IDENTIFYING CONSISTENT COMPOUNDERS IN INDIA

AN INVESTMENT STRATEGY DISCUSSION

CIO: Saurabh Mukherjea, CFA
saurabh@Marcellus.in

Head of Sales: Pramod Gubbi, CFA
pramod@Marcellus.in

KEY STEPS FOR IDENTIFYING CONSISTENT COMPOUNDERS

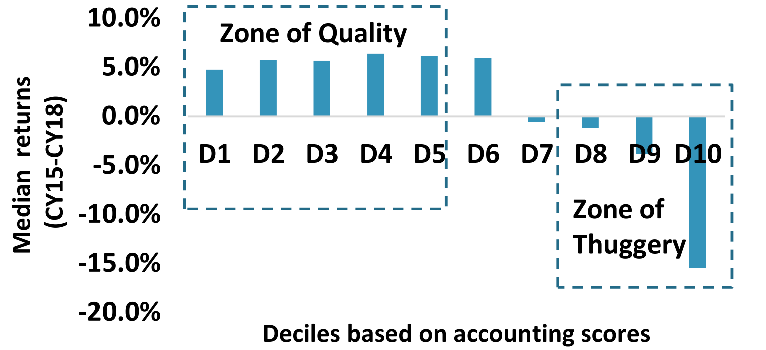
1. Identify companies with clean accounts
2. Identify companies with track record of superior capital allocation
3. Amongst companies which pass steps 1 & 2, identify those with high barriers to entry

STEP 1: IDENTIFY COMPANIES WITH CLEAN ACCOUNTING

Ten forensic accounting checks used to identify naughty companies

Category	Ratios
Income statement checks	(1) Cashflow from operations (CFO) as % of EBITDA
	(2) Volatility in non-operating income
	(3) Provisioning for doubtful debts as a proportion of debtors overdue for >6 months
Balance sheet checks	(4) Yield on cash and cash equivalents
	(5) Contingent liabilities as % of Networth (for the latest available year)
	(6) Change in reserves explained by the profit/loss for the year and dividends
Auditor checks	(7) Growth in auditor's remuneration to growth in revenues
Cash theft checks	(8) Miscellaneous expenses as a proportion of total revenues
	(9) CWIP to gross block
	(10) Free cash flow (cashflow from operations + cashflow from investing) to median revenues

Strong correlation between accounting quality and shareholders' returns



Note: Returns above represent median of decile-wise median returns calculated for every year from CY15 (accounting scores based on FY15 financials) to CY18 (accounting scores based on FY18 financials).

Methodology

We look at over six years of consolidated financials for the universe of firms.

We first rank stocks on each of the 10 ratios individually (outlined in the table on the left). These ranks are then cumulated across parameters to give a final pecking order on accounting quality for stocks.

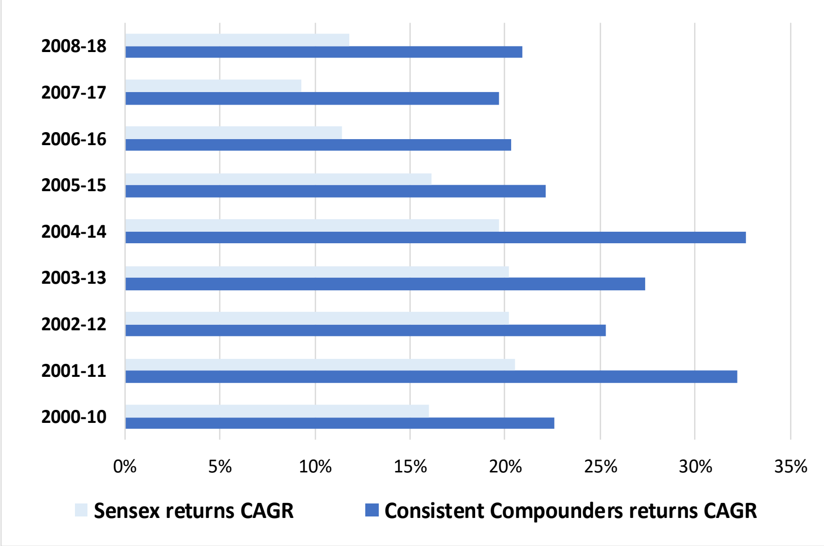
This framework draws upon Howard Schilit's legendary text on forensic accounting, "Financial Shenanigans".

STEP 2: IDENTIFY COMPANIES WITH SUPERIOR CAPITAL ALLOCATION

We create a list of stocks using a twin-filter criteria of double digit YoY revenue growth and return on capital being in excess of cost of capital, each year for 10 years in a row.

Next, we build a portfolio of such stocks each year and hold each of these annual iterations of portfolios for the subsequent 10 years (without any churn).

The bar chart on the right shows the back testing performance of such a filter based portfolio.



Source: Bloomberg. Note: Only the Consistent Compounder Portfolios which have finished their 10 year run have been shown. Note: These are total shareholder returns in INR terms.

There are two conclusions from this exercise:

- This filter based portfolio delivers returns of 20-30% p.a. (of INR returns) and 8-12% outperformance relative to the Sensex.
- The volatility of returns of such portfolios, for holding periods longer than 3 years, is similar to that of a Government of India Bond

Returns here (both for our portfolio and for the Sensex) are on a Total Shareholder Return basis i.e. all dividends are included in the returns.

