30-year *manthan*, 1 *mantra*: QGLP

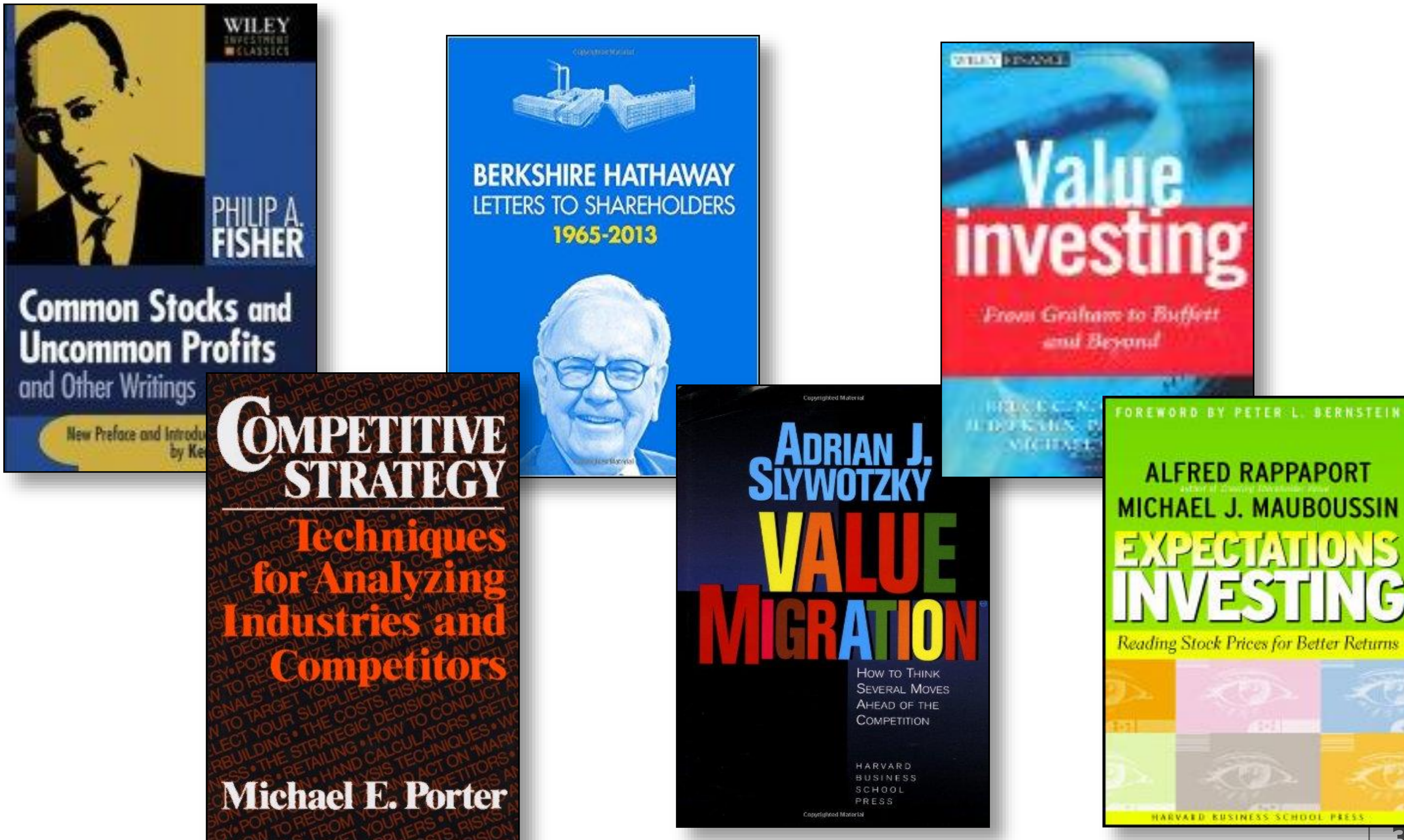
Think Equity Think QGLP Contest 2018 : Backdrop

For more details & clarifications, email thinkQGLP@motilaloswal.com

The *manthan* (churn)

The *manthan* – Knowledge churn

Wide-range of readings on business & investing



The *manthan* – Knowledge churn

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Rich learnings from 22 years of Wealth Creation Studies

Warren Buffett's investing process

a) A business we understand;

b) Favorable long-term economics;

c) Able and trustworthy management; and

d) A sensible price-tag.

— 2007 Annual Letter

The *mantra*: QGLP

QGLP in a nutshell

"QGLP – Quality, Growth, Longevity, reasonable Price"

Quality of business x Quality of management

- Stable business, preferably consumer facing
- Huge business opportunity
- Sustainable competitive advantage
- Competent management team
- Healthy financials & ratios

Growth in earnings

- Volume growth
- Price growth
- Mix change
- Operating leverage
- Financial leverage

Price

- Reasonable valuation, relative to growth prospects
- High margin of safety
- Prefer stocks with PEG of around 1x

Longevity – of both Q & G

- Long-term relevance of business
- Extending competitive advantage period
- Sustenance of growth momentum

Q – Quality

High quality business x High quality management

Quality of business

- Large profit pool
- Size of opportunity
  (eg IT, Pharma, Financials)
- Competitive landscape
  - Monopoly (Bosch), Oligopoly (OMCs)
  - Dominant market share
    (Asian Paints, United Spirits)
- Niche / Strategic opportunity
  (Eicher, Page Industries)
- Favourable demand-supply

Quality of management

- Unquestionable integrity
  - Impeccable corporate governance
  - Concern for all stakeholders
  - Preferably paying full tax and
    a well-articulated dividend policy
- Demonstrable competence
  - Excellence in strategy & execution
  - Sustaining competitive advantage
- Growth mindset
  - Long-range profit outlook
  - Efficient capital allocation

G – Growth in earnings

- **Understanding short-term Growth is a science but Understanding long-term Growth is an art**

- **Growth is a lollapalooza of C, V, P, M**

  i.e. Cost, Volume, Price, Mix

  (lollapalooza is a big effect from large combinations of factors)

G – Growth in earnings

High earnings growth situations

- Value Migration – flow of value (profit & market cap) from outmoded businesses to superior businesses (e.g. wired telephony to wireless, public sector banks to private banks, etc)
- Sustained industry tailwind
- Small base with large opportunity
- New large investment getting commissioned
- Inorganic growth through M&A
- Consolidation of competition
- Operating & Financial leverage
- Turnaround from loss to profit

L – Longevity

Longevity of both Quality and Growth

- Long-term relevance of the company's products & services
- No breakdown of the business model in the foreseeable future
- Extending competitive advantage period:
  — maintaining edge over peers through innovation, strengthening of brands, deepening distribution, etc
- Sustenance of growth momentum:
  — huge opportunity size
  — periodic new product launches / capacity expansion
  — non value-dilutive inorganic growth

P – Price

Reasonable Price i.e. well below intrinsic value, leaving good Margin of Safety

- Several valuation approaches possible
- Some proprietary formulas –

1. **Payback ratio**

   Less than 1x is almost a sure shot formula for multi-bagger

$$\textbf{Payback ratio} = \frac{\textbf{Market Cap}}{\textbf{Next 5 years PAT}}$$

2. **PEG (PE to [future] Growth)**

   Less than 1x improves chances of huge wealth creation

QGLP: Case Studies

QGLP Case Studies

1. RBL Bank
2. Alkem Laboratories
3. Sterlite Technologies

Disclaimer

The companies discussed here are for illustrative purposes only, and should not be construed as investment advice.

