RW ADVISORS

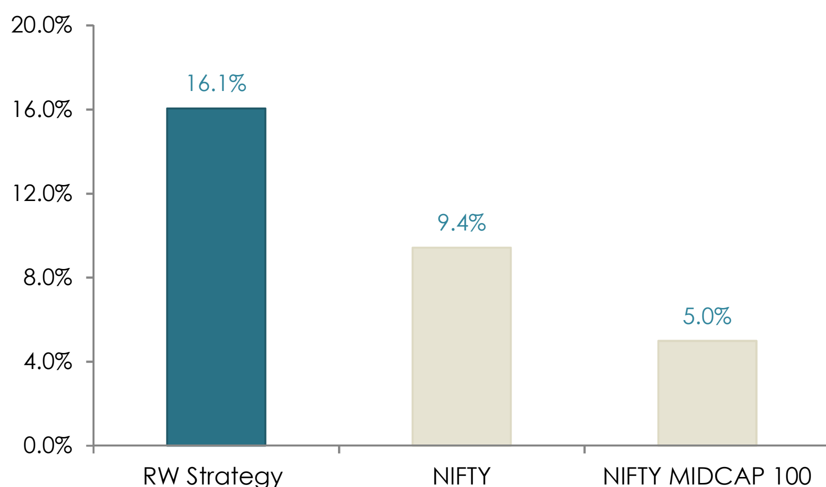
Quarterly Update

September 2019

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.

Chart 1: RW Strategy Performance (Actual IRR)



Top Performers

Scrip Name	Purchase Date	Purchase Price (Rs.)	CMP (Rs.) as of 30-09-2019)	Growth (%)
HDFC Bank	13-Feb-14	317	1227	287%
Bajaj Finance	17-Jan-18	1,702	4,050	138%
Abbott India	17-Mar-17	4,524	10,597	134%
Nestle India	3-Oct-18	9,418	13,916	48%
Asian Paints	1-Sep-17	1,196	1,764	47%

Holding Companies

Asset Concentration	Holding
No. of Companies	18
Top 5 Company Holdings	43.8%
Top 10 Company Holdings	70.3%
Highest Exposure	HDFC Bank (10.4%)

Sector Allocation

Sectors	Allocation (%)
BFSI	44.6%
FMCG	14.8%
Paints & Varnishes	14.5%
Pharmaceuticals	8.8%
IT Services	7.9%

Market Capitalization

Market Capitalization	Holding (%)
Large Cap	68.6%
Mid Cap	31.4%
Small Cap	0.0%
Avg. Market Cap (Rs. Bn)	1,954

Qualitative Analysis

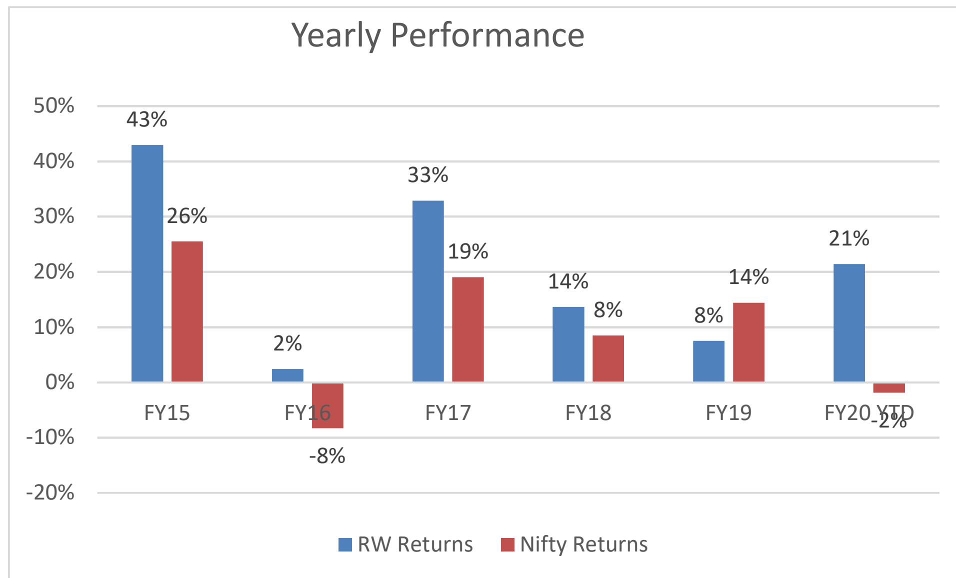
Parameters	TTM
PAT Growth	21.4%
PE	52.4x
ROE	22.2%

Holding Period

Holding Period	No. Of Scrips
Less than 1 Year	11
Between 1 to 3 Years	5
More than 3 Years	2

Disclaimers and Risk Factors

RW Strategy Inception Date: 17th December, 2013, Data as on 30th September, 2019, Data Source: RW Internal Research. RW Strategy results are for an actual Client as on 30th September, 2019. 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.