STEP 3: IDENTIFY COMPANIES WITH HIGH BARRIERS TO ENTRY

In-depth bottom-up research of companies which pass our filters to assess sustainable competitive moats and build a portfolio of 10-15 stocks which consistently compound earnings.

What do we look for in our research?

- **Look for managements with an obsessive focus on the core franchise instead of being distracted by short-term gambles outside the core segment.**
- **Look for companies which relentlessly deepen their competitive moats over time**
- **Look for promoters who are sensible about capital allocation, i.e. refrain from large bets (especially those outside core franchise) and return excess cash to shareholders**

'Most companies tend to focus on short-term results and hence that makes them frequently do things that deviate away from their articulated strategy . . . these diversions take them away from the path they have to travel to achieve their long-term goals...'—**Rama Bijapurkar, leading market strategy consultant**

In Most Sectors, the top 1-2 Companies Account for 80% of the Profit Pie

Sector	Top 2-3 players Accounting for 70-80% of the Profit Pie
Paints	Asian Paints, Berger Paints
Small cars	Maruti Suzuki, Hyundai
Biscuits	Britannia, Parle
Cigarettes	ITC
Adhesives	Pidilite
Cooking oil	Marico, Adani
Hair oil	Marico, Bajaj Corp

THE POWER OF A FILTER BASED APPROACH

Unique DNA of these companies: By "filtering in" companies with a history of very consistent fundamentals over very long time periods, the portfolio is skewed towards companies with a DNA built around relentlessly deepening their competitive moats despite disruptive changes taking place both inside as well as outside the organization. More often than not, such DNA sustains over the subsequent 5-10 years investment horizon of the filter based approach.

Power of compounding: Holding a portfolio of stocks untouched for 10 years allows the power of compounding to play out, such that the portfolio becomes dominated by the winning stocks while losing stocks keep declining to eventually become inconsequential.

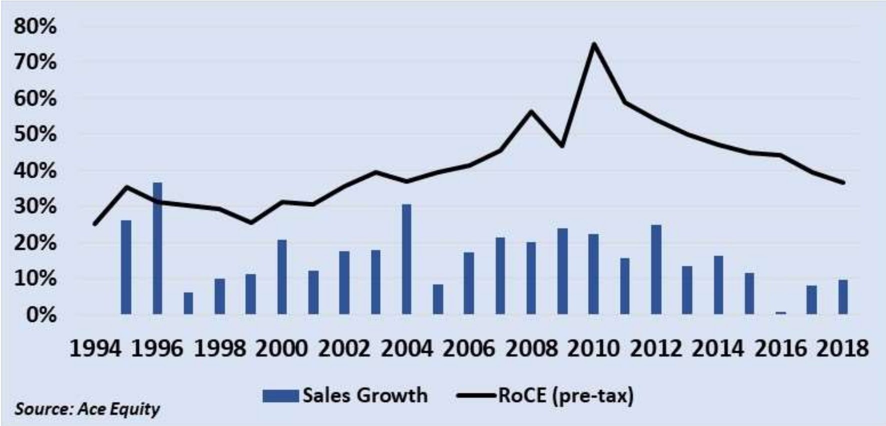
Avoiding the pitfalls of psychology and reducing transaction costs: Being patient with a portfolio helps cut out 'noise' of trying to time entry / exit decisions. With no churn, this filter based approach also reduces transaction costs. Consider two data points: (a) In a portfolio with 70% churn (average churn of large cap mutual funds), 20bps broking cost and 30bps impact cost, churn reduces the terminal value of the portfolio (after 10 years) by <u>10%</u> (i.e. a drag of 120bps on the 10-year CAGR); and (b) deferring the 10% long term capital gains tax payable on the portfolio by 10 years enhances the terminal value of the portfolio by <u>8%</u> (i.e. 100bps increase in the 10-year CAGR) vs a portfolio where capital gains are paid each year.

CASE STUDY: ASIAN PAINTS

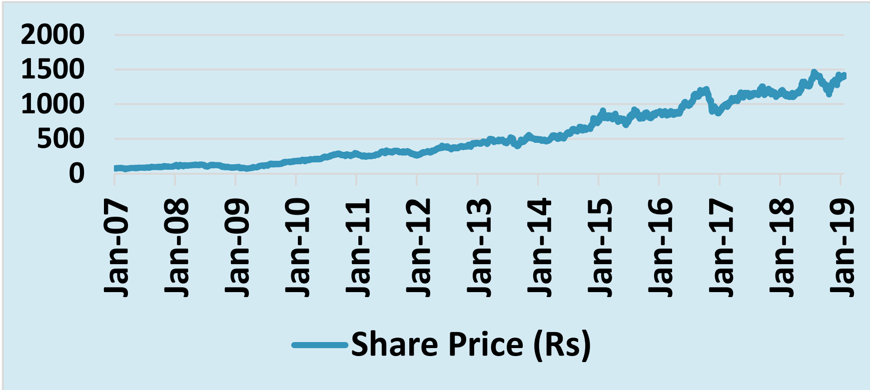
'We have been lucky to have new jewels in the form of professional managers who attempted to do things that haven't been done before, and lucky to have a management that allowed them to do so'
— K.B.S. Anand, MD & CEO, Asian Paints

- Attracts top quality talent from the most prestigious institutions and then grooms and empowers them. Result – talented & independent professional management team.
- Makes use of technology to improve efficiencies, retaining and improving margins over the years. E.g. Use of Mainframe Computers for demand forecasting in early 1970s.
- Very strong relationship with distributors developed over the years by helping them grow.

