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Wealth Creation Guide

by Raamdeo Agrawal

A systematic approach to identifying wealth creating companies, based on over 20 years of experience in the capital markets.

5 STEPS TO LOCATE A WEALTH CREATOR

The first rule of investing is 'Don't lose money'. The second rule of investing is 'Don't forget rule No. 1'! It is essential to stick to these rules when it comes to investing, in order to avoid the possibility of capital erosion. To apply these rules successfully and to create wealth through equity investing one must evaluate the following parameters:

1 ASSESS THE ENTRY BARRIERS CREATED BY A COMPANY PARAMETER

Entry barrier should be preferably intellectual in character

Remember, a stock is nothing but a stake in the company's business. So, observe the company's business and the entry barriers created by it. The entry barrier should be more 'intellectual' in character rather than 'physical'. This is because while it is next to impossible to compete with a strong brand (an intellectual barrier), competitive advantage associated with a piece of land (a physical barrier) disappears when a competitor acquires one as well. Strong brands such as 'Thums-Up', 'Parle-G', etc. have enabled their companies to retain the top spot. However, at times there could be exceptions. For instance, the entry barrier associated with TISCO would be its large base of iron ore and coal, which allows it to lower its raw material cost drastically vis-à-vis its competitors for long time to come.

Entry barrier should be long-lasting

An entry barrier should not only be strong, but also long lasting. Such companies will keep making money because their entry barriers keep working for them. For instance, Britannia may not be the best managed company but its strong brand continuously earns money for it.

Buy into such companies at the earliest

As an investor, buy into such businesses ahead of the crowd. If an entry barrier has been established very recently, it may not yet be exploited by the business. Accordingly, the market would not have valued it in the company's share price. For instance, when Financial Technologies (promoters of MCX) got its commodity exchange license and launched it, the popular opinion held was that it would be unable to execute the business well. But, today, it has emerged as a premier commodity exchange. Investing in such companies before the market sees their potential delivers best appreciation.

"Though difficult to practice, think ahead of the crowd"

2 MANAGEMENT SHOULD BE COMPETENT AND PASSIONATE

Choose companies that are led by a competent and passionate team. Both these attributes are equally important. Competence or passion alone will not work. An individual with a local degree combined with passion would have greater growth prospects than one who has a Harvard degree but no passion. A company like Pantaloon Retail is a shining example of how passion can create wealth.

"The definition of a great company is one that will remain great for many years"

3 MANAGEMENT SHOULD HAVE INTEGRITY

Integrity is the most crucial quality that a company's management must have. Such companies not only run their businesses in a honest manner, they are also honest to all their stakeholders, be it employees, the government or the shareholders. If honesty is part of a company's DNA, it will be fair to its smallest stakeholders - the minority retail shareholders. Companies such as Tata and Infosys have this quality, which has added to their growth and market attractiveness immensely.

The above mentioned three characteristics (long lasting intellectual entry barrier, competent and passionate management and integrity) must all be simultaneously present in a company that you choose to invest in.

"Without management integrity, no margin of safety can be high enough"

4 BUY LOW

The price that you pay for a stock determines your rate of return. So, it is essential that you get your purchase price right. While some companies come out on top with respect to all the first three parameters, the returns falter when it comes to the purchase price.

For instance, HUL comes on top with respect to all the first three parameters but has not delivered as much as far as its stock goes. Its stock delivered a CAGR of approximately just 3 per cent over the last 5 years, when the market delivered a CAGR of approximately 44 per cent over the same period. In the bible it is said that "love takes care of a lot of sins".

Likewise in investments, purchase price takes care of a lot of mistakes. You can make mistakes on assessing the first three parameters, since they are subjective in nature, but getting the right purchase price covers up for all your mistakes. Hence, estimate the expected value / intrinsic value of the company and keep an adequate margin of safety in the purchase price.

"It is much more important to buy cheap than to sell dear"

5 HAVE PATIENCE

When you buy a house you don't expect it to appreciate overnight. You look at its appreciation over a long period. The same goes with equity. After having bought a company that conforms to all the above four criteria, you need to have patience.

Investing in equities is often driven by two emotions-greed and fear. And patience is the mantra that helps overcome these emotions. Patience makes the difference between investing and speculation. It's like a fertilizer to the investment process.