A word about year on year performance:

RW's performance on a year on year basis was higher than the index by atleast 5 percentage points for most of the years since inception. FY19 was an exception, where we underperformed the index by 6% points. Incidentally, this was the year we doubled down on Emami, Motilal and Eicher. Although, it is tough to predict the performance in the short-run , the strategy to invest in good businesses should hold us in good stead. Even if we shave off 15% return (so that the stocks in the portfolio revert mean valuations) for 60% of the portfolio, which has run ahead of fundamentals – we should still be clocking around 14 to 15% return instead of the 16% IRR that we show in the first page. Given that it still beats large cap index NIFTY50 by 4 to 5% points per annum, we would consider this performance satisfactory.

The heartening thing here continues to be that most of the stocks in the portfolio are category leaders with zero debt and have demonstrated reasonable growth in earnings despite the macro-headwinds. We intend to keep the portfolio this way. Value is good but growth is critical. **Some of the stocks are exhibiting very high valuations and we make an attempt to address this issue in this update.**

It is probably a good thing to begin with the following quote from Feynman, "The first principle is that you must not fool yourself and you are the easiest person to fool" especially when you are dealing with large numbers😊

Growth stocks in India right now are literally reaching the skies, especially the valuations. Our own portfolio might have best of the companies but the P/E has never been this high. It leads us to two fundamental questions - **When will the growth stocks de-rate? What is the maximum price you can pay for a stock?**

The link below gives a very refreshing perspective on growth stocks, especially Walmart.
http://www.philosophicaleconomics.com/2014/03/wmt/

You really can pay 600 P/E for a stock and still get away with market beating returns

"The reason that Wal-Mart produced a fantastic return from 1974 to now is NOT that it was cheap relative to its present or near-term future earnings. ***By the standards of 1974, it was actually a growth stock–priced at almost twice the market multiple.*** *In the current market, an equivalent valuation would be something like 30 or 40 times earnings–for a business with uncomplicated earnings that had already been in operation in Arkansas for three decades. It produced a fantastic return because it was a fantastic business, with miles and miles of growth still in front of it.*

Now, what is the maximum price that you should be willing to pay for $WMT, knowing what it's going to become? And what sort of valuation would this price imply? One way to answer the question would be to discount $WMT's total return from 1974 to today at the rate of return of the overall market. $WMT at $12 produced a 40 year annual total return of 23%. It turns out that the price that would bring this return down to the market rate, 12%, is roughly $600.

In 1974, $600 for a $WMT share would have represented a PE ratio of more than 600. In the current market, which is much richer, this would be the equivalent of something like 1500 times trailing earnings–again for a company with undistorted earnings that has been in operation for decades."

In simple words, one ***can*** pay 600 times trailing earnings for a super-duper company and still get away with market beating returns. Think about this, at the point of buying a stock, you can pay up 600 years of earnings assuming the current year earnings stay constant. No company has lasted that long without growth – growth as Mr. Ambani would say, is life. It is true that finding the next Walmart has a near-zero probability, unless the process is impeccable. Despite the slim-pickings, if one were to latch onto a winner like Walmart, it can change the wealth equation quite dramatically.

One of the fundamental reasons why investors always underestimate valuation multiples is our inability to see and think long-term. The longer a business sustains, higher can be the initial multiples because of compounding. Very few businesses have long term sustaining power, such businesses offer intrinsic margin of safety. D-Mart may fit this criteria with a large growth opportunity.

Walmart is an extreme example but we do have companies in our own backyard that have demonstrated this phenomenon. Mr. Damani's investment in Infosys as written in the book, Masterclass with Super-Investors (https://www.amazon.in/Masterclass-Super-Investors-Vishal-Mittal/dp/9388304187/ref=pd_rhf_dp_p_img_1?_encoding=UTF8&psc=1&refRID=BZQG4XMDSDRRQD35NJQ5) amply demonstrates this message from yesteryears.

Exhibit 1 - Infosys: Probably the fastest 100 bagger ever, but when do you sell?