Sales Growth and ROCE over 10 Years



Share Price and CAGR over 10 Years [CAGR 30%]



CASE STUDY: HDFC BANK

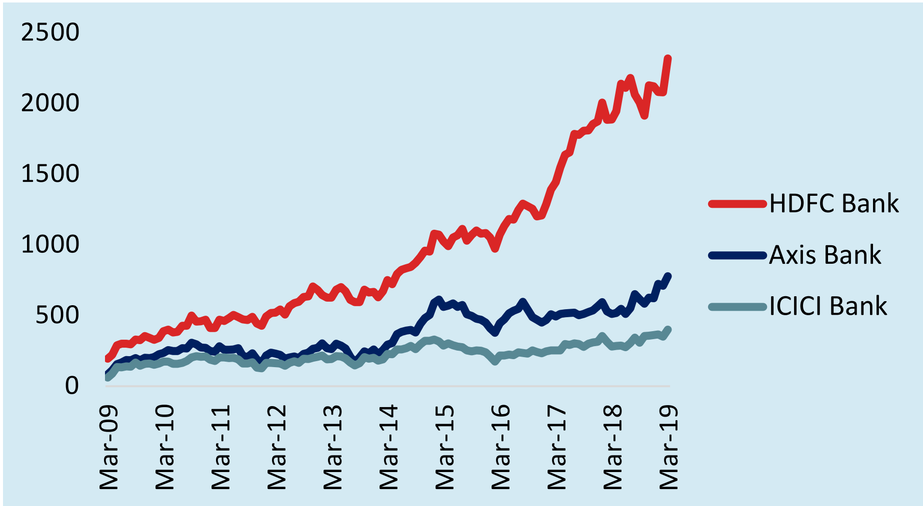
“When we came here, we had foreign banks with products and services and nationalized banks with brand and money — and we said we will bring both together.”
— Aditya Puri, MD, HDFC Bank

- Strategic focus on building a low-cost franchise – first to build low cost CASA franchise, first to introduce “at par cheques” for cooperative banks in return of these banks keeping interest free deposits with HDFC Bank.
- Heavy focus from 2000 on building a market leading position retail franchise – pioneer in mobile banking.
- Learns from others’ mistakes before venturing in any new segment - started pushing credit card business post Lehman crisis and is now the market leader in segment.

Key Performance Matrices: HDFC Bank vs Peers (FY 2015 -19)

Indicators	*HDFC Bank*	*ICICI Bank*	*AXIS Bank*
Net Interest Margins	4.13 %	3.00 %	3.25 %
Gross NPA to Gross Advances	1.12 %	6.99 %	4.05 %
Avg. ROAs	1.88 %	1.07 %	0.96 %
Avg. ROEs	18.48 %	10.55 %	10.18 %

Share Price over 10 Years- HDFC Bank vs Peers [CAGR 30%]



STRONG 10 YR EARNINGS GROWTH MAKES P/E REDUNDANT

$$P = P/E \times E$$

DOES NOT COMPOUND OVER TIME

COMPOUNDS OVER TIME

STRONG 10 YR EARNINGS GROWTH MAKES P/E REDUNDANT

		ΔP	=	ΔP/E	+	ΔE
A for Airlines (e.g. Telcos)	P/E doubles	+7%	=	+7%	+	0%
	P/E halves	-7%	=	-7%	+	0%
B for Buffett (e.g. Maruti, HUL)	P/E doubles	+19%	=	+7%	+	12%
	P/E halves	+5%	=	-7%	+	12%
C for CCP (e.g. Asian Paints, HDFC Bank)	P/E doubles	+32%	=	+7%	+	25%
	P/E halves	+18%	=	-7%	+	25%

MARCELLUS' CONSISTENT COMPOUNDERS
Q2FY20 PERFORMANCE & FY20 ESTIMATED PERFORMANCE

Stock Name	Q2FY20			FY20E		
	Rev. growth	PBT growth*	PAT growth	Rev. growth	PBT growth	PAT growth
Stock 1	8%	1%	30%	13%	17%	34%
Stock 2	9%	14%	70%	13%	18%	41%
Stock 3	48%	41%	63%	49%	42%	54%
Stock 4	7%	19%	72%	12%	25%	48%
Stock 5	15%	19%	45%	15%	18%	31%
Stock 6	17%	14%	23%	17%	14%	19%
Stock 7	6%	12%	37%	4%	11%	25%
Stock 8	16%	15%	40%	19%	22%	35%
Stock 9	0%	16%	17%	4%	19%	19%
Stock 10	9%	4%	33%	10%	7%	23%
Stock 11	12%	-7%	24%	8%	-5%	7%
Stock 12	3%	6%	41%	7%	9%	32%
Stock 13	14%	21%	79%	15%	17%	44%
Weighted Average	**13%**	**13%**	**46%**	**15%**	**15%**	**32%**
NIFTY50	**-3%**	**-3%**	**8%**			

Source: Marcellus Investment Managers; Ace Equity; NIFTY50 Q2 performance & FY20 estimates are from Motilal Oswal Research; *PBT growth is on like-to-like basis adjusting for the effect of IndAS116

