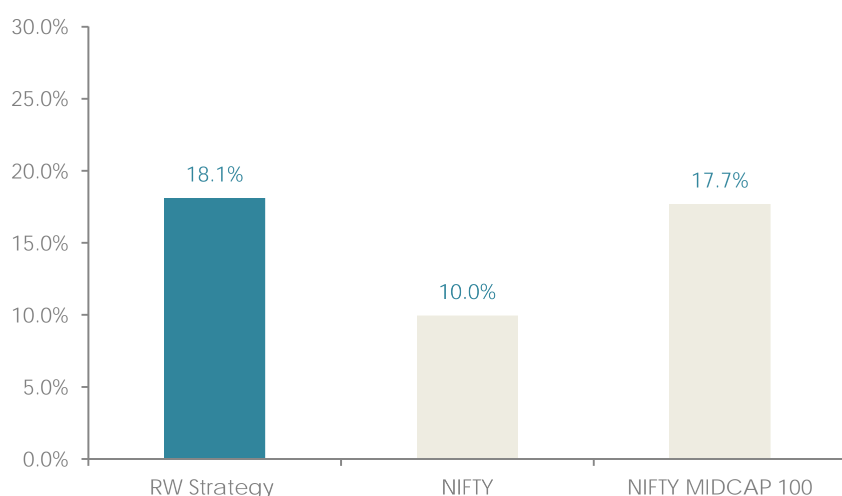
RW ADVISORS

Quarterly Update — March 2018

Investment Objective

RW Investment Advisors uses a proprietary framework that combines fundamental and technical factors to identify businesses that can create long term wealth. The guiding philosophy is capital protection and compounding over longer periods.

RW Strategy Performance (Internal Rate of Return)



Top Performers

Scrip Name	Purchase Date	Purchase Price (Rs.)	CMP (Rs.) as of 28-03-2018	Growth (%)
HDFC Bank	13-Feb-14	634	1,891	198.4%
Maruti Suzuki	07-Apr-16	3,476	8,863	155.0%
Kotak Bank	22-Jul-14	437	1,049	139.8%
Indusind Bank	30-Nov-16	1,079	1,796	66.4%
Titan Ltd.	9-Oct-17	619	941	52.2%

Holding Companies

Asset Concentration	Holding
No. of Companies	23
Top 5 Company Holdings	36.2%
Top 10 Company Holdings	61.6%
Highest Exposure	Kotak Bank (9.7%)

Sector Allocation

Sectors	Allocation (%)
Banking & Finance	34.6%
Auto & Auto Ancillaries	14.3%
Paints & Varnishes	12.8%
Consumer Durables	11.3%
FMCG	7.8%

Market Capitalization

Market Capitalization	Holding (%)
Large Cap	69.2%
Mid Cap	22.3%
Small Cap	8.5%
Avg. Market Cap (Rs.Bn)	1,214

Qualitative Analysis

Parameters	TTM
PAT Growth	19.5%
PE	41.5x
ROE	23.2%

Holding Period

Holding Period	No. Of Scrips
Less than 1 Year	12
Between 1 to 3 Years	8
More than 3 Years	3

Disclaimers and Risk Factors

RW Strategy Inception Date: 17th December, 2013, Data as on 28th March, 2018, Data Source: RW Internal Research. RW Strategy results are for an actual Client as on 31st March, 2018. Returns of individual clients may differ depending on time of entry in the Strategy. Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments. The stocks forming part of the existing portfolio under RW Strategy may or may not be bought for new client. The Company names mentioned above is only for the purpose of explaining the concept and should not be construed as recommendations from RW Advisors. Strategy returns shown above are post fees and expenses.

Since the last quarter update in Dec 2017, RW portfolio and Nifty corrected by ~4%, while the mid-cap index dropped by 9%, something that was very likely, given the valuations for the mid-cap index were very high at the start. Although our portfolio was fairly sheltered from the drawdown, there were bigger declines across mid / small caps in the market - some of them even corrected by 30-40%.

What is fascinating is that some of the most expensive companies in the portfolio have done far better than the low priced companies eg. Titan, Page etc – ***which only goes to show that valuation, in isolation, gives a distorted picture, it needs to be seen in tandem with business strength.*** Case in point is Jagran Prakashan – the stock has not delivered returns over the last couple of years, despite low valuations. Therefore, it is wise to ***prune companies with competitive head-winds or those operating in saturated markets, despite optically low valuations***.