All numbers in Crores								
Infosyzkrieg	**Mar-95**	**Mar-96**	**Mar-97**	**Mar-98**	**Mar-99**	**Mar-00**	**Mar-01**	**Mar-02**
Net Sales	55	89	139	258	509	882	1901	2604
Growth (%)	*92%*	*62%*	*56%*	*86%*	*97%*	*73%*	*116%*	*37%*
PAT	13	21	37	60	133	286	623	807
PAT Margin	24%	24%	27%	23%	26%	32%	33%	31%
Growth (%)	*65%*	*62%*	*76%*	*62%*	*122%*	*115%*	*118%*	*30%*
Market Cap	NA	359	731	2928	9673	58887	27012	24721
P/E (x)	NA	17	20	48	73	206	43	31
RoE (%)	30	30	38	42	36	41	56	42
Debt/Equity	0.1	0.1	-	-	-	-	-	-
Dividend Payout (%)	25	17	11	16	19	10	11	10

In the quarterly update from Dec 2017, we discussed how Titan went on to become a 225 bagger for Mr. Rakesh Jhunjhunwala in 2003 and a 20 bagger for someone like us, who would have invested after the turnaround became far more apparent in the numbers. Infosys is somewhat of a similar story except it did not need a turn-around, but needed a lot of gumption to hold at pretty elevated multiples.

It fitted in a lot of CANSLIM principles taught by Mr. William O' Neil and was available at very reasonable valuations. All in all it was a whopping 170 bagger in 5 years, 80 bagger in 6 years, 70 bagger in 7 years - Staggering in every sense of the word and was the probably the fastest 100 bagger anywhere in the world. More on 100 baggers here: https://www.amazon.in/100-Baggers-Stocks-100-1/dp/1621291650

If we were to teleport ourselves into that era, it was a perfect pitch for someone like us, ofcourse with a large dose of hindsight bias.

- Market leader - **Yes**
- No debt on balance sheet, cash generation is a must, ROCE upwards of 20% - **Yes**
- Able management? – **Looks like that!**
- Price reaction – **Yes, positive**
- Respect the 200 **weekly** moving average – i.e. sell below – **Still needs to be tested**

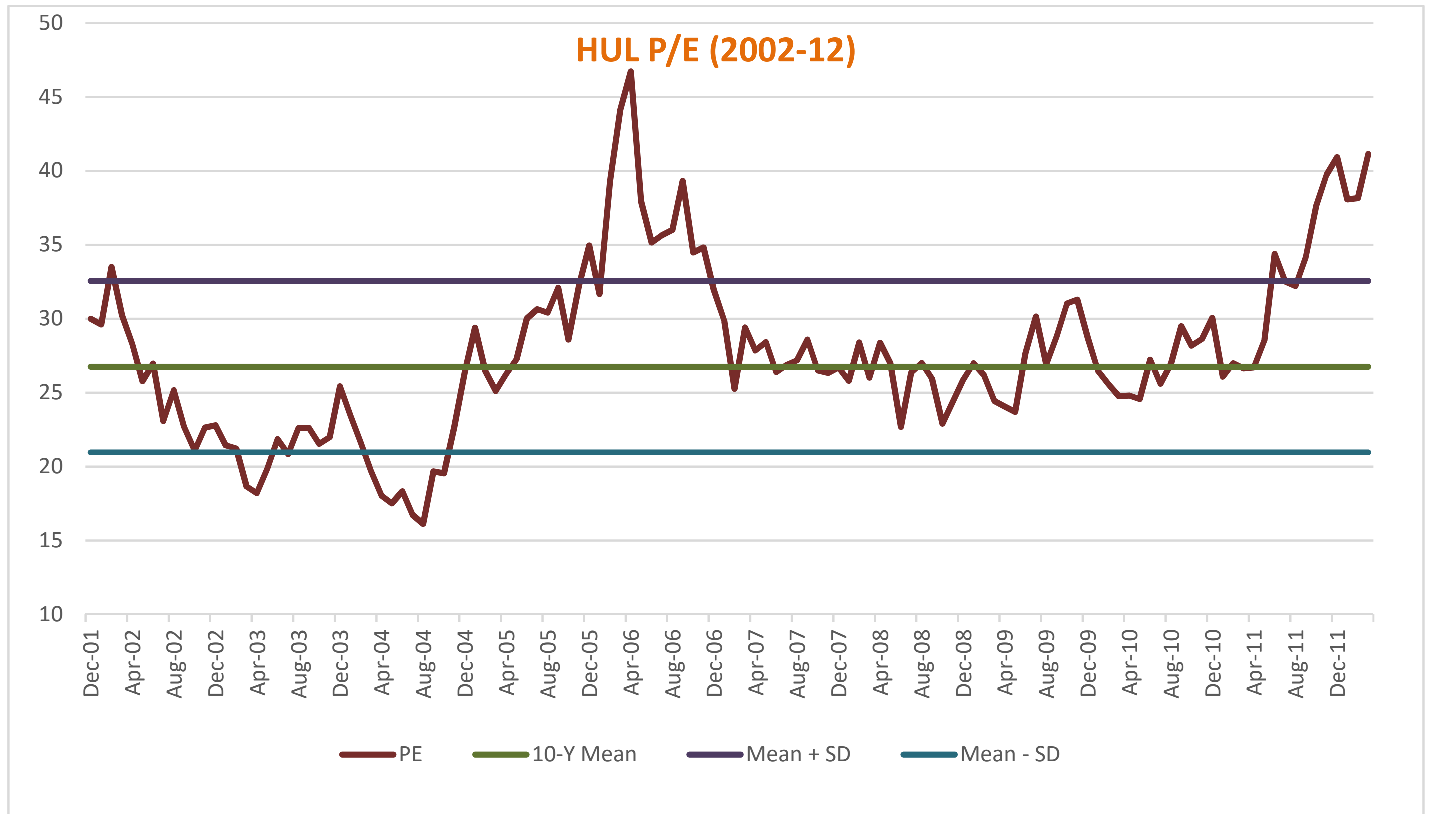
The reason to discuss Infosys is that 1) it was growing earnings at upwards of 70% 2) it was available cheap until 1997 3) it went to reeling heights of 206 P/E at the height of craziness. From our stand-point, if we had invested 5% of the portfolio in 98 assuming that we were late to the party**, it went up 20 x in two years**. In otherwords, it would have been **50% of the portfolio assuming rest of the portfolio stayed flat over these two years**, which is just crazy.