MARCELLUS' CONSISTENT COMPUNDERS PERFORMANCE OVER FY16-19

Stock Name	PAT growth				Avg ROCE *
	FY16	FY17	FY18	FY19	FY16-19
Stock 1	11%	8%	45%	12%	38%
Stock 2	24%	11%	4%	6%	39%
Stock 3	42%	44%	36%	60%	21%
Stock 4	38%	27%	-1%	8%	31%
Stock 5	38%	17%	10%	17%	41%
Stock 6	20%	19%	21%	21%	18%
Stock 7	-3%	10%	10%	12%	36%
Stock 8	12%	44%	24%	16%	13%
Stock 9	24%	12%	2%	37%	44%
Stock 10	-52%	78%	22%	31%	52%
Stock 11	18%	15%	30%	14%	64%
Stock 12	58%	7%	12%	-4%	39%
Stock 13	17%	0%	34%	9%	28%
Weighted Average	**20%**	**22%**	**19%**	**17%**	**36%**
NIFTY50	**-1%**	**7%**	**4%**	**-2%**	

Source: Marcellus Investment Managers; Ace Equity; ROE considered for Banks/NBFCs

FY14-19: HIGH QUALITY STOCKS WERE IN VOGUE

- BSE100 index delivered earnings CAGR of 4%, but underwent a 50% expansion in its P/E multiple from 18x to 26x
- Despite it being a phase of significant P/E expansion for the index, share price outperformance was driven by earnings growth

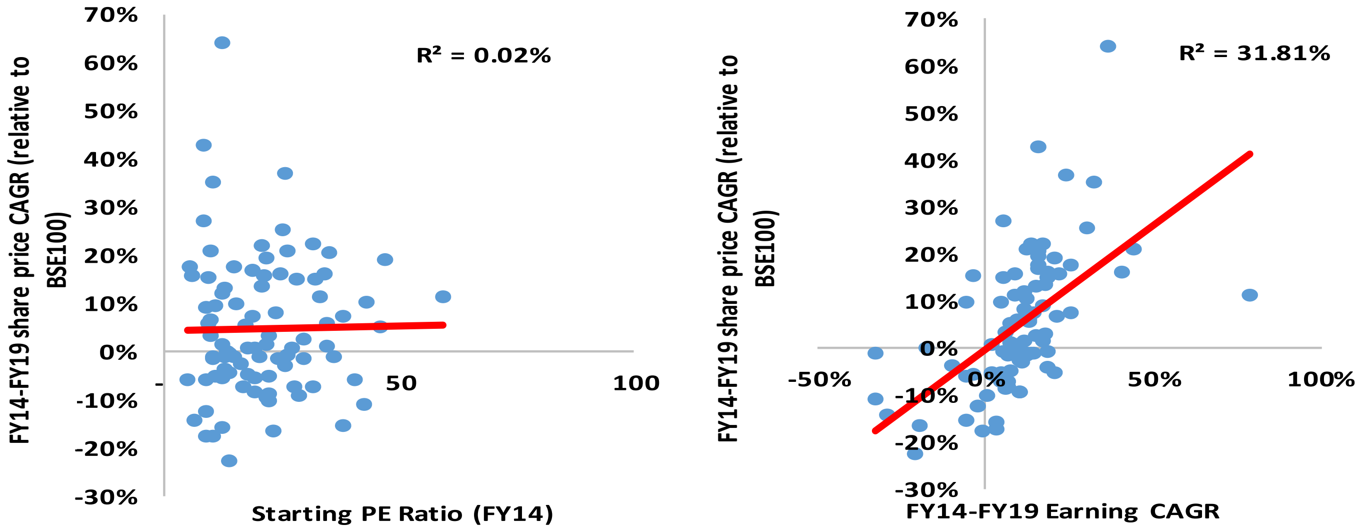
PE Multiples for FY14 and FY19 and EPS and Share Price CAGR from FY14 to FY19

	PE - FY14	PE - FY19	EPS CAGR (FY14-19)	Share price CAGR (FY14-19)
BSE100	18	26	4%	12%
Asian Paints Ltd	43	66	12%	22%
HDFC Bank Ltd	21	28	18%	25%

Alpha in EPS = alpha in share prices

Source: Ace Equity, Marcellus Investment Managers

Correlation between relative share price performance with starting PE and EPS CAGR



Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS or where EPS isn't available in the start or end period have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded.

FY04-08: CAPEX & INFRA BOOM

- Earnings growth was broad based with only a narrow gap between quality stocks & not-so-quality stocks. P/E expanded at modest pace.
- Despite it being a phase of broad-based earnings growth, share price outperformance was driven by earnings growth rather than starting P/E

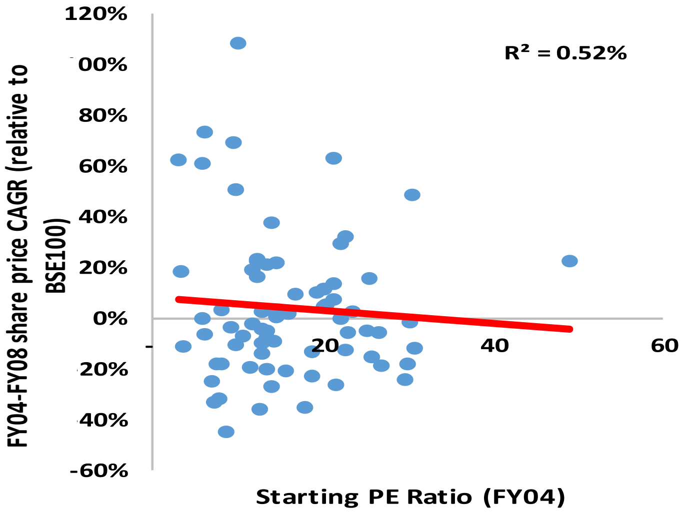
PE Multiples for FY04 and FY08 and EPS and Share Price CAGR from FY04 to FY08