RBL Bank

Company background

- RBL Bank is one of India's fastest growing private sector banks with an expanding presence across the country.
- The Bank offers specialized services under six business verticals:
  1. Corporate & Institutional Banking
  2. Commercial Banking
  3. Branch & Business Banking
  4. Agri Business Banking
  5. Development Banking and Financial Inclusion
  6. Treasury and Financial Markets Operations.
- It currently services over 4.9 million customers
  — network of 266 Branches, 199 Banking Outlets and 369 ATMs
- RBL Bank's current market cap is around INR 22,000 crores

RBL Bank – QGLP in a nutshell

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Asset Management
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CONTEST

QGLP – Quality, Growth, Longevity, reasonable Price

Quality of business x Quality of management

- Massive value migration from state-owned banks to private banks
- RBL has more than doubled customer base in last two years to nearly 5 mn
- RBL's GNPA (1.4%) and NNPA (0.8%) at reasonable levels
- RBL's return ratios on a steady uptrend

Growth in earnings

- Long growth runway – RBL's profits are a fraction of private banks' profits
- Vision 2020 on track : 30-35% CAGR in advances with 1.5% ROTA
- Assets to double from INR 62,000 crores to INR 128,000 crores
- Expect FY18-21 EPS CAGR of 34%

Price

- Current P/E of 33x is rich, but defendable considering robust 34% EPS CAGR
- 3-year target price of INR 1,145 at exit P/E of 30x
- Robust 30% return CAGR; BUY

Longevity – of both Q & G

- Longevity of Quality – High focus on Effective Risk Management and Asset Quality
- Longevity of Growth – Multi-decadal opportunity for private banks in India

Q — Quality

❑ Quality of Business

- Banking in India is a large and secular business
  - Under-penetrated: bank credit to GDP at 51% (China 250%; USA 150%)
  - 20-year CAGR: deposits 17%, credit 18%
- Relentless Value Migration from state-owned banks to private banks

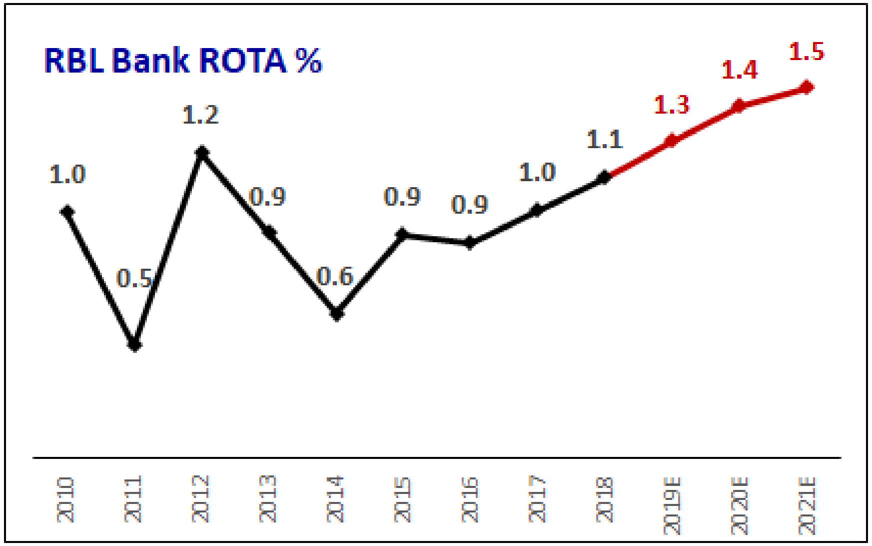
Porter's Five Forces – Moderately favourable competitive landscape

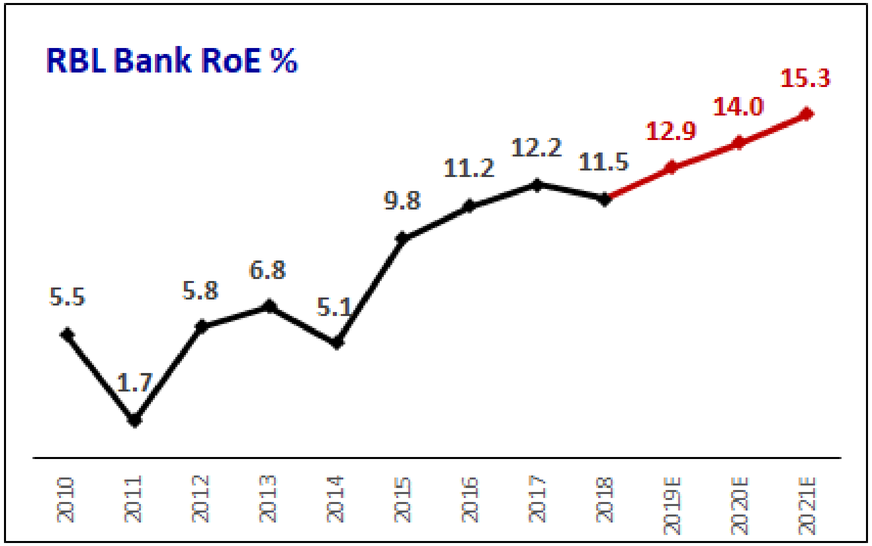
Force	Comment	Sector Score
1. Inter-firm rivalry	High	0
2. Bargaining power of customers	Medium	0.5
3. Bargaining power of suppliers	Low	1
4. Threat of new entrants	Medium	0.5
5. Threat of substitutes	Low	1
	TOTAL	**3 out of 5**

Q — Quality

❑ Quality of Business (continued)

- RBL has more than doubled customer base in last two years to ~5 mn
- RBL's GNPA (1.4%) and NNPA (0.8%) at reasonable levels
- CASA ratio is steadily recovering over the last 4 years
  - — from 18% in FY15 to 24% in FY18
- RBL's return ratios – on a steady uptrend





