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“The Unusual Billionaires”
- Saurabh Mukherjea

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Greatness is a nebulous concept

'The ancient Romans were used to being defeated. Like the rulers of most of history's great empires, they could lose battle after battle but still win the war. An empire that cannot sustain a blow and remain standing is not really an empire'— Yuval Noah Harari, 'Sapiens: A Brief History of Humankind' (2011)

Source: huffingtonpost.com

The stock market's definition of "greatness" is flawed

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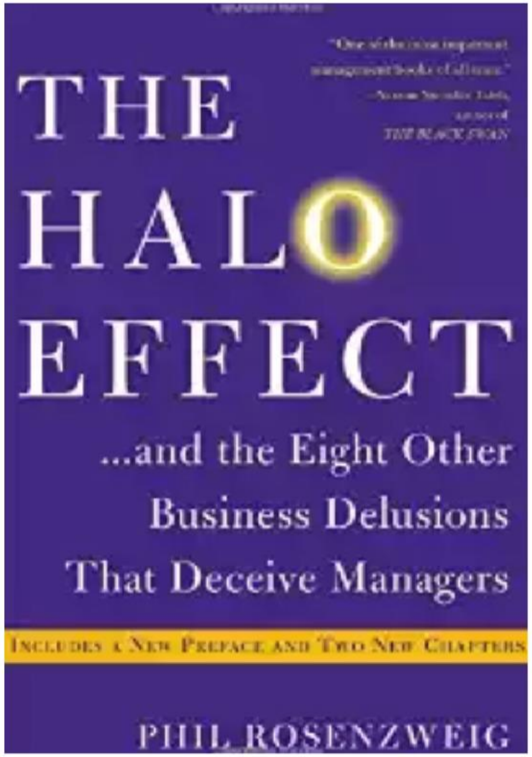
- Psychologist Edward Thorndike said that the "**halo effect**" is a type of cognitive bias in which an observer's overall impression of a person, company, brand, or product influences the observer's feelings and thoughts about that entity's character or properties.
- The halo effect is a specific type of confirmation bias.

- Phil Rozenzweig says the stock market suffers from this effect:

"A central problem that clouds so much of our thinking about business is The Halo Effect. Many things we commonly believe lead to company performance – corporate culture, leadership and more – are often simply attributions based on company performance."

- Here is a list of the Indian companies that have been given The Economic Times "company of the year" award:
  - 2015: HUL (1 year return: 9%)
  - 2014: TCS (1 year return: 42%)
  - 2013: Sun Pharma (1 year return: 71%)
  - 2012: HDFC Bank (1 year return: 35%)



Quantifying greatness in Indian corporate life (or the search for Rahul Dravid)

- **Step 1**: Define Companies: Within the listed universe, I will limit my search to the 1,500 companies with a minimum market cap of Rs100cr [$15m] as the reliability of data on companies smaller than this is somewhat suspect.

- **Step 2**: Define Long Periods: A decade in India usually accommodates both the up and down cycles of the economy.

- **Step 3**: Define Superior Financial Performance: At the very basic level, a company doing well would mean that it is profitable and it is growing (by successfully reinvesting its profits). Over very long periods of time, the twin filters of growth and profitability, in my view, are sufficient to assess the success of a franchise. Thus, my stock-selection filters are companies that have delivered **revenue growth of 10 %** ***and*** **Return on Capital Employed (ROCE) of 15%** every year for the past ten years.
  For Financial Services firms, I use ROE of 15% and loan growth of 15% every year for the past ten years.