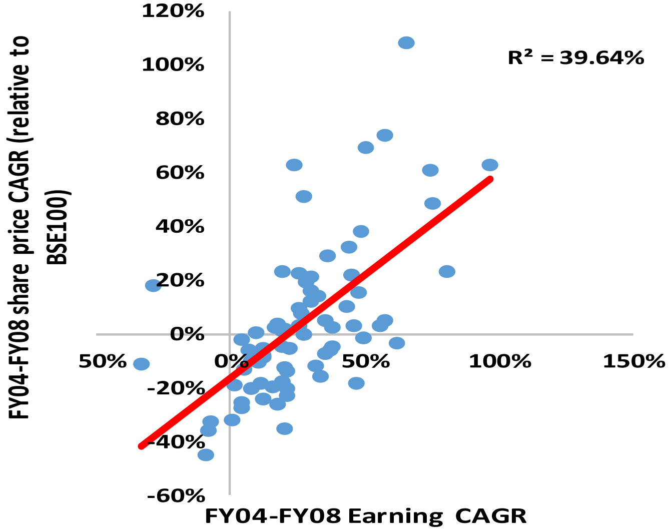
	PE - FY04	PE - FY08	EPS CAGR (FY04-08)	Share price CAGR (FY04-08)
BSE100	16	20	22%	29%
Asian Paints Ltd	20	28	30%	41%
HDFC Bank Ltd	21	29	26%	37%

Alpha in EPS = alpha in share prices

Source: Ace Equity, Marcellus Investment Managers

Correlation between relative share price performance with starting PE and EPS CAGR





Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS or where EPS isn't available in the start or end period have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded.

FY94-04: P/E MULTIPLES HAVE HALVED

- BSE100 underwent a massive compression in P/E from 47x to 16x. This P/E compression was broad based including quality stocks also
- Despite it being a phase of significant P/E compression, share price outperformance was driven by earnings growth rather than starting P/E

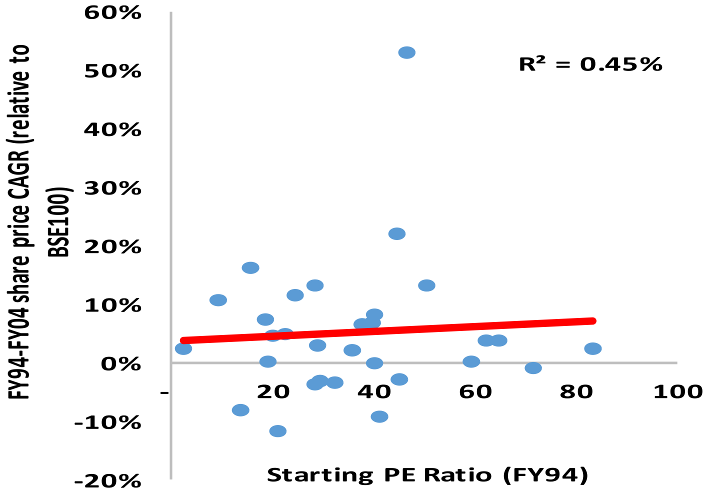
PE Multiples for FY94 and FY04 and EPS and Share Price CAGR from FY94 to FY04

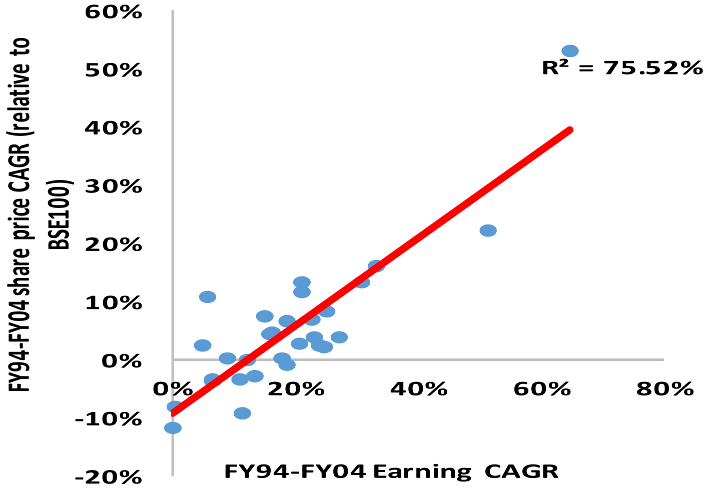
	PE - FY94	PE - FY04	EPS CAGR (FY94-04)	Share price CAGR (FY94-04)
BSE100	47	16	17%	5%
Asian Paints Ltd	38	20	19%	12%
HDFC Bank Ltd**	32	21	43%	35%
ITC Ltd	40	16	23%	12%
Nestle Ltd*	64	22	20%	8%

Alpha in EPS = alpha in share prices

*Source: Ace Equity, Marcellus Investment Managers; *Period considered is from CY94 to CY04; **Starting PE multiple is from FY96 and EPS and Share Price CAGR is for 8 years from FY96 to FY04.*

Correlation between relative share price performance with starting PE and EPS CAGR





Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded;
For 5 companies EPS from FY95 and EPS CAGR for 9 years have been taken due to non-availability of data.