Q — Quality

❑ Quality of Management

➢ Unquestionable Integrity

- High quality of underwriting and disclosure
- High skin in the game – outstanding ESOPs at 9.4% of capital base, and ~50% of employees covered under ESOP plan
- Senior management own over 5% of the bank

➢ Demonstrable Competence

- New management inducted in 2010
- Led by Vishwavir Ahuja — rich 20-year experience with Bank of America, including as head of India operations
- Demonstrated capability by turning around old, regional bank into a modern, pan-India bank
- Strong board and professional team

➢ Growth Mindset

- 30-35% CAGR in advances targeted through FY20

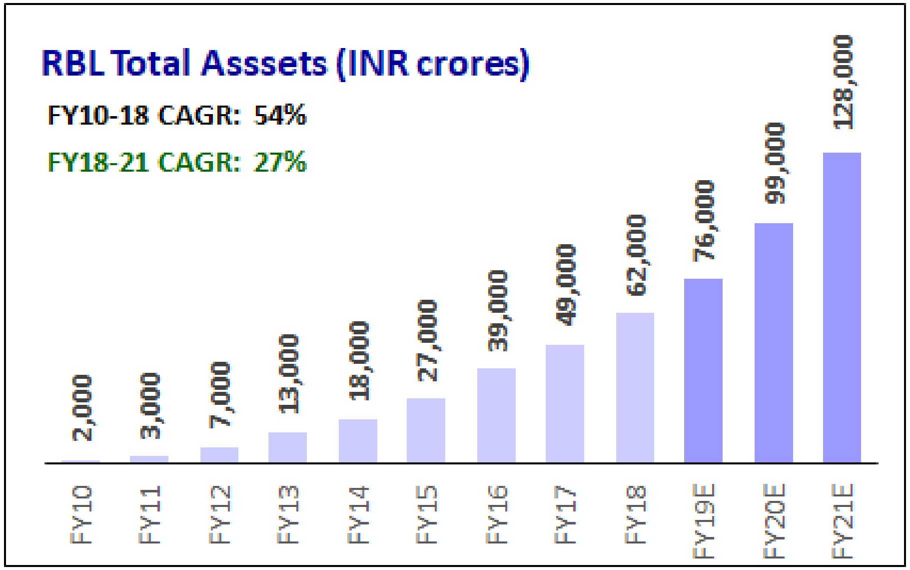
G — Growth in earnings

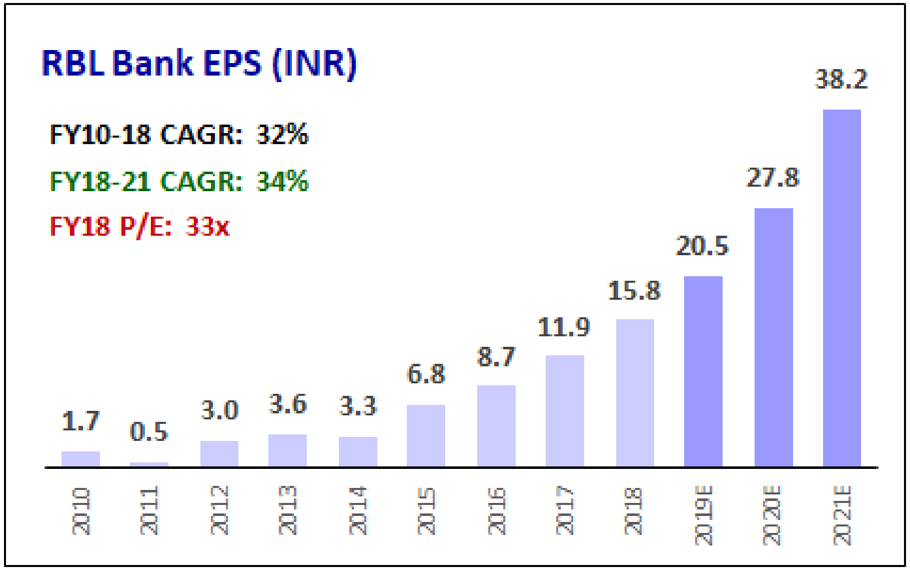
- **Long growth runway**
  — RBL's profit is a fraction of total private sector bank profits

(INR crores)	**FY18**	**FY21 E**	
Private sector banks' PAT	45,000	75,000	*(@18% CAGR – last 10-year)*
RBL Bank's PAT	635	1,725	*40% CAGR*
RBL PAT as % of total	**1.4%**	**2.3%**	

G — Growth in earnings

- Vision 2020 on track : 30-35% CAGR in advances with 1.5% ROTA
- Assets to double from INR 62,000 crores to INR 128,000 crores
- Expect FY18-21 EPS CAGR of 34%





L — Longevity

❑ Longevity of Quality

- High focus on Effective Risk Management and Asset Quality

❑ Longevity of Growth

- Multi-decadal opportunity for private banks in India
- RBL's small base in a large profit-pool sector helps ensure longevity of earnings growth

P — Price

Valuation rich, but defendable considering robust PAT growth

- Current P/E 33x and P/B 3.3x
- FY21 P/E 14x and P/B 2x
- 3-year target price of INR 1,145 at exit P/E of 30x
- **Robust 30% return CAGR; BUY**

INR crores	FY18	FY21 E	CAGR
Total assets	62,000	1,28,000	**28%**
ROTA	1.1%	1.5%	
PAT	635	1,725	**40%**
EPS (INR)	15.8	38.2	**34%**
Exit P/E (x)	33	30	
Mkt Cap	21,900	52,000	**33%**
Stock price (INR)	**522**	**1,145**	**30%**