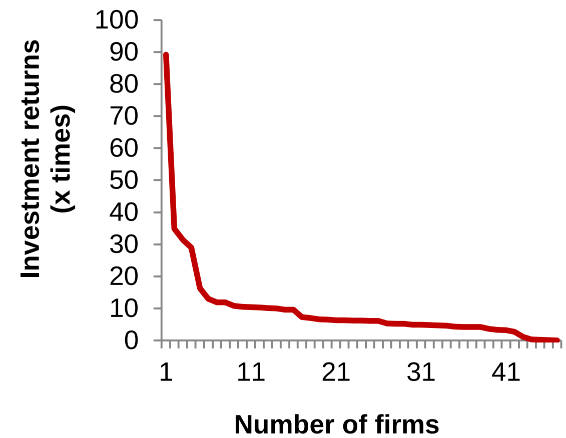
Source: http://www.lovemarks.com/lovemark/rahul-dravid/

Enter the "Coffee Can" portfolio

'In investing, as in auto racing, you don't have to win every lap to win the race, but you absolutely do have to finish the race. While a driver must be prepared to take some risks, if he takes too many risks, he'll wind up against the fence. There are sensible risks—and there are risks that make no sense at all'—Capital Group fund manager Rob Kirby quoted in Charles D. Ellis's Capital: The Story of Long-Term Investment Excellence (2004)

- Kirby, in a note written in 1984, narrated an incident involving his client's husband. The gentleman had purchased stocks recommended by Kirby in denominations of US$5000 each but, unlike Kirby, did not sell anything from the portfolio. This process (of buying when Kirby bought but not selling thereafter) led to enormous wealth creation for the client over a period of about ten years.
- The wealth creation was mainly on account of one position transforming to a jumbo holding worth over US$800,000, which came from a zillion shares of Xerox. Impressed by this approach of buy & forget, Kirby coined the term Coffee Can Portfolio; the 'coffee can' harkens back to the Wild West, when Americans, before the widespread advent of banks, saved their valuables in a coffee can and kept it under a mattress.

One or two firms generate exponential returns at the end of the portfolio term (10 years)



*Source: Peter Thiel's 'Zero to One'; Ambit Capital Research*Distribution of actual returns of companies in our completed coffee can portfolios after 10 year period(end of the term)*

