## Q3 Is the company profitable? If not, is it expected to emerge?

### Objective:

Companies are capital input-output machines. The main objective of companies is to optimize return on capital invested. The first step in this process is to be profitable i.e. earn return on capital higher than cost of capital. This question is a test of the same.

Further, a company may not be currently earning return on capital higher than cost of capital. In such case, the question to be asked is: Is it expected to emerge? (Emergence here means the company achieving return higher than cost of capital for the first time, or after a long break.)

### What to look for:

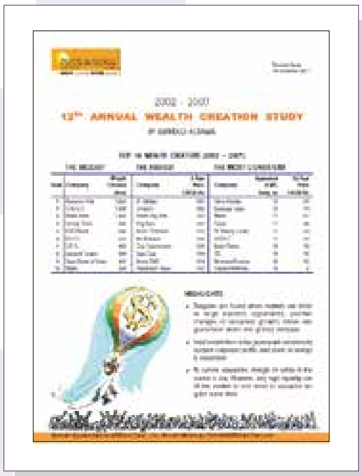
- **Return on Equity greater than Cost of Equity:** Our favorite measure of profitability is Return on Equity (RoE). A company can be said to be profitable if it consistently earns Return on Equity higher than Cost of Equity. As stated in Framework #2, Cost of Equity is the minimum return expected by investors on a stock. Our threshold Cost of Equity is 13%. So, we deem companies to be profitable only if their RoE is consistently higher than 13%.
- **For Emergence,** look for companies which have reported RoE > 13% for the first time ever, or after quite a while.

Based on return on capital, Warren Buffett classifies companies into 3 types – Great, Good and Gruesome (Framework #6).

## Framework #6

### Great, Good, Gruesome

In our 13th Wealth Creation Study (2008), we wrote - "Every year, Warren Buffett personally writes the Chairman's annual letter to shareholders of his diversified company, Berkshire Hathaway Inc. His 2007 letter has a section on "Businesses – The Great, the Good and the Gruesome", where he discusses what kind of companies Berkshire likes and what it wishes to avoid."



#### Defining Great, Good and Gruesome

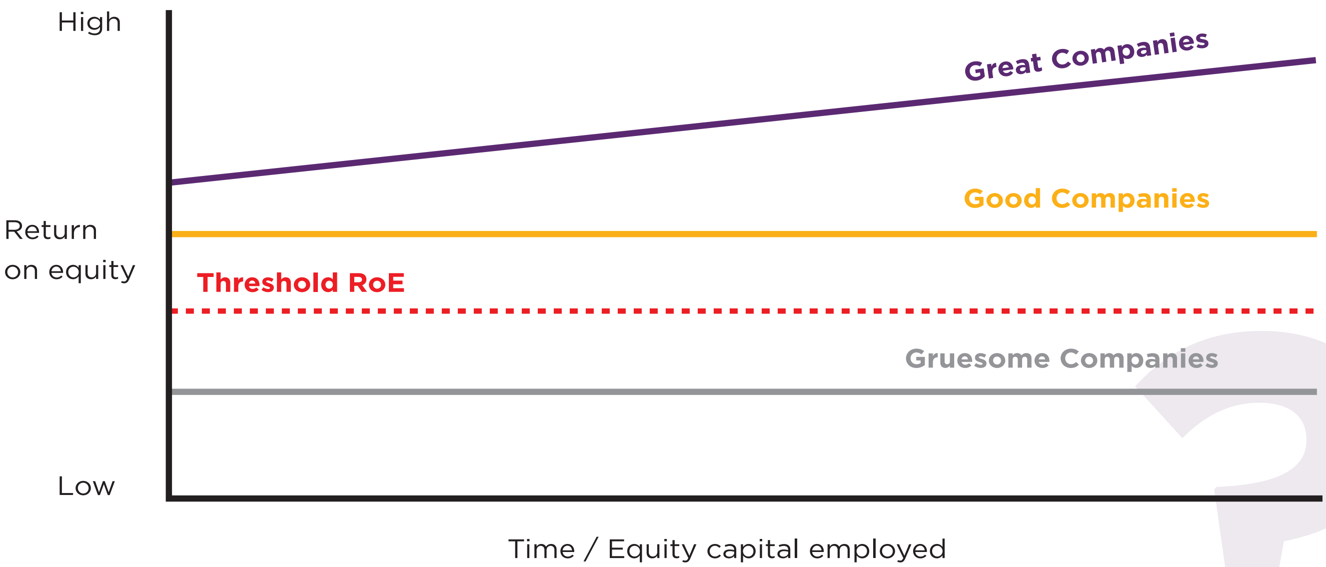
Buffett equates the Great, the Good and the Gruesome companies to three types of bank savings accounts, where the interest rate is RoE.

# Framework #6

He says, "Think of three types of savings accounts. 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. Finally, the Gruesome account both pays an inadequate interest rate and requires you to keep adding money at those disappointing returns."

Graphically, Great, Good and Gruesome companies can be depicted as under.

## Depicting Great, Good, Gruesome




## Understanding Great, Good, Gruesome

### Great companies

A truly Great company must have an "enduring moat" (i.e. long-term competitive advantage) that protects excellent returns on invested capital. This is possible only in either of two cases:

1. It must possess powerful brand(s), or
2. It must be a low-cost producer.

Great companies tend to grow slower than their Good and Gruesome counterparts. But the key aspect of this growth is that it is achieved by consuming very little additional capital. Over time, given the power of compounding, Great companies become significant cash machines with high RoE and high dividend payouts.