FY04-19: THE LONG TERM STORY

- On a long-term period covering the different market phases, it is the earnings growth which drives the returns
- 70% of the index returns is explained by earnings & less than 30% by P/E expansion

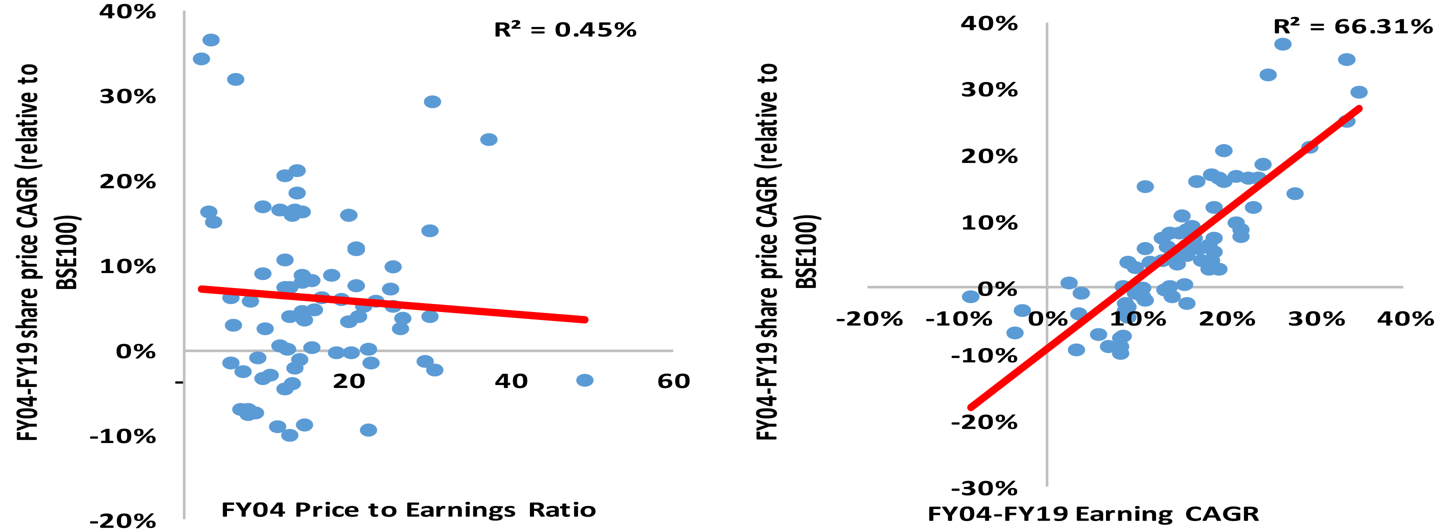
PE Multiples for FY04 and FY19 and EPS and Share Price CAGR from FY04 to FY19

	PE - FY04	PE - FY19	EPS CAGR (FY04-19)	Share price CAGR (FY04-19)
BSE100	16	26	10%	14%
Asian Paints Ltd	20	66	20%	30%
HDFC Bank Ltd	21	28	23%	26%
ITC Ltd	16	29	14%	19%
Nestle Ltd*	25	67	13%	20%

Alpha in EPS = alpha in share prices

*Source: Ace Equity, Marcellus Investment Managers; *Period under consideration is from CY03 to CY18*

Correlation between relative share price performance with starting PE and EPS CAGR



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Companies with EPS CAGR >100% or opening PE >100 have been excluded.

HOW MARCELLUS' CCP HAVE PERFORMED DURING THE PAST DECADE

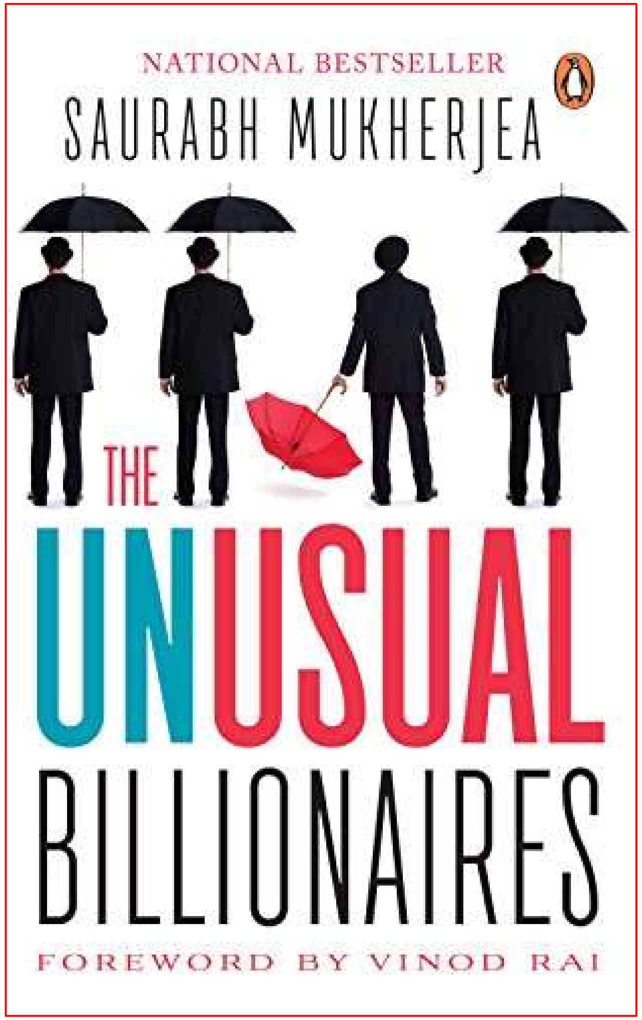
- It is worth noticing that India witnessed a significant moderation in economic activity during FY14-19 with Nominal GDP growth in India being in single digits – significantly lower than long term historical average. BSE 100 delivered EPS CAGR of just 4% during this period.
- In such a period, Marcellus' CCP have managed to deliver EPS CAGR of 19%
- This outperformance of 15% in earnings has supported the share price outperformance of Marcellus' CCP over index returns