P — Price

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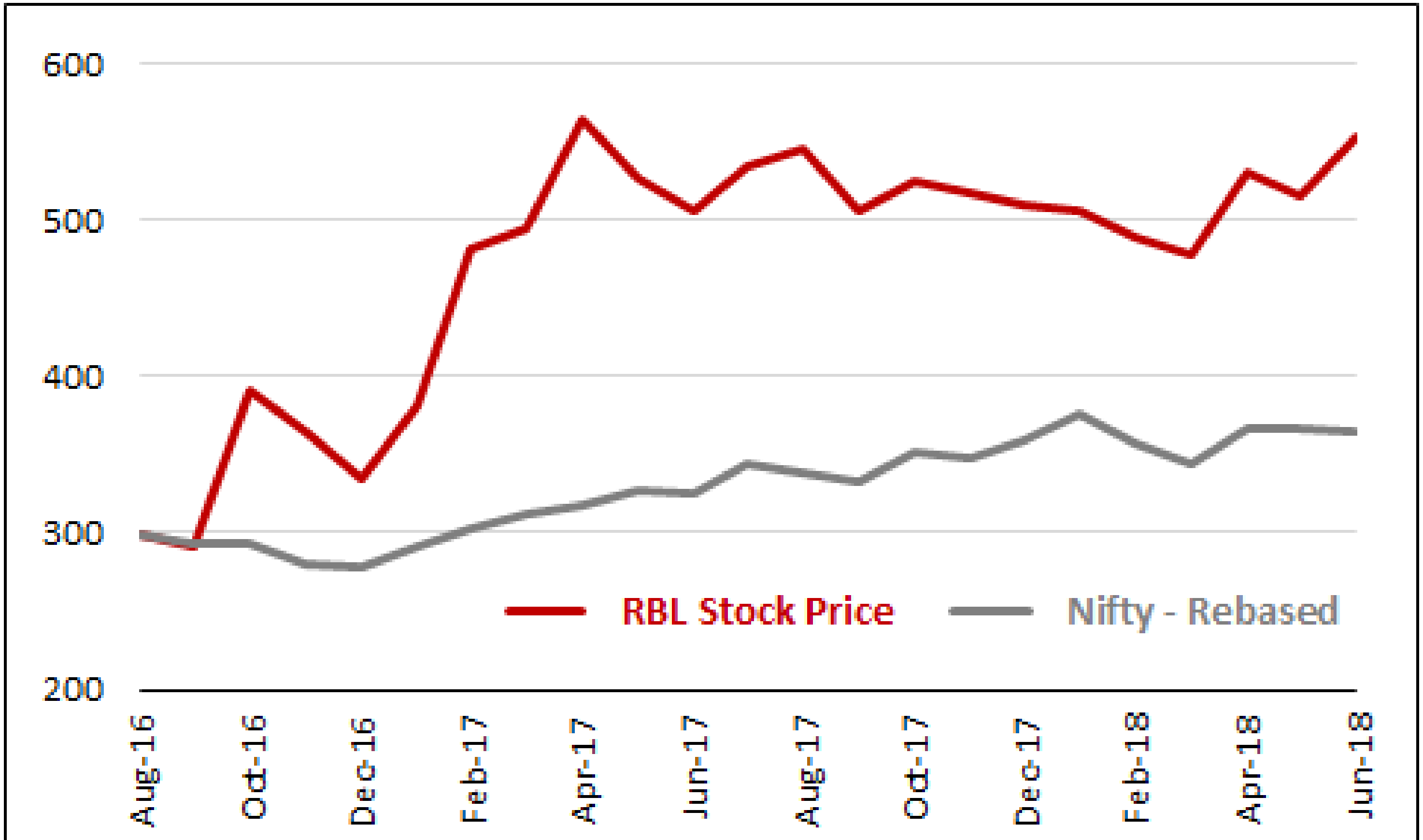
Expect RBL Bank's stock outperformance to continue



Risks & Concerns

- Loan book is not sufficiently seasoned
- 14% of RBL's FY18 loan-book is micro-finance
- Attracting and retaining human capital will remain a challenge

Alkem Laboratories

Company background

- Alkem is one of the largest pharma companies in India with a domestic market share of 3.4%.
- Currently, it has 14 manufacturing facilities across five locations in India and two manufacturing facilities in the US.
- Over time, Alkem has built a strong capabilities in R&D, marketing and distribution. Currently, it has one of the best reach in urban and rural areas.
- Its strong R&D capability has led to its 13 brands now featuring among top 300 brands in India (a feat not many companies have achieved).
- Using India as the cash cow, Alkem has successfully adopted the M&A route to venture into the US market in 2011. Since then, US revenues today are sizeable at US$ 200 mn (20% of total revenue).
- Alkem's current market cap stands at INR 25,800 crores.

Alkem Labs – QGLP in a nutshell

THINK EQUITY THINK Q.G.L.P. CONTEST

QGLP – Quality, Growth, Longevity, reasonable Price

Quality of business x Quality of management

- Alkem has a strong domestic franchise: 7th rank in India Pharma Market
- MR productivity is one of the highest in India
- Zero leverage with last 5-year average RoE of 20%
- High skin in the game – promoters hold 66% stake

Growth in earnings

- India, US and Rest of World all in growth mode
- Improving MR productivity driving EBITDA margins, up 500bp over FY15-18 to 16.5%
- Expect 3-year PAT CAGR of 25%

Price

- P/E of 39x FY18 is defendable considering 25% earnings CAGR, rising RoE and near-zero debt
- Target Price of INR 3,700 (35x FY21E EPS)
- Expect 3-year return CAGR of 20-25%

Longevity – of both Q & G

- Indian Pharma Market has the potential to grow at 10-15% for long; Alkem has the ability to grow faster than the market
- Enough headroom to improve margins
  - US business has just broken even

Q — Quality

Quality of Business

Porter's Five Forces – Fairly favourable competitive landscape for pharma

Force	Comment	Sector Score
1. Inter-firm rivalry	Medium	0.5
2. Bargaining power of customers	Medium	0.5
3. Bargaining power of suppliers	Low	1
4. Threat of new entrants	Low	1
5. Threat of substitutes	Medium	0.5
	TOTAL	**3.5 out of 5**

- Strong domestic franchise: 7th rank in India Pharma Market
- High penetration in the rural market
- MR productivity one of the best in industry at INR 6.5 mn per year per MR
- This has helped the company to clock higher volumes in the Acute segment (85-90% of India revenues) v/s peers, leading to 17% revenue CAGR in the India business over the last 5 years (800bp industry outperformance).
- Healthy Balance Sheet: Zero leverage with last 5-year average RoE of 20%
- Low asset intensity: FCF generation is robust at 45% of PAT

Q — Quality

❑ Quality of Management

➢ Competence

- 7th largest company in the Indian pharma market with market share of 3.4% v/s no. 1 ranked Sun's market share of 6.2%.
- 13 brands feature among the top 300 brands in India – best-in-class
- Company has also embarked on acquisitions in the US and India, and has been managing them well to address future growth

➢ Integrity

- Healthy track record of corporate governance
- High skin in the game – promoters hold 66% stake in the company
- Concern for minority shareholders: Steady dividend payout of 15-17%