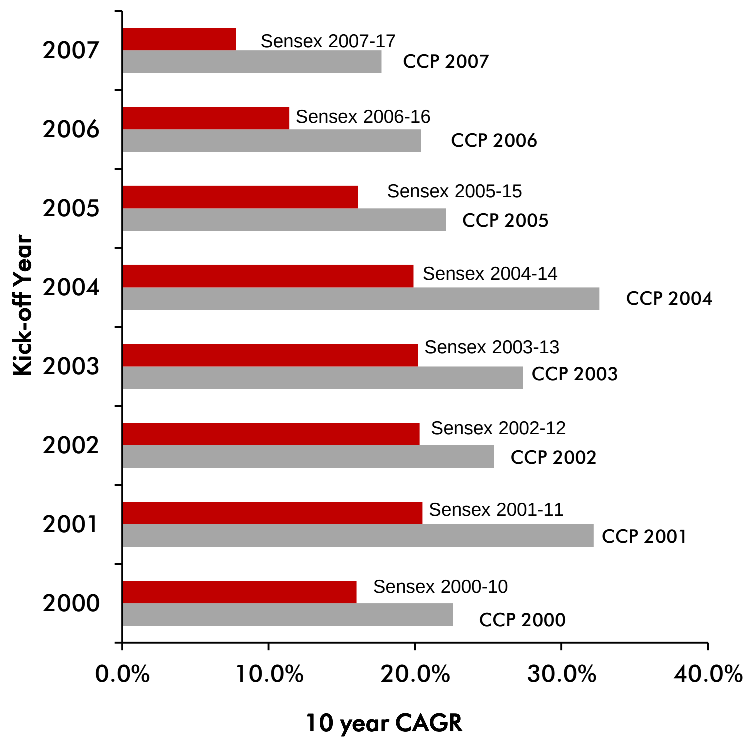
Creating Coffee Can portfolios in India

- In the period from FY1991 to FY2000, five companies meet the twin requirements of 10% revenue growth and 15% ROCE - NIIT, Cipla, Hero Moto, Swaraj Engines and HDFC. This gives us the Coffee Can Portfolio 2000.
- I now track the price performance of the Coffee Can Portfolio 2000 for the ten-year period, 30 June 2000 to 30 June 2010. For this, I allot an equal amount of money in each of these five stocks, say Rs100. Thus the value of my portfolio at the start of my analysis is Rs500. I find that at the end of ten years, the value of this portfolio has risen to Rs3,831. This implies an annual return of 22.6% versus 16% by the Sensex in the same period.
- Repeating the same process for the subsequent 16 years gives me 16 Coffee Can Portfolios (CCPs) of which:
    - Eight are complete: FY2000, FY2001, FY2002, FY2003, FY2004, FY2005, FY2006, FY2007
    - Eight are incomplete (i.e., the ten year run is not finished as yet): FY2008, FY2009, FY2010, FY2011, FY2012, FY2013, FY2014, FY2015

The CCPs outperform the Sensex by at least 4% points p.a. – slide 1 of 2

- The CCPs have, on average, 12 companies.
- Each of the sixteen Coffee Can Portfolios (eight complete and eight incomplete) has outperformed the Sensex.
- The outperformance of the Coffee Can Portfolios is almost always in excess of 4 percentage points per annum.
- A subset of large cap companies in the CCP has also successfully beaten the Sensex on all sixteen occasions. These large companies were in the top-100 stocks by market cap (at the start of the period under consideration). We call this subset the large-cap portfolio.
- The CCPs also have much lower 'maximum drawdown' than the Sensex, implying superior risk-adjusted performance

Coffee Can Portfolio vs. the Sensex



Source: Bloomberg, Ambit Capital Research Note: Only the completed 8 Coffee Can Portfolios (CCP) have been shown

The CCPs outperform the Sensex by at least 4% points p.a. – slide 2 of 2

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Exhibit 1: Back-testing results of completed eight iterations of the Coffee Can Portfolio (i.e. these iterations have run their complete course of ten years) using total shareholder returns

Kick-off year*	All cap CCP (start)	All cap CCP (end)	CAGR Return	Outperformance relative to Sensex	Large cap CCP (start)	Large cap CCP (end)	CAGR Return	Outperformance relative to Sensex
2000	500	3,831	22.6%	6.6%	400	3,338	23.6%	7.6%
2001	600	9,802	32.2%	11.7%	300	3,622	28.3%	7.8%
2002	800	7,709	25.4%	5.1%	500	4,182	23.7%	3.3%
2003	900	10,175	27.4%	7.2%	600	7,791	29.2%	9.0%
2004	1,000	16,849	32.6%	12.7%	500	3,679	22.1%	2.1%
2005	900	6,643	22.1%	6.0%	500	2,968	19.5%	3.4%
2006	1,000	6,376	20.4%	9.0%	600	2,918	17.1%	5.7%
2007	1,500	7,650	17.7%	9.9%	1,000	4,046	15.0%	7.3%

Source: Bloomberg, Capitaline, Ambit Capital research. Note: Portfolio at start denoters an equal allocation of Rs100 for the stocks qualifying to be in the CCP for that year. *The Portfolio kicks off on 30th June of every year.

Exhibit 1: Back-testing results of incomplete eight iterations of the Coffee Can Portfolio (i.e. these iterations have not run their complete course of ten years) using total shareholder returns

Kick-off year*	All cap CCP (start)	All cap CCP (end)	CAGR Return	Outperformance relative to Sensex	Large cap CCP (start)	Large cap CCP (end)	CAGR Return	Outperformance relative to Sensex
2008	1100	5,209	18.9%	8.7%	800	3,450	17.6%	7.5%
2009	1100	5,144	21.3%	11.5%	900	2,937	15.9%	6.1%
2010	700	2,413	19.3%	10.9%	300	974	18.3%	9.9%
2011	1400	2,857	12.6%	4.0%	400	967	15.9%	7.2%
2012	2200	6,330	23.5%	11.4%	500	1,104	17.2%	5.0%
2013	1800	5,443	31.9%	19.8%	600	1,364	22.8%	10.7%
2014	1600	2,653	20.9%	16.9%	700	1,117	19.1%	15.1%
2015	2000	2,683	19.2%	9.7%	1200	1,459	12.4%	3%