### Good companies

Good companies grow at healthy rates, but need large increases in capital to sustain growth. Like Great companies, they too enjoy competitive advantage and make healthy profits. However, they need to reinvest a significant proportion of these profits for growth.

## Framework #6

### Gruesome companies

Paradoxically, Gruesome companies tend to enjoy very high growth rates, which turns out to be a trap. These companies require significant capital for such growth, and then earn little or no money. Buffett says, "Think airlines. Here a durable competitive advantage has proven elusive since the days of the Wright brothers ... The airline industry's demand for capital ever since that first flight has been insatiable. Investors have poured money into a bottomless pit, attracted by growth when they should have been repelled by it."

## Characteristics of Great, Good and Gruesome companies

Return on equity is the financial differentiator of Great, Good and Gruesome companies. However, numbers are lag indicators, and are the outcome of several qualitative characteristics of the businesses. We summarize them below.

## Great, Good, Gruesome – A comparison

| Criteria | Great | Good | Gruesome |
|---|---|---|---|
| **Nature of business** | • Stable business i.e. no rapid or continuous change | • Subject to moderate change | • Business likely to have rapid changes |
| **Competitive advantage** | • High and rising competitive advantage from brand / lowest-cost production | • Steady competitive advantage | • Low or no competitive advantage |
| **Pricing power** | • High pricing power | • Moderate pricing power | • Pricing power absent |
| **Management** | • Low dependence on greatness of management | • Management, key success factor | • High dependence on management |
| **Growth** | • Typically moderate growth; high growth rates a rarity | • Moderate-to-high growth rate | • High growth rates |
| **Capital intensity** | • Low capital intensity; high level of intangible assets | • Moderate-to-high capital intensity | • Very high capital intensity |
| **RoE** | • High and rising RoE | • Stable, attractive RoE | • Low / falling RoE |
| **Dividend payout** | • Typically, high dividend payout | • Reasonable dividend payout | • Low or zero dividend payout |
| **Examples:** | • Hindustan Unilever, Nestle | • HDFC Bank, Avenue Supermart | • MTNL, Jet Airways |

# Framework #7

## Emergence & Endurance

In our 18th Wealth Creation Study (2013) titled Uncommon Profits: Emergence & Endurance we wrote -

Enduring Value Creators are companies which successfully manage the journey from Emergence to Endurance. This is achieved by a favorable combination of one or more industry-level and company specific factors. Early identification of such companies enables investors to fully participate in the company's Uncommon Profit generation through its lifecycle.

**Case Study for successful Emergence to Endurance: Titan Company**

### Company background

Titan Company (then, Titan Industries) was incorporated in 1984 as a joint venture of Tata Group and TIDCO (Tamil Nadu Industrial Development Corporation) for the manufacture of wristwatches. Today, it is one of the largest integrated own brand watch manufacturer in the world. In 1995, Titan entered the large but fragmented Indian jewelry market with the brand Tanishq. Today, jewelry accounts for over 80% of Segment Revenue and EBIT.

### Year of Emergence

2003

### Key business driver of Emergence

Value Migration in jewelry sector from unorganized to organized sector

### Company Unique Value Proposition

100% hallmarked jewelry from the house of Tatas

### Post-emergence financial performance highlights

| | 2003 | 2008 | 2013 |
|---|---|---|---|
| Revenue (INR bn) | 7 | 31 | 101 |
| CAGR (%) post-emergence | | 32 | 30 |
| PAT (INR bn) | 0.2 | 2 | 7 |
| CAGR (%) post-emergence | | 53 | 45 |
| **RoE (%)** | **23** | **40** | **42** |
| Divd Payout Ratio (%) | 0 | 23 | 26 |
| **Market Cap (INR bn)** | **2** | **47** | **228** |
| P/E – Trailing (x) | 12 | 30 | 31 |
| Stock Price (INR) | 2 | 53 | 257 |
| **Return CAGR (%)** | | **85** | **59** |
| Sensex CAGR (%) post emergence | | 39 | 20 |
| **Outperformance (%)** | | **46** | **39** |

# Framework #7

We have compiled a checklist comprising industry-level and company-specific factors for an Emerging Value Creator. Clearly, more the number of positive ticks against these points, higher the probability of the company emerging as a Value Creator.

## Emerging Value Creator Checklist: More the positive ticks, greater the confirmation

### Industry-level factors

- Is the industry's competitive landscape favorable? Do players enjoy superior bargaining power / terms of trade with customers and/or suppliers?
- Does the industry enjoy a large profit pool which can be effectively tapped into by a company with a unique value proposition or strategy?
- Is the industry showing trends of value migration? Or does it offer opportunity for the same in future?
- Is the industry fairly stable i.e. less prone to destabilizing factors like business cyclicality, high production innovation, and regulatory controls?
- Is it a new industry or strategic opportunity with huge potential?

### Company-specific factors

- Does the company have a solid corporate-parent and management team?
- Does the company have a unique value proposition or strategy to over-come competitive forces?
- Does it enjoy bargaining power with its customers and/or suppliers? How strong is the advantage?
- Is the company a market leader or a pioneer?