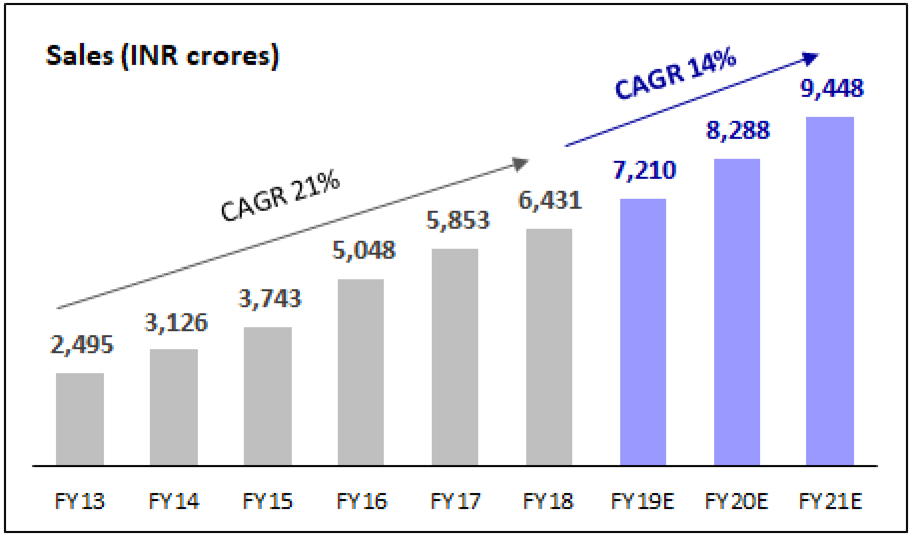
➢ Growth Mindset

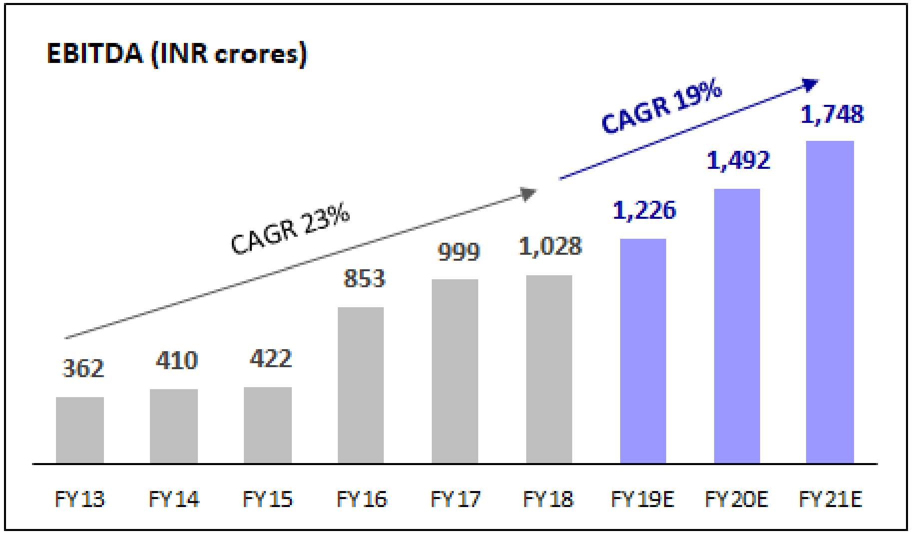
- With India as a cash cow, the company has successfully transformed its US business through investments in well thought-out areas of R&D and M&As
- The US business achieved EBITDA break-even in FY18

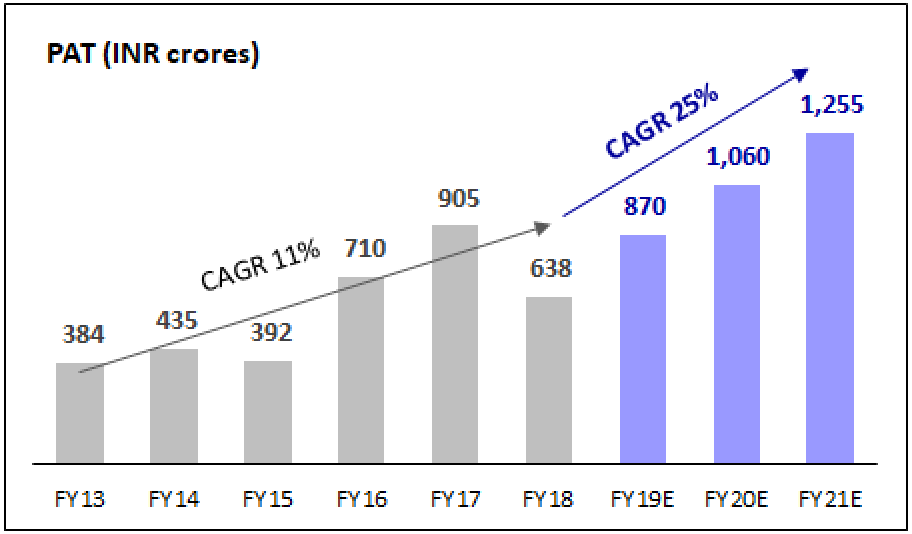
G — Growth in earnings

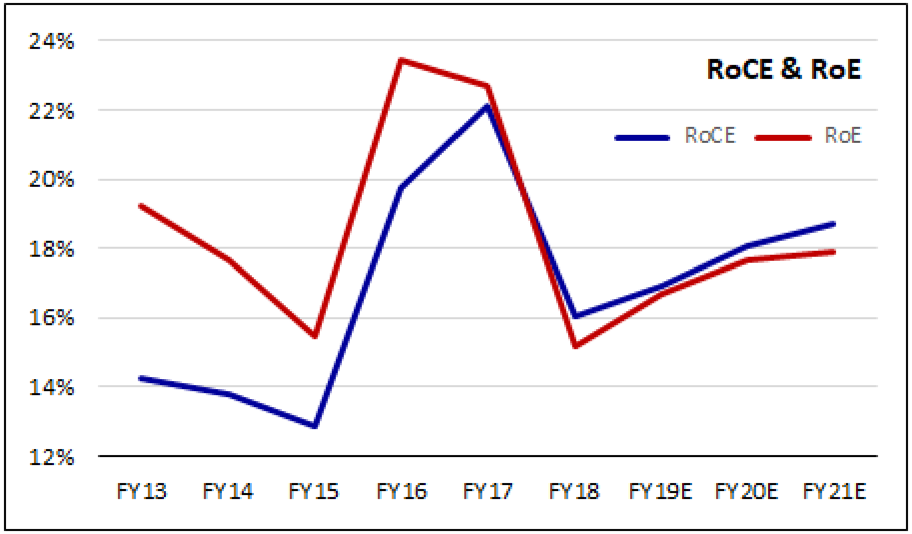
- FY15-18 CAGR: Sales 20%, EBITDA 35%, PBT 28%;
  PAT CAGR lower at ~18% due to higher taxation 13% in FY15 to 26% in FY18
- Improving MR productivity: In spite of hiring of 1,500 MRs over the last 2 years, EBITDA margins are up 500bp over FY15-18 to 16.5%
- Expect 12-15% revenue CAGR over next 3 years led by –
  - India business (70% of revenues) well placed to grow at mid-teens
  - US business (25% of revenues) set to grow at 12-15%
  - RoW business (10% of revenues) will grow at 10-15%
- Expect EBITDA margins to expand 250bp min over the next 3 years, led by operating leverage
- As a result, expect PAT to clock 25% CAGR over the next 3 years