*Following is an illustration from Mr. Bharat Shah's excellent book (*of Long term Value & Wealth Creation From equity Investing*) on the criticality of growth for generating higher returns:*

TABLE 16 : SNAPSHOT

TABLE SHOWING INVESTMENT RETURNS OF HIGH QUALITY BUSINESSES (ROCE > 30%) WITH LOW EARNINGS GROWTH (PROFIT GROWTH < 15%)

Category	FY 2003-12						FY 2007-12					
	Core ROCE	ROE	OP	PAT	IR	Dividend Payout	Core ROCE	ROE	OP	PAT	IR	Dividend Payout
Growth <15%												
Best Friends: (Core ROCE > 50%)	131.4%	32.5%	9.1%	12.1%	19.5%	51.3%	147.8%	33.3%	9.4%	10.7%	13.5%	50.0%
Good Friends: (Core ROCE 30-50%)	41.8%	23.5%	11.0%	14.8%	16.0%	41.2%	39.3%	21.1%	5.6%	7.4%	1.2%	44.9%
Growth > 15%												
Core ROCE >50%)	144.3%	40.2%	18.5%	22.2%	29.4%	47.5%	174.0%	44.3%	16.5%	19.2%	16.7%	47.9%
Core ROCE (30-50%)	38.4%	24.8%	18.6%	22.4%	30.4%	27.2%	42.0%	23.9%	13.0%	14.1%	10.1%	25.5%

IR: Investment Return (Compounded annually)

(Source: of Long term Value & Wealth Creation From equity Investing)

" The **Best Friends group** (ROCE > 50%) has given average returns (not counting dividends) of 20% CAGR (FY03-12) and 14% CAGR (FY07-12). Some of them are 3M India, VST Industries, HUL, Aventis, PGHH, Abbott, Bharat electronics and Castrol. Mind you, if you take the same ROCE (>50%) and earnings growth at higher than 15%, then many more worthies are added to the list of choices available, like Titan, CRISIL, SKF India, Nestle, Swaraj Engines"

"**Good Friends group** (ROCE in between 30% to 50%) have also been good during FY03-FY12 but not so good during more difficult period of FY07-12 (1% CAGR of returns). CMC, Bluedart, Clariant, Foseco India are a few companies in the list. Once again, interestingly, if the combination chosen were to be ROCE of 30 to 50% and growth higher than 15%, then more worthies get added to the list like Marico, Shree Cements, Exide industries"

Find below modified versions of the graph above - there are a number of learnings for a long term investor:

Investing in early part of the Bull Cycle

Growth < 15%					Growth > 15%				
ROCE > 50%		FY03	FY12	CAGR	ROCE > 50%		FY03	FY12	CAGR
	PAT	100.0	279.5	12.10%		PAT	100.0	607.6	22.20%
	Stock Price	100.0	496.9	19.50%		Stock Price	100.0	989.3	29.00%
	Multiple Expansion	1.0	1.9	7.40%		Multiple Expansion	1.0	1.8	6.80%
ROCE 30% to 50%		FY03	FY12	CAGR	ROCE 30% to 50%		FY03	FY12	CAGR
	PAT	100.0	346.3	14.80%		PAT	100.0	616.6	22.40%
	Stock Price	100.0	380.3	16.00%		Stock Price	100.0	1090.2	30.40%
	Multiple Expansion	1.0	1.1	1.20%		Multiple Expansion	1.0	2.0	8.00%

- Between FY03 thru FY12, companies with higher growth generated double the return of the companies with lower growth – exactly in-line with their PAT CAGR
  - **Growth companies deserve better multiples – Premiums could vary from 100% during a bull cycle to 30% in low growth periods**
  - If Bajaj Corp trades at 25 x (P/E), HUL can trade at 50 x. It is probably justified if the growth is sustainable
  - Notion of looking at valuation multiples in isolation is futile and business analysis is paramount inorder to understand the growth runway.
- **Investing in low growth companies worked out ok (highlighted in yellow), but you had to invest in companies with ROCEs in excess of 50% and growth in the range of 10-12% inorder to generate IRRs close to 20%**
  - CARE ratings in our portfolio falls into this category
- There was no real difference in returns between companies with ROCEs above and below 50% as along as growth was strong – something like the rising tide lifting all boats.
- Overall, investing outcomes were benign as you had wind in your sails – because starting valuations were helpful

Investing in late stage of the Bull Cycle

Growth < 15%					Growth > 15%				
ROCE > 50%		FY07	FY12	CAGR	ROCE > 50%		FY03	FY12	CAGR
	PAT	100.0	166.2	10.70%		PAT	100.0	240.6	19.20%
	Stock Price	100.0	188.4	13.50%		Stock Price	100.0	216.4	16.70%
	Multiple Expansion	1.0	1.1	2.80%		Multiple Expansion	1.0	0.9	-2.50%
ROCE 30% to 50%		FY03	FY12	CAGR	ROCE 30% to 50%		FY03	FY12	CAGR
	PAT	100.0	142.9	7.40%		PAT	100.0	192.5	14.00%
	Stock Price	100.0	106.1	1.20%		Stock Price	100.0	161.1	10.00%
	Multiple Expansion	1.0	0.7	-6.20%		Multiple Expansion	1.0	0.8	-4.00%