Source: Bloomberg, Capitaline, Ambit Capital research. Note: Portfolio at start denotes an equal allocation of Rs100 for the stocks qualifying to be in the CCP for that year. *The Portfolio kicks off on 30th June of every year. CAGR returns for all the portfolios since 2008 have been calculated until 30th Jun'17 (except for the live portfolios for the years 2014 and 2015 for which CAGR returns have been calculated since these portfolios were launched in Nov '15 and Nov '16

So why…

- …do we have so few companies that make it to the CCPs?
- What, if anything, is common to the companies that repeatedly make it to the CCPs?
- Why does the CCP construct deliver outperformance with low volatility so consistently?
- "The Unusual Billionaires" seeks to answer these three questions using case studies spanning the last forty years of:
  - Asian Paints
  - Berger Paints
  - Page Industries
  - Marico
  - Astral Poly
  - HDFC Bank
  - Axis Bank

  These seven companies (plus ITC) featured in the most number of CCPs

The eight companies which are first among equals

Number	Company name	Number of time ROCE>15% (last 10 years)	Number of times revenue growth > 10% (last 10 years)
1	Asian Paints	10	10
2	Astral Poly	10	10
3	Berger Paints	10	10
4	ITC	10	10
5	Marico*	10	10
6	Page Industries	10	10
7	HDFC Bank Ltd.	10	10
8	Axis Bank Ltd.	10	10

*Source: Capitaline, Company, Ambit Capital research; Note: * Marico demerged its Kaya business in 2014. After adjusting for the de-merged business the revenue growth was greater than 10% in FY14.*

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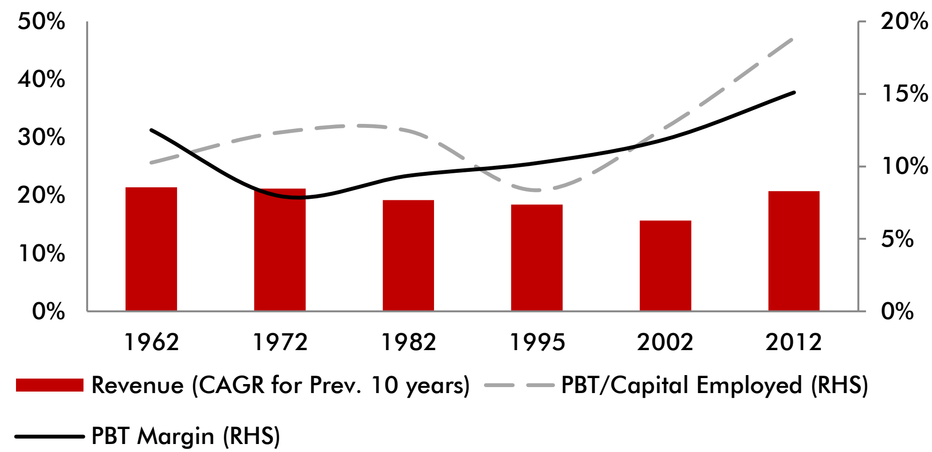
'The business of business is a lot of little decisions every day mixed up with a few big decisions' — Tom Murphy, CEO of Capital Cities Broadcasting in William Thorndike's The Outsiders (2012)

- **Firstly**, the management team has to have an obsessive focus on the core franchise instead of being distracted by short-term gambles outside the core segment.

'*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 . . . the willingness to resist the temptation of short-term 'off-strategy' profits for long-term sustainable gain is not there in most Indian companies.*'—Rama Bijapurkar, a leading market strategy consultant and independent director

Case studies: Marico, Page Industries, HDFC Bank

Decadal revenue, profitability and capital employed growth for Asian Paints from 1952 onwards (growth here is measured through CAGR)



Source: Company, Ambit Capital Research

There are three things that separate the Unusual Billionaires from everybody else- slide 2 of 2

- **Secondly**, the company has to relentlessly deepen its competitive moats over the course of time (I'm talking about decades here).