"In reality, patience is crucial, but it is a rare commodity"

RAAMDEO AGRAWAL'S 10 INSIGHTS ON WEALTH CREATION

1. Wealth creators are driven by a passion for leadership in business
2. In euphoric times, investors focus on the price of a share rather than the price of the company
3. Mid- cap stocks have the propensity to create wealth faster than heavy weight blue chips
4. Stock prices are determined by 'marginal opinion' and not by majority opinion
5. While examining a company's expansion plans, remember that growth in a franchisee of the same business is likely to be more rewarding in the future than growth from a totally new line of business
6. At all times, in all markets, in all parts of the world, the tiniest change in interest rates changes the value of every financial asset
7. Wealth creating companies have substantially higher RoE and RoCE than most others that are comparable
8. Market follies contribute enormously to the creation of mega multi- baggers
9. A high growth business, which is run by an outstanding management and purchased with a five year payback outlook of less than 1, has a good chance of being a big winner
10. Purchase price discipline, that is, maintaining a huge margin of safety at the time of purchase, is paramount because it covers a multitude of errors committed while investing

DISCOVERING WEALTH CREATORS IN THE INDIAN STOCK MARKETS

We have been studying wealth creators in the Indian equity markets for over a decade. Every year, our Wealth Creation Study looks at the capital markets over the past five years to discover trends in wealth creation. Here are some interesting insights, gleaned from these studies.

Study I Qualitative and Quantitative aspects of Wealth Creators (1991-1996)

The first study explains that wealth creating companies have a substantially high RoE (Return on Earning) and RoCE (Return on Capital Employed). Wealth Creators display a high correlation between RoE and P/E (Price Earning ratio). It advises that there is an inherent margin of safety in buying stock at a P/E ratio substantially lower than its sustainable RoE. Amongst other things, it reveals that mid-cap stocks have the propensity to create wealth faster than heavy weight blue chips but the surety of wealth creation is greater for large-cap stocks.

Study II Good Businesses, which get better (1992-1997)

This study states that, "the principle one must bear in mind while identifying a right business is that the business economics must not only be distinctly superior but should also get better with time". It further recommends picking market leaders in various business segments since Wealth Creators are driven by passion for leadership in business.

Study III Competitive strengths of Wealth Creators (1993-1998)

This study like the previous two, observes that focused business activities are the stepping stone to wealth creation. In addition, it points out that superior technology and strong brands are key competitive strengths of Wealth Creators.

Study IV Characteristics of growth and Valuation of growth (1994-1999)

This study advises us that consistency, profitability and sustainability are the key drivers to the valuation of growth. It also highlights the magic of compounding. What makes growth valuable is its power to compound returns over a period of time.

Study V Outstanding Management (1995-2000)

The quality of the company's management plays a vital role in the creation of wealth. The management should have important attributes such as depth to sustain the competitive edge, a long range profit outlook and unquestionable integrity to achieve better visibility of earnings and better valuation.

Study VI Three Components of Value (1996-2001)

This study points out that value investing starts with having a better understanding of the intrinsic value of the company than the rest of the market. We can divide a company's intrinsic value into three parts:

Asset Replacement Value: This is the current value of a company's assets. The basic value of a business with no competitive advantage is the replacement cost of its assets. Any new entrant can get these by paying the current price.

Earning Power Value: This is the ability of a company to earn returns. A competitive advantage or some kind of entry barrier allows companies to earn higher returns than the cost of the capital.

Growth Value: This is the ability of a company to benefit from growth. Amongst other things, new lines of business without competitive advantage are unlikely to earn attractive returns on additional capital for a meaningful period of time.

Study VII Value of a stock (1997-2002)

This study underlines two factors, which are critical to determine the value of stock-dividends(which are dependent on long term earning power of the company) and discount rate (the rate at which future dividends are discounted to the present value). It also makes an interesting point about value.

Study VIII Transitory or Enduring Wealth Creators (1998- 2003)

Multi-baggers are super stocks that multiply in value over a period of time. These are created by a combination of the nature of the business they belong to, and the quality of their management. Multi- baggers are of two types: transitory and enduring. Transitory Multi-baggers attract a lot of crowd and media attention, but they always give nasty end results-their financials do not support their value or worth at the peak. Enduring Multi-baggers on the other hand are those companies whose wealth creation is long lasting.