G — Growth in earnings









L — Longevity

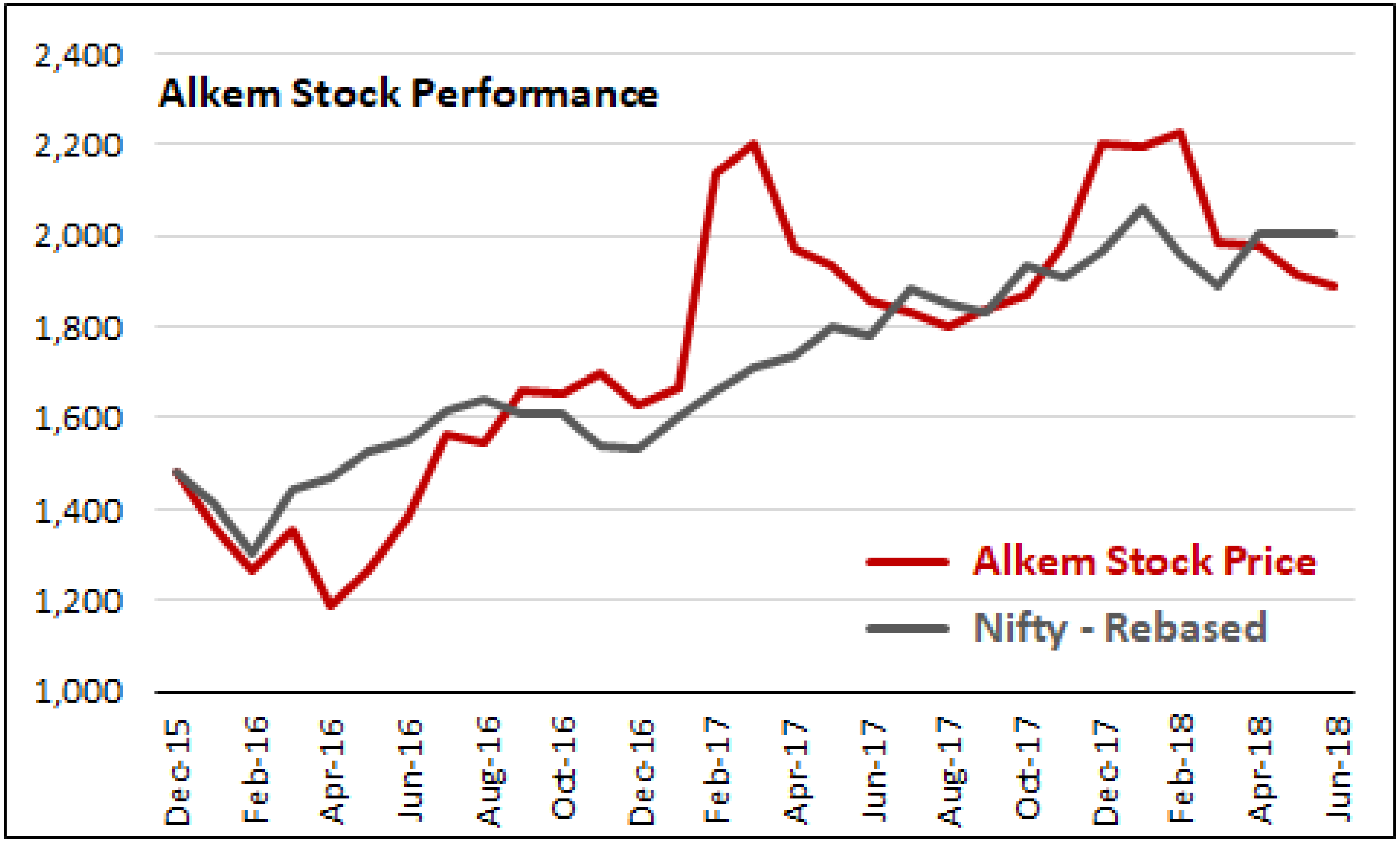
- Indian Pharma Market has the potential to grow at 10-15% for long; Alkem has the ability to grow faster than the market
- Alkem’s continued investments in building manufacturing/technology assets imply sustained growth visibility
- Enough headroom to improve margins
  — US business has just broken even
- Lean balance sheet ensures continued free cash generation to handle adversities, if any

P — Price

- P/E of 39x FY18
- We believe the valuation is defendable considering:
  — 25% Earnings CAGR over FY18-21E
  — expansion in RoE by 250 bps over the next 3 years
  — Lean Balance Sheet with Net D/E of 0.1x
- Target Price of INR 3,700 (35x FY21E EPS)
- **Expect 3-year return CAGR of 20-25%**

INR Crores	FY18	FY21 E	CAGR
Revenues	6,431	9,448	**14%**
EBITDA Margins	16.4%	18.5%	
PAT	638	1,258	**25%**
EPS (INR)	53.4	105.0	**25%**
Exit P/E (x)	39	35	
Mkt Cap	25,800	44,233	**21%**
Stock price (INR)	**2,100**	**3,700**	**21%**

Expect Alkem to recover from recent underperformance



Risks & Concerns

- Near-term threat to earnings –
  - Regulatory risks in the US and
  - Price-cap initiative from the Indian government
- Higher than anticipated rise in prices of key starting materials sourced from China

Sterlite Technologies

Company background

- Sterlite Technologies is a leading global provider of optical fibre, the fastest known medium for high-speed data networks.
- It manufactures optical fibre from sand, and is forward integrated to offer broadband services and network & telecom solutions.
- In India, 45% of all data travels on Sterlite Tech's solutions.
- Globally, the company is present in over 100 countries.
- Sterlite Tech has a current market cap of INR 13,500 crores.

Sterlite Tech – QGLP in a nutshell

THINK EQUITY THINK Q.G.L.P. CONTEST

QGLP – Quality, Growth, Longevity, reasonable Price

Quality of business x Quality of management

- Steady Value Migration from voice to data
- One of 7 global, fully integrated companies which make optical fiber
- Global cost leadership
- Order Book INR 5,200 cr, +73% YoY, executable over 1.5-2 years

Growth in earnings

- 5G wave will drive global demand for optical fibre cables
- Opportunities in Bharat Net/NFS/ Smart Cities space
- Expect 20% CAGR in India OFC demand
- Expect 3-year earnings CAGR of 30-35%

Price

- TTM P/E of 35x
- No case for major de-rating given FY18-21 earnings CAGR of 30%, and RoE robust at 30%+
- FY21E target price of INR 700 offers 27% return CAGR

Longevity – of both Q & G

- Long track record with marquee clients
- Presence in China confirms sustainable competitive advantage
- 5G rollout offers long growth runway
- Company is growing inorganically as well