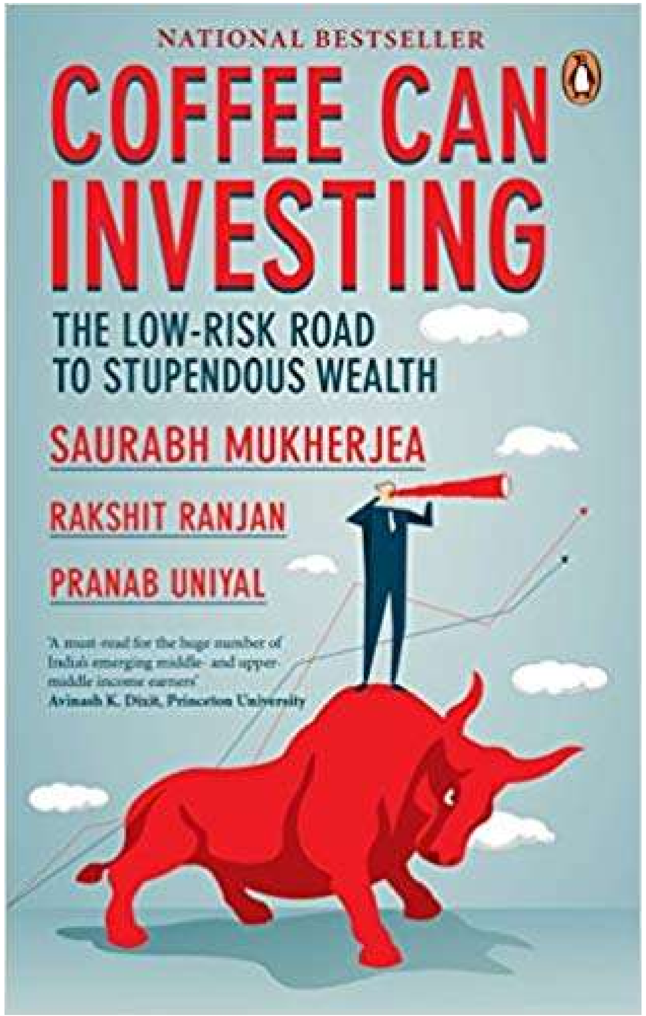
Earnings CAGR for Marcellus' CCP companies over the past decade

CCP Stocks	3 Yrs	5 Yrs	9 Yrs	10 Yrs
	FY16-19	FY14-19	FY10-19	FY09-19
Stock 1	7%	11%	11%	18%
Stock 2	11%	15%	17%	20%
Stock 3	5%	16%	15%	24%
Stock 4	21%	21%	25%	26%
Stock 5	28%	23%	21%	27%
Stock 6	46%	41%	53%	61%
Stock 7	19%	21%	29%	29%
Stock 8	13%	22%	19%	29%
Stock 9	42%	8%	10%	12%
Stock 10	21%	18%	22%	22%
Stock 11	15%	20%	26%	32%
Stock 12	11%	7%	13%	14%
Stock 13	16%	18%	19%	20%
Weighted average	**19%**	**19%**	**21%**	**26%**

Source: Ace Equity, Marcellus

TWO BESTSELLING BOOKS WHICH WILL GIVE YOU MORE INFORMATION





MANAGEMENT TEAM BIOS

Saurabh Mukherjea, CFA - Chief Investment Officer

Saurabh is the former CEO of Ambit Capital and played a key role in Ambit's rise as a broker and a wealth manager. When Saurabh left Ambit in June 2018, assets under advisory were $800mn. In London, Saurabh was the co-founder of Clear Capital, a small cap equity research firm which he and his co-founders created in 2003 and sold in 2008. In 2017, upon SEBI's invitation, he joined SEBI's Asset Management Advisory Committee. In 2019, Saurabh was part of the five man Expert Committee created by SEBI to upgrade & update the PMS regulations. Saurabh has written three bestselling books: Gurus of Chaos (2014), The Unusual Billionaires (2016) and "Coffee Can Investing: The low risk route to stupendous wealth" (2018). Saurabh was educated at the London School of Economics where he earned a BSc in Economics (with First Class Honours) and MSc in Economics (with distinction in Macro & Microeconomics).

Pramod Gubbi, CFA – Head of Sales

Pramod is Head of Sales in Marcellus and manages the sales & marketing efforts of the firm. He also sits on Investment Committee that discusses and approves investment strategies of the firm. Pramod was previously the MD & Head of Institutional Equities at Ambit Capital. Prior to that Pramod, served as the head of Ambit's Singapore office. Before joining Ambit, Pramod worked across sales and research functions at Clear Capital. Besides being a technology analyst, Pramod has served in technology firms such as HCL Technologies and Philips Semiconductors. Pramod did his B.Tech from Regional Engineering College, Surathkal and has a Post-graduate Diploma in Management from the Indian Institute of Management – Ahmedabad.