We would not have sold down until the price went down INR 53 from the peak of INR 184, if we had used the 200 week filter for selling down. That's a whopping 70% decline! Natural given the elevated multiple it went to, but painful. We would have waited because the growth did not come down for the company and the rise in 2000 was textbook definition of parabolic. Mr. Damani on the other hand sold his holdings at 30% to 40% decline from the top and he invested much early. The gumption to hold on that long and not let greed interfere after a 30 to 40% decline is a virtue. He sold off and went away as he aptly believes that every bull market has a new set of leaders aka multibaggers. This **makes me conclude stocks that go parabolic need a different exit criterion, despite having a long stop at the 200W line**.

This leads us back to our fundamental questions **When will the growth stocks de-rate? When is the right time to sell?**

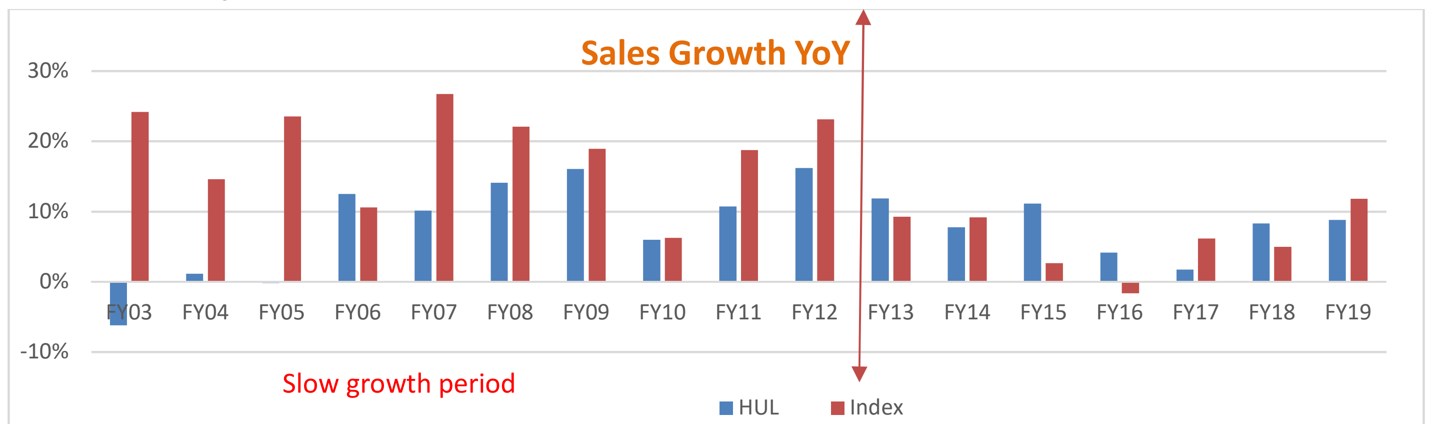
To answer the first question, we looked at two of the richly valued stocks in our portfolio with long history viz. Hindustan Unilever (HUL) and Nestle.