Q — Quality

Quality of Business

- Steady value migration from voice to data
- Inclination of consumers towards high-speed internet
- One of 7 global, fully integrated companies which make optical fiber
- Cost leadership
- Order Book of INR 5,200 cr, +73% YoY, executable over 1.5-2 years

Porter's Five Forces – Attractive competitive landscape

Force	Comment	Sector Score
1. Inter-firm rivalry	Low	1
2. Bargaining power of customers	Medium	0.5
3. Bargaining power of suppliers	Low	1
4. Threat of new entrants	Low	1
5. Threat of substitutes	Low-to-Medium	0.5
	TOTAL	**4 out of 5**

Q — Quality

❑ Quality of Management

➢ Unquestionable Integrity

- Strong Board of Directors comprising of 50% Independent Directors
- No significant Related Party Transactions
- Concern for minority shareholders – 15% Dividend Payout despite capex

➢ Demonstrable Competence

- Power transmission business de-merged in 2015 for focus on OFC
- Global cost leadership in optical fibre
- Healthy terms of trade: Working capital less than 60 days
- RoE consistently rising; currently over 30%

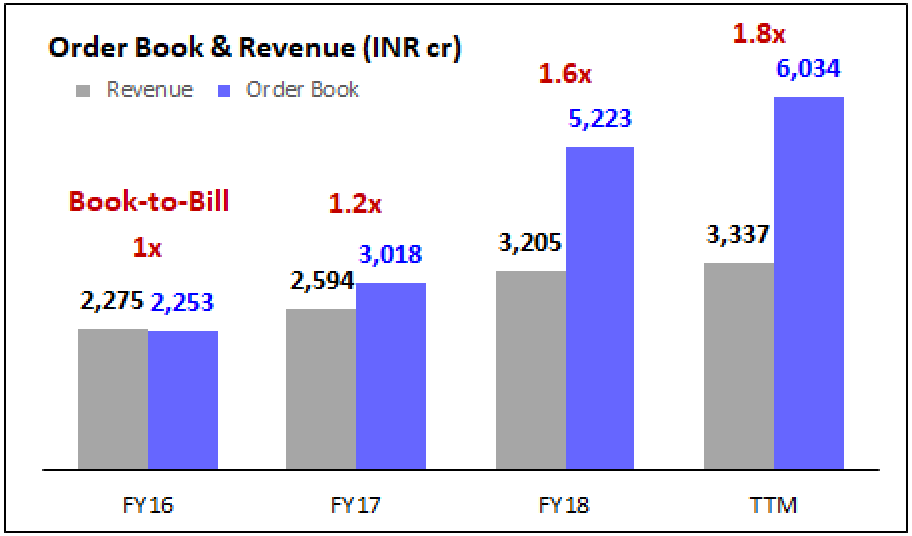
➢ Growth Mindset

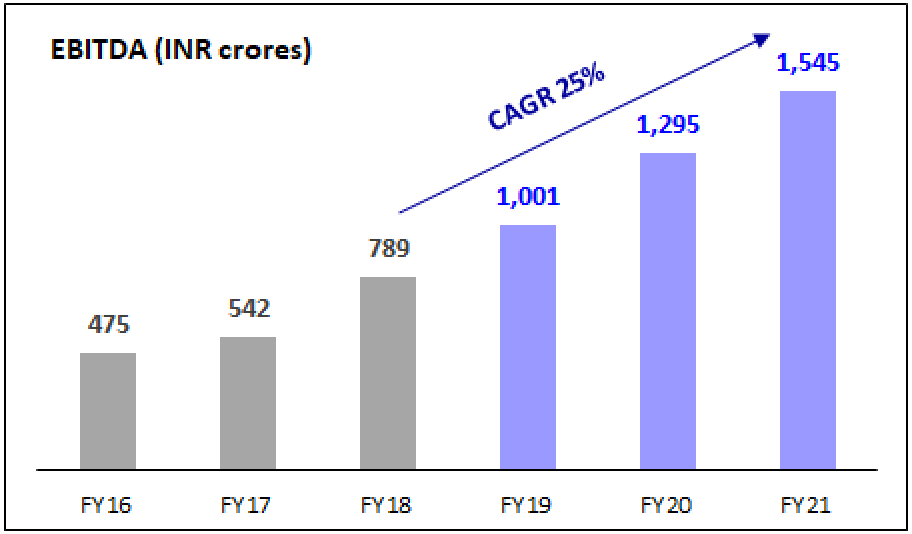
- Optical fibre capacity to double over next 3-4 years
- Phased capex of INR 1,200 crore
- Recently acquired Metallurgica Bresciana, a European OFC manufacturer
- Strategic guidance of PAT of US$ 100 mn by FY20 v/s US$ 50 mn in FY18