'*Often the question, "Why will we be better at doing that than other people?" will have a clear and affirmative answer, and it is typically those firms that can give that answer and act on it that are successful'* — John Kay, the economist and *Financial Times* columnist, in *The Foundations of Corporate Success* (1993)

Case studies: Asian Paints, Astral Poly

- **Thirdly**, the people calling the shots at the company have to be sensible about capital allocation, i.e. refrain from large bets (especially those outside core franchise) and return excess cash to shareholders if the cash cannot be deployed to good effect by the company.

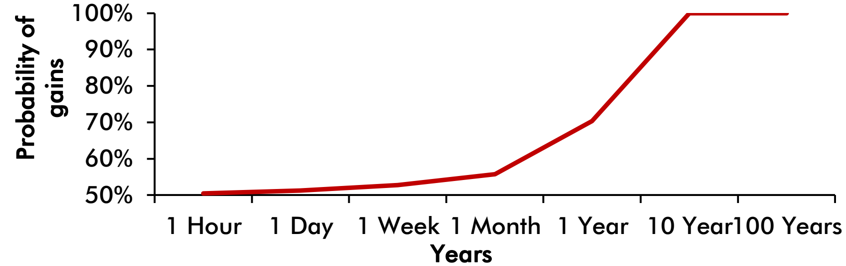
'Good management teams work on proving a concept before investing a lot of capital. They are not likely to put a lot of money in all at once hoping for a big payoff'—Michael Shearn, The Investment Checklist (October 2011)

Case studies: ITC, Asian Paints

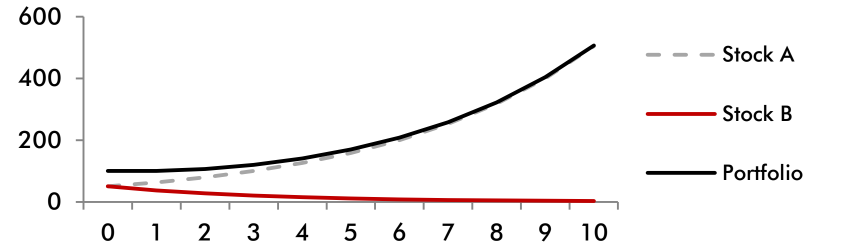
The Coffee Can construct brings five powerful effects into play – slide 1 of 2

- **Reason 1: Higher probability of profits over long term**: As the time horizon increases, the probability of generating positive returns goes up. For instance, taking mean Sensex returns at 16% per annum and standard deviation at 29%, the probability of generating positive returns goes up to 70% if the time horizon is one year; the probability tends towards 100% if the time horizon is 10 years.
- **Reason 2: Power of compounding**: Holding a portfolio of stocks for 10 years allows the power of compounding to play out its magic. Over the longer term, the portfolio comes to be dominated by the winning stocks whilst losing stocks keep declining to eventually become inconsequential.
- **Reason 3: Neutralizing the negatives of 'noise'**: Investing and holding for the long term is the most effective way of killing 'noise' that interferes with the investment process. Once you have identified a great franchise and you have the ability to hold on to it for a long time, there is no point trying to be too precise about timing your entry or your exit. If you try to time that entry/exit, you run the risk of "noise" rather than fundamentals driving your investment decisions

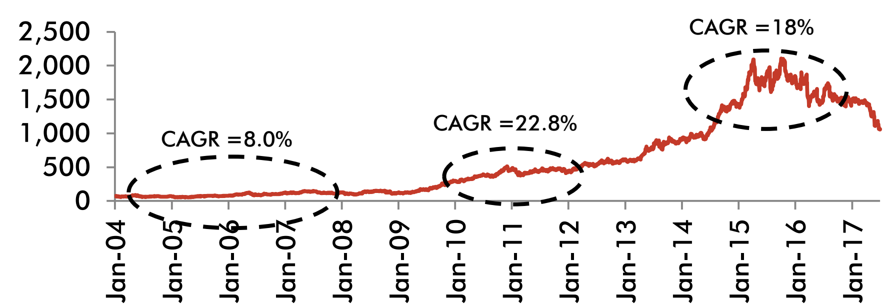
Probability of gains from equity investing in India increase disproportionately with increase in holding horizons