Exhibit 2 – Hindustan Unilever's P/E ratio between 2002 and 2012



For a large part till 2012, HUL was a big laggard compared to the broader market. **The key here is the broader market grew atleast 10 to 15% higher between FY02 till FY05, FY07, FY08; 5 to 10% higher in FY11**. Only exception when HUL had higher growth compared to the market was FY06 and guess what - it got re-rated from 25 P/E to 45 P/E. Market pays inordinately high multiples for **relative growth** (RG). In a world full of blind men, the one eyed jack is the king!

Exhibit 3 – Sales growth for HUL and all the listed companies between FY03 and FY19

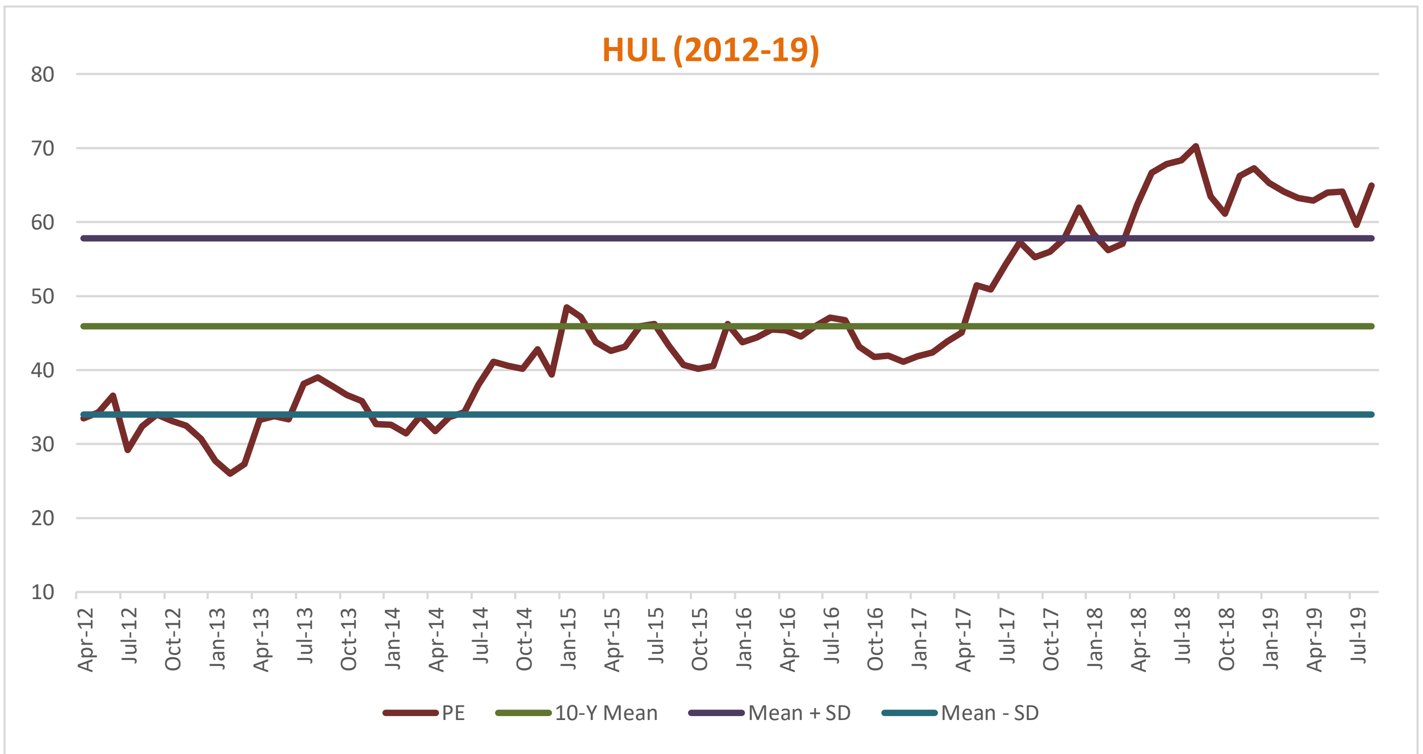


Between FY03 and FY12, HUL had higher sales growth than the market only once in FY06. On the contrary starting FY13, because of wider economic slowdown HUL's relative growth held up in 4 of the 6 years. Change in management's stance after activism in Nestle globally and 3G capital knocking at the doors of kraft Heinz had a big role to play in this dramatic change. HUL's stock was amply rewarded in the due process as the TTM P/E multiple moved up from 50 x to 65 x (as can be seen in the next chart). All this is happening in the back ground of lower interest rates globally - gravitational pull for the stocks has somewhat reduced.

