing period



Economic Moat:
Applying in equity investing

Backtesting the Economic Moat hypothesis (contd)

Finding #3: EMCs' outperformance is sector agnostic

- EMCs are likely to outperform benchmarks across sectors, even if the sector itself is out of market favor.
- Thus, out of our 22 homogenous sector groupings, EMCs underperformed the Sensex in only two sectors – Oil Refining and Textiles.

Economic Moat: Applying in equity investing

Backtesting the Economic Moat hypothesis (contd)

Finding #4: Future not too meaningful for EMCs, critical for non-EMCs

- Mortality rate of EMCs is likely to be low. By 2012 only 11 of 74 turned into non-EMCs (mortality<15%). But even these companies beat the Sensex
- EMCs which remained so did not do much better than initial performance
- Non-EMCs who upgraded into EMCs delivered the highest return at 27%, albeit with a mortality rate of 75%
- Worse of all, non-EMCs which remained so delivered only 8% return.

Payoff Matrix

2003-12 EMCs		1995-02 EMCs: No	1995-02 EMCs: Yes
	Yes	27%	26%
	No	8%	20%

2003-12 Sensex return was 18%

Backtesting the Economic Moat hypothesis (contd)

Applying the methodology to Nifty constituents in year 2002

We applied our backtesting methodology to 38 constituents of Nifty in 2002. The results were similar to that of the broader universe –

- EMCs outperform both non-EMCs and overall Nifty
- Non-EMCs underperform Nifty
- EMCs which maintain status quo do not report materially high returns
- But non-EMCs which upgrade to EMCs deliver high returns
- Non-EMCs which stay so perform the worst

Stock returns on 2002 Nifty

	Price CAGR	No. of cos.
EMC	22%	29
Non-EMC	16%	9

Nifty payoff matrix

2003-12 EMCs		1995-02 EMCs: No	1995-02 EMCs: Yes
	Yes	21%	22%
	No	4%	14%

38 stocks return: 20%
Nifty return: 16%

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Applying the methodology to current Nifty

We have bifurcated current Nifty stocks into EMCs and non-EMCs using the backtesting methodology –

1. Company and sector average RoE data 2005 to 2012, and
2. In some cases, discretion based on currently known information and subjective opinion

Prognosis based on past experience

1. In our view, there are 27 EMCs and 23 non-EMCs in the current Nifty
2. Expect EMC basket to outperform non-EMCs and Nifty itself
3. Expect about 6 non-EMCs (25% of 23) to upgrade to EMCs and deliver handsome returns
4. Non-EMCs which maintain status quo will eventually be replaced in the Nifty

Nifty: The Economic Moat classification

Nifty EMCs (27 companies)	
Asian Paints	Kotak Mahindra Bank
Axis Bank	Larsen & Toubro
Bajaj Auto	Lupin
Bharti Airtel	M & M
Coal India	Maruti Suzuki
GAIL (India)	NTPC
Grasim Inds	O N G C
H D F C	Punjab National Bank
HDFC Bank	Sesa Goa
Hero MotoCorp	State Bank of India
Hind Unilever	Sun Pharma
Infosys	TCS
ITC	UltraTech Cement
Jindal Steel	

Nifty non-EMCs (23 companies)	
ACC	ICICI Bank
Ambuja Cem.	JP Associates
B H E L	Power Grid Corpn
B P C L	Ranbaxy Labs
Bank of Baroda	Reliance Inds
Cairn India	Reliance Infra
Cipla	Siemens
DLF	Tata Motors
Dr Reddy's Labs	Tata Power
HCL Technologies	Tata Steel
Hindalco Inds	Wipro
I D F C	

Thank You !

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Happy Investing In

Economic Moats

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