Date	February 09, 2018	Publication	Mint	Pg No.	18

'There are clear signs of economic recovery'

BY LATHA VENKATESH, SONIA SHENOY, ANUJ SINGHAL
CNBC-TV18

ANIRUDDHA CHOWDHURY/MINT

Ambit Capital chief executive Saurabh Mukherjea.

Investors should not rush into buying stocks which have fallen the most if the index corrects further, according to Ambit Capital chief executive Saurabh Mukherjea. Instead, Mukherjea said, look for good companies. A good company is one that has given consistent growth in revenue for the last 10 years with a return on capital at 15%, he said. In an interview, Mukherjea said the economy is recovering and the stock market is overvalued and by year-end, this overvaluation will get cleansed out. He said the global economy was steaming along and it looked like across the world, including in India, investors had pre-empted recovery by buying ahead of it. Now a correction of 15% could bring things on a stable footing, he said, adding that in India, the cause for a fall could be long-term capital gains (LTCG) while for US markets it could be a rise in bond yields.

Edited excerpts:

I am sure you have seen other instances of market losing suddenly so much, but will it take a long time now to recover its mojo?

I think there is the short term technical factor to contend with which is long terms capital gains (LTCG) tax. I think between now and the year end, we are grappling with the complications that LTCG creates. However, I am not that pessimistic about next year, we have been saying for a while now, I think for the best part of the last 12 months, that the markets are fully valued. So with that proviso that I do not see the overall market having upside, I think on the macro front we have been very constructive over the last four or five months.

I think the signs are pretty clear, we are seeing a fairly concerted recovery come through whether it is in bank credit, whether it is in cement demand, auto demand. So the economy clearly is recovering and my reckoning is it will probably take the summer before the mood changes away from the concerns around the bond market, the concerns around LTCG. I think by summer, hopefully with index at a more sensible levels, we should see a resumption in more optimism vis-à-vis the stock market. However, the economy clearly is recovering, the stock market is overvalued, and hopefully between now and the year end, that overvaluation gets sort of cleansed out of the system.

The joke doing the round is that the LTCG has impacted the global markets as well; that day was the peak for a lot of markets, US market also. Your sense of what has happened to the global asset classes, global equity markets, and are we going to go through a bit of a rough year, within a bull market a bit of a down year?

It could well be that we have a rough year. Again, just like India, the global economy is also seeing a concerted recovery. I was just watching, you guys were flashing that the US economy hitting 3.5% unemployment rate which is I think a decadal high, Japan is at full employment, and Germany is at full employment, so, the global economy is steaming along, and it looks as if what has happened is across the world, including India, we have pre-empted the recovery by buying ahead of the recovery, and hence a pause and a correction of say as much as 15% will sort of balance things again and put us in a good footing to then rise with the economy. We have sort of second guessed the economic recovery too much and therefore a cleansing is necessary. In our country LTCG could be the trigger for that, and in America, the 10-year bond yield ripping through could be the trigger for that correction.

As they say, the great time or the best time to buy is when there is fear in the market and there is fear right now. You have written this book called 'Coffee Can Investing', it is low risk road to stupendous wealth, that looks mouth-watering, is there anything like low risk and how do you get to stupendous wealth. So tell us what do you do in a market like this and how do you pick stocks?

What we have been telling our clients for the last four or five years, I think on this program itself, I must have repeated this mantra several times that buy high quality names, and sit patiently on them. The Coffee Can Investing really is about that, buy companies which are consistently growing at a decent cliff, with sensible return on capital employed (ROCE), and sit tight.

What you typically see in India is, if you do this, you typically get around 10x in 10 years, which is why I say stupendous wealth. I think 10x in 10 years by my definition is pretty good going which is around 24-25% compounding. I think that mantra holds just as much today as it did a year ago, but the proviso is patience. If you are buying the Indian market today, when the market is in the near term fully valued, you got to be patient.

Let us take a few examples, Current Account and Savings Account (CASA) funded banks in our country, there are several banks where CASA is nearly 50%, the economy is recovering, CASA funded banks will benefit from the recovery. Some of the CASA funded banks that are at four times price to book, but there are others at nearly one times price to book.

So, straightforward way to capitalize on what is clearly an on-going recovery will be buy sensibly run banks and then sit patiently rather than sort of gyrating with the market on a weekly basis.

But what is your definition of good companies because things look good now, like Graphite India looked very good a year ago, all the way for the last 10 months, so, what would you call a good company?

What has alarmed me over the last 12 months is there has been a lot of buying of companies which are clearly not good; they are neither good in terms of sustainable earnings performance nor good from an accounting perspective. So good in our definition, in the simple definition of Coffee Can is, if you can grow revenues in India at, at least 10% for 10 consecutive years, with a ROCE of 15%, you are right up there, you sort of this nirvana in our country. Unfortunately or fortunately, only 17-18 companies pull it off.

However, systematically you buy those 17-18, you tend to get 10x in 10 years in the decade that typically follows. Now do we have plenty of companies in India who pull off 10% revenue growth and 15% ROCE?