The other key reasons why HUL did well especially post 2013 include:

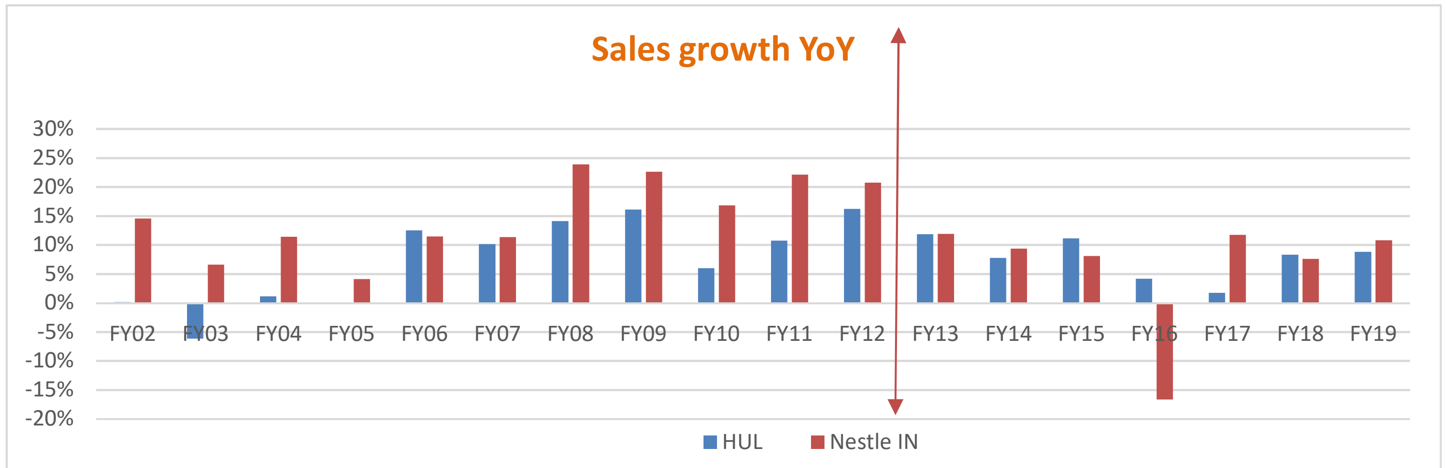
- Compliant organized players benefited disproportionately post Demonetization as cash sales got hit
- The company was well prepared for the post GST regime vs someone like Emami, which was much more dependent on wholesale distribution channel
- Urban centricity also helped shore up the numbers while the rural continued to be in distress
- Cost cutting got ingrained into the company after global activism

Exhibit 4 – HUL's TTM P/E between FY12 and FY19



If one were to hazard a guess as to what would lead the multiples down **<u>– either the economy stages a broad-based recovery across the board or HUL's growth rate falters due to continued rural stress, making HUL's RG less attractive – these seem like the causes that could lead to significant time-correction/de-rating</u>**. This is something we need to be prepared for and re-orient our portfolio when the time comes, just like our exit in LTTS. FY19 was the first such year when HUL's growth has lagged the broader index, let's see if the trend continues.

Exhibit 5 – Sales growth HUL vs Nestle



Similar story comes across when one compares HUL vs Nestle – Nestle's growth was far better vs HUL for the most part till FY12. Starting FY13, HUL did equally well compared to Nestle, notwithstanding the FY16 maggi fiasco.

Key learnings:

- For growing companies, longevity of the business is far more important than valuation
- We typically underestimate how much a business can deliver in the long term
- Relative valuations are a big function of relative growth
- We should watch for 1) slowing relative growth for our portfolio companies or 2) broad sector pick-up
    - **Both these events could derate the companies that we have in the portfolio, reducing near term IRRs – We have to be prepared for it**
    - **Sell now and buy later does not work, because we don't know for sure the contours of the likely de-rating. All we know, is these are the best companies in their respective spaces**

Sincerely,
Chaitanya