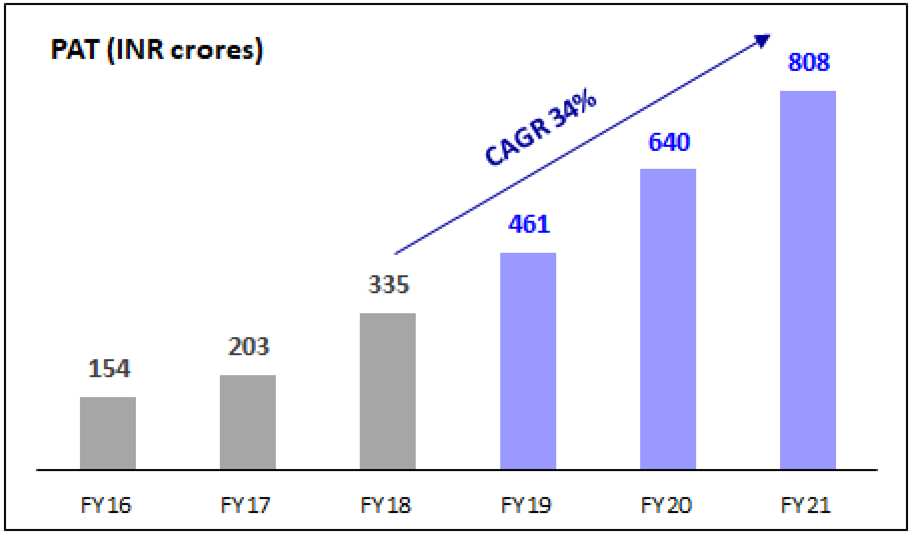
G — Growth in earnings

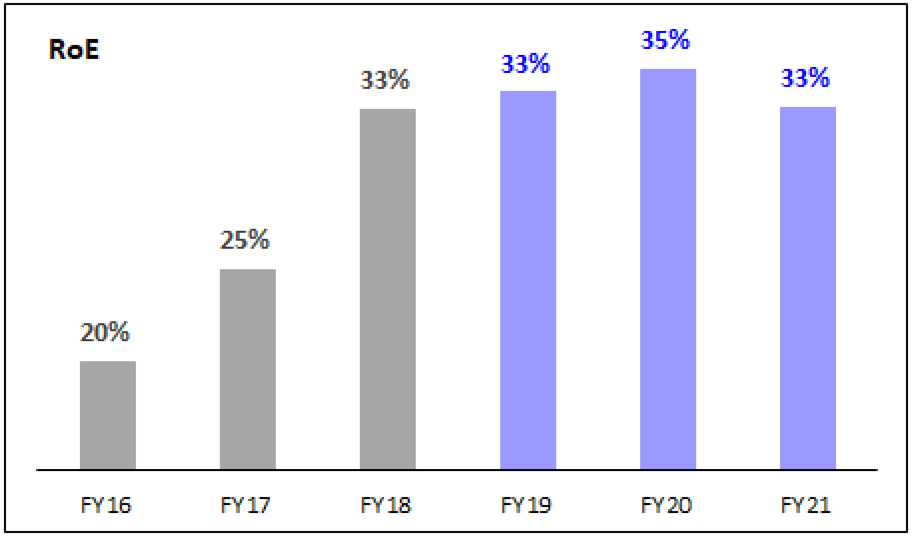
- 5G wave will drive global demand for optical fibre cables
- Robust opportunities in Bharat Net / NFS / Smart Cities space
- Expect 20% CAGR in India OFC demand
- Sterlite Tech is doubling Optical Fibre capacity from 30 mn fkm (fibre km) to 60 mn fkm in 3-4 years
- Management has given strategic guidance of US$ 100 mn PAT by FY 2020, effectively double that of FY 2018
  - Acquisition of Metallurgica Bresciana is likely to expedite this target
- Expect 3-year earnings CAGR of 30-35%

G — Growth in earnings









L — Longevity

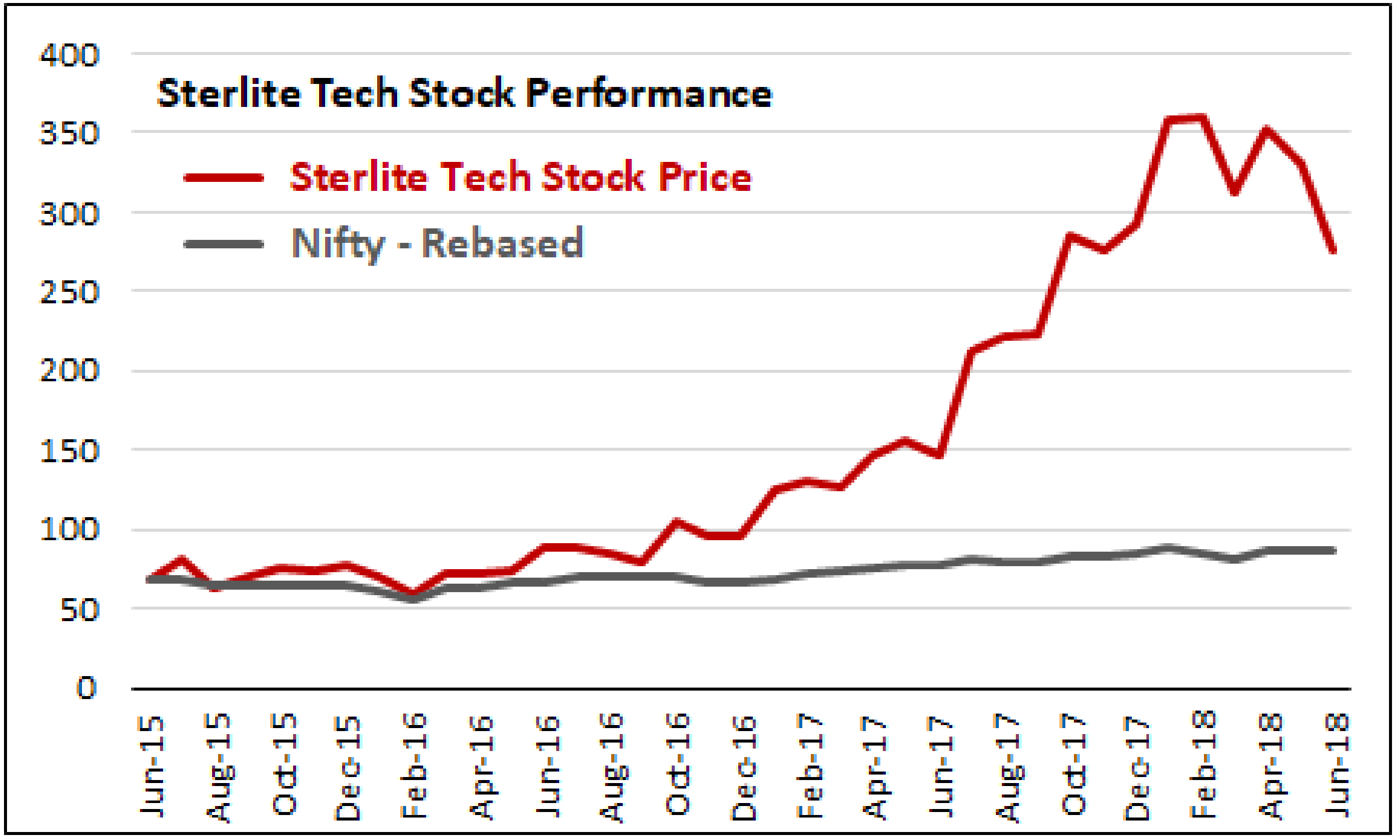
- Long track record with marquee clients
- Presence in China confirms sustainable competitive advantage
- 5G rollout globally offers long growth runway
- Company is growing inorganically as well

P — Price

- Stock is currently trading at TTM P/E of 35x; FY18 P/E of 41x
- No case for major de-rating given –
  - FY18-21 earnings CAGR of 30%
  - RoE robust at 30%+
- **FY21E target price of INR 700 offers 27% return CAGR**

INR Crores	FY18	FY21 E	CAGR
Revenues	3,205	6,631	**27%**
EBITDA Margins	24.6%	23.3%	
PAT	335	808	**34%**
EPS (INR)	8.4	20.2	**34%**
Exit P/E (x)	41	35	
Mkt Cap	13,600	28,300	**27%**
Stock price (INR)	**340**	**700**	**27%**

Expect Sterlite Tech's stock outperformance to continue



Risks & Concerns

- Optical Fibre prices tend to be contingent on action of Chinese manufacturers
- Demand growth may taper off once 5G rollout is complete

Best wishes for your participation in the

Think Equity Think QGLP Contest, 2018

For more details & clarifications, email thinkQGLP@motilaloswal.com