Rakshit Ranjan, CFA - Portfolio Manager

Rakshit spent 6 years (2005-2011) covering UK equities with Lloyds Bank (Director, Institutional Equity Research) and Execution Noble (Sector Lead analyst). During these six years, he was ranked amongst the top-3 UK Insurance analysts (Thomson Reuters Extel survey) in the mid-cap space. Since 2011, Rakshit led Ambit Capital's consumer research franchise which got voted as No.1 for Discretionary Consumer and within top-3 for Consumer Staples in 2015 and 2016. He launched Ambit's Coffee Can PMS in Mar'17 and managed it till Dec'18. Under his management, Ambit's Coffee Can PMS was one of India's top performing equity products during 2018. Rakshit has a B.Tech from IIT (Delhi).

MARCELLUS

FUND STRUCTURE

Marcellus offers Consistent Compounders Portfolio with a zero fixed fees option

The Consistent Compounders PMS comes with ZERO entry load/exit load and with no lock-in. Our clients can choose any of the following fee structures:

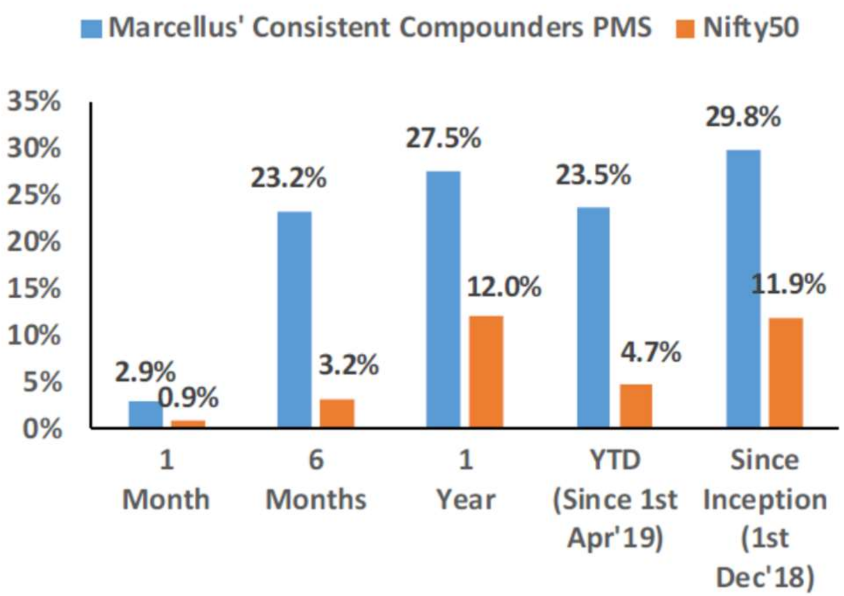
1. a fixed fees model (2% p.a. fixed fees + zero performance fees) or
2. a variable fees model (zero fixed fees + performance fees of 20% profit share above a hurdle of 8%, no catch-up)*
3. a hybrid model (1% p.a. fixed fees + performance fees of 15% profit share above a hurdle of 12%, no catch-up).

High water mark applies for performance fees

Minimum investment: INR 50 lacs

FUND PERFORMANCE (AS ON 31ST DEC 2019)

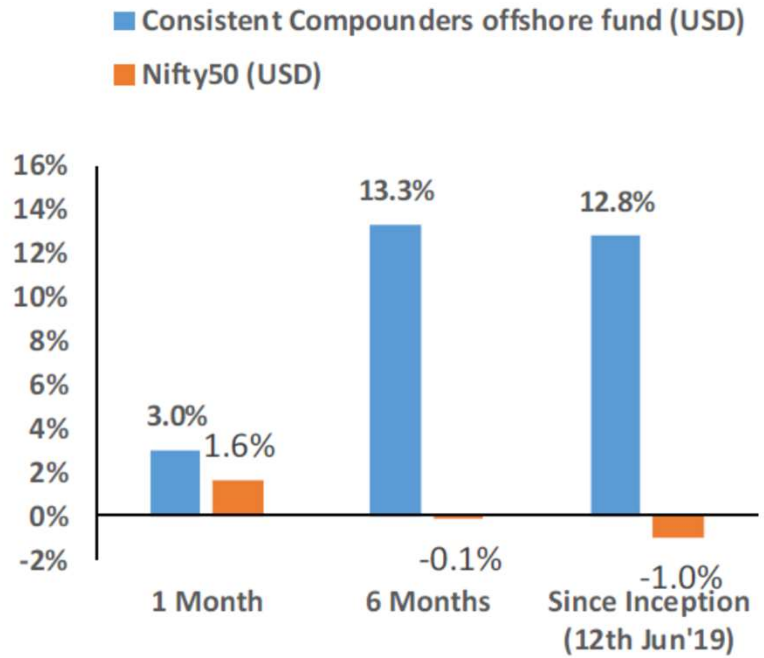
Exhibit 1: Marcellus' Consistent Compounders PMS performance as on 31st Dec'19 (INR)



Source: Marcellus, Bloomberg; All returns are absolute returns net of fees and expenses (TWRR / XIRR)

Returns are absolute and NOT annualised

Exhibit 2: Consistent Compounders offshore fund advised by Marcellus - as on 31st Dec'19 (US$)



Source: Marcellus; All returns are net of fees and expenses

MORE RESOURCES

Marcellus Investment Managers Pvt Ltd

http://marcellus.in/

Our newsletters are available on:

http://marcellus.in/newsletters/

Our research is available on:

http://marcellus.in/resources/

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