Study IX Business cycles in commodity business (1999- 2004)

When demand is high and capacities are being fully or nearly fully utilised, prices and profits rise. This attracts more investment into capacity creation, which eventually leads to over capacity in the industry and finally a glut situation (excess supply).This is a typical feature of commodity companies which have a boom and trough every few years. Understanding these cycles could help you time your investment in such stocks.

Study X Understanding Price and Value (2000- 2005)

This study examines the dilemma of what price should you pay for wealth creating stocks if you aim to augment your wealth through investment in these. It explains the need to understand that price is what you pay and value is what you get or you expect to get in the future. Earnings, dividends, assets and sentiments all have an effect on price determination. The study reminds us that consistent wealth creators (like any other stock) have to be bought cheap and sold when they are dear.

Study XI Importance of ' Terms of Trade' (2001- 2006)

The working capital requirements of the company are determined by the ' terms of trade' that the business enjoys. Better terms of trade not only brings down the cost of working capital but also enhances the company's RoCE (Return on Capital Employed). According to the study 'terms of trade' refers to the ratio of debtors to creditors, where, the lower the ratio the better. A company enjoys favourable 'terms of trade' if its debtors are lower than its creditors while conversely and adverse 'terms of trade' could mean very high working capital requirements, rendering the business unprofitable.

Study XII India - The Next Trillion Dollar opportunity (2002- 2007)

This study presents the scenario for India's journey from USD 1 trillion in 2007 to USD 2 trillion by 2012 and its impact on a few businesses and the stock market. According to the study, given the current GDP growth rate, its expected that India will touch a GDP figures of USD 2trillion (assuming current Re/USD parity) by 2012.

Study XIII Understanding of Great, Good and Gruesome companies (2003-2008)

This study presents the importance of buying Great companies (perpetual bonds) at reasonable prices and avoiding the Gruesome companies. This study states that the Great, the Good and the Gruesome companies are three types of bank savings accounts, where RoE (return on equity) is considered as the interest rate. The Great one pays an extraordinarily high interest rate that will rise as the years pass. The Good one pays an attractive rate of interest that will be earned also on deposits that are added. The Gruesome account not only pays an inadequate interest rate but also requires you to keep adding money at those disappointing returns.

Study XIV Winner Categories + Category Winners = Formula for Wealth Creation in the NTD Era (2004-2009)

This study presents a winning formula for wealth creation as its theme. The formula for Winner Categories is the blend of categories benefiting from India's Next Trillion Dollar GDP opportunity & their scalability. Category Winners are companies from Winner Categories, which have high Entry Barriers and Great Managements. The formula used for the winning investments is the combination of the category winners & the respective reasonable valuation. The most important step for the Wealth Creation is the amalgamation of the Winner Categories

& the Category Winners.

India's NTD Era will see a huge boom in consumption and savings/investment, which will throw up several Winner Categories i.e. those which grow at over 1.5x GDP growth rate, and are consolidated in nature. Category Winners bought at reasonable (not necessarily cheap) valuation create significant wealth over the long term.

Study XV UU Investing: Creating wealth from the Unknown and Unknowable (2005-2010)

This Study presents the theme of UU investing (unknown and unknowable). UU investing is the process of identifying good investments when the level of uncertainty is well beyond traditional levels. UU situations offer asymmetric payoffs; these can be exploited only by investors with complementary skills, unusual judgement, and no fear of hindsight criticism.

3 simple steps on UU investing

Step 1: Know the Success Principles

Step 2: Look for UU situations

Step 3: Be aware of UU pitfalls

Other Key Conclusions

- TTS - Ten Trillion Dollar Savings through 2020 - will throw up many UU investing opportunities in Indian financial services.
- India's high linear economic growth will create exponential situations in several other businesses as well - the perfect backdrop for UU investing.

" Wealth Creation is the art of buying a rupee for 40 paise "

About Motilal Oswal

The driving philosophy of Motilal Oswal Securities Ltd. is 'Solid Research. Solid Advice'. Our research has won awards and accolades from various institutions over many years which includes Best Performing Equity Broker at the CNBC TV 18 Financial Advisor Awards 2010 and also Rated as No.1 Broker at the ET Now - Starmine Analyst Awards 2009 With over 1504 business locations across more than 591 cities, Motilal Oswal is well suited to handle all your wealth creation and wealth management needs. Motilal Oswal Financial Services, the parent company is a well-diversified financial services group having businesses in securities, commodities, investment banking, private equity and asset management

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