No we do not, it is around a dozen and a half, but using that construct you can even buy smallcap stocks which have had say good five to six years of sensible growth, clean accounting, and the interesting thing is those stocks have not run up nearly as much as the stocks with weaker accounting and shady fundamentals. That was I think really alarming part about October-December, really shady companies were rocketing through on high volumes.

I just wanted to complete that point you were making about LTCG, but the Budget was beyond LTCG, right? There was this clear shift about political Budget, minister on record said that this year Budget has to be looked at the fact that we are going into an election year, there is maybe probability of advancing general elections as well, though finance minister (FM) has denied that. However, do you think politics could be a bit of a risk for the market from here on?

I think you are right that the budget has a little bit more fiscal slippage than most of us would like, but that being said, we expected it. In the context of Indian politics and the context of five year cycles in our country, I think this sort of fiscal slippage in a pre-election year is par for the course. I think baring the LTCG, the rest of the budget was broadly along expected lines.

You said 10x in 10 years looks like a pretty good growth, it looks exceptional I was going through your book in which you have put a period of 2004 to 2014 when some of these stocks in your portfolio gave you about 30% or 33% per annum absolute returns. These are stocks like Infosys, Hero MotoCorp, Cipla, Container Corp. (CONCOR), HDFC, etc. However, some of these industries have changed a lot since then, IT for example, pharmaceutical for example, does the structure still hold for some of these good quality companies?

I think you are right, the identity of the winners does change as the Indian economy evolves. So for example over the last couple of years the Coffee Can portfolio has had companies from the building materials sector.

So there is a pipe company which consistently shows up in the Coffee Can portfolio. This year we added a midcap pharmaceutical company which has now shown 10 years of super numbers. So the identity of the winners changes a little bit year to year. So, between year T and T+1, the portfolio will change by around 20%.

However, over a 10 year interregnum, if you stick to this mantra over 10 years, you tend to get around that 24-25% compounded mark which is the 10x in 10 years.

So, yes, the metrics that we are using, 10% revenue growth and ROCE, itself are doing the job for you of helping you adjust to the changes in the country. So maybe IT services had its sort of high known, but it looks like aspirational consumption, discretionary consumption is going to have a bumper decade and gradually these filters that we use, pull more aspirational consumption stocks into your portfolio and you prosper with a growing economy.

Is it something like autopilot, like in 2010 you sat with balance sheets, did your excel on say a 1,000 companies for 2000 to 2010. In 2011 you do it from 2001 to 2011. So those that do not make their appearance you start pushing out?

Yes that is right. It is as close to autopilot. Basically what we are doing is, every year when the annual reports come out around autumn, so year-end is March, you wait till autumn when all the annual reports are out, and you rebalance basis the preceding 10 years of financial numbers. What we are trying to avoid, which is I suppose the biggest sin of my profession, what we are trying to avoid is forecasting. We are not trying to forecast EPS growth, and ROCE, we are simply looking at the last 10 years of performance and saying let me choose companies which are robust in their 10 year performance and buy them.

INTERVIEW

If I hold them long enough, the entry price becomes irrelevant in terms of long term performance. So you are buying high quality companies and letting the long term compounding do the magic for you.

But then it is all a numbers game, you are not putting in points for corporate governance, guys who are not coming to the capital market too often, those are all reflected in the numbers, you do not put anything else?

Absolutely. I think in large and midcap investing, you are absolutely right. In large and midcap investing, we are doing exactly that. We are saying let us be as rigid as possible about the numbers, let us not be subjective about the last 10 years of financial performance.

However, in small cap stocks where the 10 year performance sometimes is not there, in case of recent IPOs we do not have the 10 years of performance, so there you do have to be a little bit more subjective.

In the book I have explained in alternative framework, I have given a separate framework for small cap investing which is necessarily a little bit more subjective.

However, in both frameworks, what we are trying to do is avoid companies where the accounting is shady, and where the corporate governance might be questionable because those I think are the biggest stress points and typically in sort of times like last week or the current juncture, your biggest risk is on weak companies with shady fundamentals you lose 50-60% in the space of six days and then that is very hard to then pullback. It is very hard to pullback from that.

Just a point on the current market setup. We have the January mutual fund inflow number which is lower than December. This market has been driven by domestic flows, we have again started to see a lot of FII outflows, does this market run a risk of large redemptions domestically as well and with the fact that FIIs are pulling out? Is this market a bit vulnerable over a next two or three month period?

Unfortunately fortunately flows in our country tend to be a function of 12 month lagging returns. So clearly if returns conk off for the say next two to three months, flows will taper off.

However, what we are banking on is, given the underlying juice, the underlying strength in the economy, by summer the market could look attractive again. Once you see that, once sensible valuations return, I am 100% confident FIIs will return. All my discussions with our FIIs clients over the last three months has been clients telling us how expensive India is and how worried they are about valuations. If those valuations normalise, the FII investor will return by hoards through the summer.