- In the 5 year period between FY07 thru FY12, it was tough to generate even a 15% compounded return as the entry valuations were quite high – It's a lot like the current market where companies are trading at rich multiples
    - We also had the great recession and Govt. inaction – despite these issues companies whose growth was higher continued to generate abnormal returns
  - Within the low growth companies as well, the companies with highest RoCEs perform relatively better
- **In a nutshell, an investor will do fairly well by investing in companies with ROCEs greater than 50% in all environments – something to think about and growth is the icing on the cake**
  - On the contrary, lower down the ROCE hierarchy, companies growing rapidly at rates higher than the internal ROCEs should be looked at with caution – for they have to raise external capital repeatedly and keep diluting ownership.

In our portfolio, of the 18 non-financial stocks, **about 35% of the stocks have core RoCEs in excess of 50%**; almost all the stocks have ROCEs in the range of 20%+ with the average around 23% - Our goal is to look out for great businesses that can go up the ROCE and growth curves over time.

Following is the key thesis on Abbott India - one of the companies in the portfolio with core ROCEs in excess of 50%

- Indian pharma market is likely to grow 10-12% over the foreseeable future despite regulatory flip-flops; Price control has in fact led to higher volume growth for companies with strong brands.

Over the last 100 years, Abbott has been a market leader across segments including 1) Women's health, gastro and hepatic ailments 2) Consumer care (Digene and Brufen) 3) Specialty care (anti-depressants) and 4) Vaccines (for influenza). It is the second largest domestic player after Sun Pharma.

Key thesis is as follows:

- **Strong Brands and New product introductions**
  - Overall, 100 brands with over 100 year history
  - Of which 6 brands are in India top 100
  - Top 10 brands account for 70% of the core business sales of the Company
  - Dominates 5 of the 9 areas it operates in
  - New Product launches: 17 in FY16, 9 in FY14, 9 in FY15 - 4 products in Vaccines, 20 products in FY11
    - So much for the idea that "pharma MNCs only launch all the new molecules in unlisted entities"

Brand name	**Rank**	**MS%**
Thyronorm	1	*53.4*
Duphaston	1	*19.0*
Udiliv	2	*10.5*
Vertin	1	*30.7*
Digene	2	*14.5*
Duphalac	1	*13.0*
Cremaffin	2	*11.0*
Zolfresh	1	*23.6*
Prothiaden	2	*6.9*
Creon	1	*34.3*

- **No royalty paid to the parent company because they already own 75% stake**
  - Stable management leadership – the last CEO spent almost 4 years before Ambati Venu became the MD
  - Given the strong brand orientation of the company, current CEO Ambati Venu comes from FMCG background. (Previous CEO Rehan Khan spent 4 years with the Company. Prior to that Vivek Mohan spent a good 8 years at the company before moving to a global role)
  - Parent increased the stake in the listed entity through serial buybacks in 2003, 2007 (stake increased to 65%), 2008 (to 68.94%), 2013 (to 75%)
- **Strong distribution engine (Novo Nordisk, Bharat Biotech etc)**
  - Along with Torrent, Abbott also distributes the products of Novo Nordisk (leader in diabetes care)
  - They also distribute high-margin vaccines from Bharat Biotech (leading player known for Zika vaccines)
  - Abbott has an asset turn of 11 x – which is by far the highest in the industry and speaks volumes about their distribution strength
- **Sustained market share gains despite mature brands and adverse regulation:**
  - Last 5 years, revenue compounded at 14%, clearly ahead of the market, along with 18% CAGR in profits
  - Stock price compounded at 26% over the last 5 years and 27% over the last 10 years - not counting the dividends
  - Despite the DPCO headwinds (price controls), company has more than made up for the price cuts by ramping up the volumes. Following is the revenue growth for Thyronorm despite DPCO which came in CY13

Rev (INR crs)	**CY13**	**CY14**	**CY15**	**CY16**	**CY17**
Thyronorm	94.5	106.9	152.1	179	193
Growth		*13%*	*42%*	*18%*	*8%*

- Concerns: Policy brakes on third-party manufacturing; merger of the loss making unlisted entity with the listed entity
- http://indiacocreates.weebly.com/b2x/abbott-joins-hands-with-puducherry-government-for-care-competency