A hypothetical portfolio with 50% strike rate and symmetry around positive and negative returns



Lupin's stock price has compounded at an impressive 26% CAGR since January 2004



Source: Bloomberg, Ambit Capital Research

The Coffee Can construct brings five powerful effects into play – slide 2 of 2

- **Reason 4: No churn**: By holding a portfolio of stocks for over ten years, a fund manager resists the temptation to buy/sell in the short term. With no churn, this approach reduces transaction costs, which adds to the overall performance of the portfolio over the long term. Eg. In a portfolio with 50% churn, 20bps broking cost and 30bps price impact cost, churn reduces the terminal value by 9%.
- **Reason 5: Back-testing results show that rebalancing does not improve returns**: Even as running the twin filters of RoCE and revenue growth each year will lead to a differing list of stocks, we are reluctant to churn the CCP as it goes against the very objective of the approach. Moreover, the Coffee Can approach without rebalancing has outperformed the one with rebalancing approach on all six occasions. The average CAGR for CCP without rebalancing over these six iterations was 24.5% vs 18.7% for CCP with rebalancing.

CAGR returns over 10-year period for CCP with and without rebalancing

	2000-2010	2001-2011	2002-2012	2003-2013	2004-2014	2005-2015	Average CAGR
CCP without rebalancing	19.3%	28.5%	22.4%	25.4%	30.8%	20.5%	**24.5%**
CCP with rebalancing	18.5%	22.6%	22.0%	17.0%	18.7%	13.5%	**18.7%**
Difference (w/o minus with rebalancing)	0.8%	5.9%	0.4%	8.4%	12.0%	6.9%	**5.8%**

Source: Bloomberg, Ambit Capital Research Note: Dates refer to the first year and last year of the ten-year holding period. Performance has been measured over a 10-yr period starting from June of the first year and ending with June of the last year. This exhibit has been reproduced without any changes from our 2nd November 2015 thematic: "The Coffee Can Portfolio…the coffee works!"

The Investment Checklist- slide 1 of 2

The volume and complexity of what we know has exceeded our individual ability to deliver its benefits correctly, safely, or reliably' – Atul Gawande, The Checklist Manifesto: How to Get Things Right (2009)

- To help investors identify potential multi-baggers outside the coffee can construct I have prepared a checklist which is inspired by Atul Gawande, the famous American surgeon , writer and public health researcher. This checklist aims to help the investors to stay focused and enforce an effective, objective and thorough decision making process and is divided under three major heads - industry attractiveness, management quality and competitive advantages.

- **Industry attractiveness**
  - Is the company's business heavily dependent on government regulation?
  - How many competitors are present in the industry and how strong is competitive intensity?
  - What is the overall size of the industry and what is its growth potential?
  - Is the company in an industry where the proportion of value add is high?
  - What is the capital intensity and capital efficiency of the industry?
  - Is the industries' business dependent on India's overall economic cycle?
  - Does the business generate excess returns for shareholders?

The Investment Checklist- slide 2 of 2

- **Management Quality**
  - Does the management have a track record of good governance and clean accounting?
  - Do the owners of the company have connections to political parties?
  - Does the company have a strong track record of efficient capital allocation?
  - Do the promoters have a track record of remaining focused on their core operations?

- **Competitive advantage**
  - What is the company's track record on innovation?
  - What is the company's investment in brands and reputation?
  - How strong is the company's architecture i.e. its network of relationships with staff, suppliers and customers?
  - Does the company own any strategic assets?
  - Does the company have ROCEs that are higher than the industry average?

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