Ambit Coffee Can Newsletter – Feb'18

How punchy can the P/E multiple of a 'great' company be?

When it comes to investing in stock markets, greatness is defined as ***'the ability of a company to grow whilst sustaining its moats over long periods of time'***. Such great companies have repeatable and defensible earnings with significant competitive advantages that defend their superior returns from the unrelenting assault of the competitors. Given the consistent track record of such rare companies, their share prices ought to trade at higher multiples - but how much?

A large proportion of investors and financial analysts use short-cut methods to value companies. Some of these include using 3/5/10-year historical average P/E or P/B multiples to arrive at the absolute valuation or using PEG (i.e. the ratio P/E divided by expected earnings growth of a stock) ratios to identify overvaluation or undervaluation relative to peers. All these methods anchor themselves either to historical valuations or to peers' performances, which becomes an unjustified comparison since it ignores two key aspects of 'great' businesses:

Firstly, valuation multiples or PEG ratios draw comparisons based only on their earnings trajectories whilst ignoring the amount of capital reinvestment required to sustain that earnings trajectory. For instance let us assume that two companies X and Y have the same earnings trajectories when A reinvests only 25% of its cash back into the business while B reinvests 50% of cash back into the business. Company A, which requires lower degree of capital reinvestment to deliver the same earnings growth, deserves a higher valuation than B, since A leaves higher free cash flows in the hands of the shareholders by generating a higher return on capital employed.

Secondly, PEG ratios or P/E multiples do NOT adequately capture the longevity of a franchise. For instance, let us assume that two companies X and Y have the same capital investment and cash generation for the next 5 years. However, while X can sustain its competitive advantages for 10 years, Y can sustain its competitive advantages for 20 years. In this case, Y deserves a higher P/E multiple than X despite delivering the same set of financials over the next 5 years.

A Discounted Cash Flows based valuation best captures both, longevity as well as capital efficiency of great companies.

So how punchy can the fair value of a 'great' company be? Let us assume that an investor has identified a company ABC which will deliver the following financial performance:

- Sustain an ROCE (Returns on Capital Employed) of 35% for the next 20 years (from 2018 to 2038); and
- Maintain a dividend payout ratio of 30% i.e. it reinvests the balance 70% earnings in the business and generates 35% ROCE on this incremental capital employed.

Let us also assume that, thanks to the popular theory of 'mean reversion', in 2038 Company ABC will trade at the current market average P/E multiple of 20x. This is possible if in 2037 there is no visibility of another 20-year runway for growth. Now the big question is – ***"At what P/E multiple in 2018 will this company deliver market average returns over the next 20 years?"*** The following points and the exhibit below show the result of this exercise for Company ABC:

- The BSE Sensex has delivered 11% CAGR over the past 25 years. So let's assume 11% CAGR to be the likely market return over the next 20 years.
- If the said company's P/E multiple in 2018 is 210x (yes, you read that right, 210!) then this company will deliver 11% compounded annualised returns over the next 20 years assuming a steady decline in its P/E to 20x by 2038.
- If, more realistically, ABC is available for investment at 50x P/E in 2018, then it will deliver 19.5% share price CAGR over the next 20 years even as the company's P/E declines from 50x in 2018 to 20x in 2038.

Conviction on fundamentals will give healthy returns even with high entry P/E

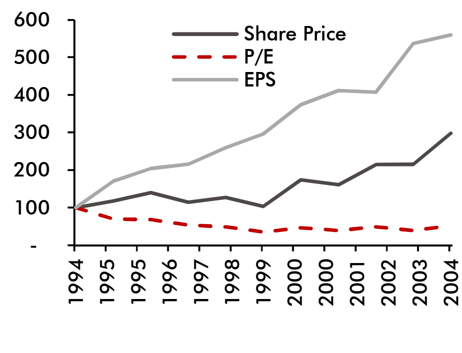
Year	Earnings	Earnings growth	Capital Employed	ROCE	Reinvestment of Earnings	P/E	20-year investment CAGR
0	100		286	35%	70%	50	
1	125	24.5%	356	35%	70%	49	
2	155	24.5%	443	35%	70%	47	
3	193	24.5%	551	35%	70%	46	
18	5,165	24.5%	14,756	35%	70%	23	
19	6,430	24.5%	18,372	35%	70%	22	
20	8,005	24.5%	22,873	35%	70%	20	19.5%

Source: Bloomberg, Ambit Capital; ROCE = Returns on Capital Employed

While the analysis discussed above makes theoretical sense, we highlight two practical examples where investing in great companies at punchy valuations has been the right decision even as these valuations have significantly de-rated thereafter.

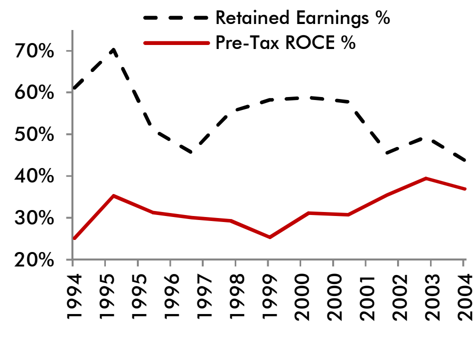
Example 1 - Asian Paints, 1994-2004: On 31st March 1994, Asian Paints was trading at a P/E multiple (trailing) of 38x when the Sensex was trading at a P/E multiple of 47x. After a decade, by 31st March 2004, Asian Paints' P/E multiple de-rated to 20x as Sensex's P/E multiple de-rated to 19x. Despite this de-rating, an investment in Asian Paints at 38x P/E multiple in 1994 would have grown at 12% CAGR (excl dividend) till 2004, when Sensex delivered only 4% CAGR over the same time period. This was because Asian Paints maintained an average ROCE of 32% with an average rate of reinvestment of earnings being 54% over these 10 years (see exhibits on the left below). Moreover, as highlighted in the exhibit on the right below, the period of 1994-2004 was not the only period when Asian Paints maintained a healthy ROCE and capital reinvestment rate. It has had such stellar track record of consistency for more than seven decades in a row!

Asian Paints' share price (1994-04)



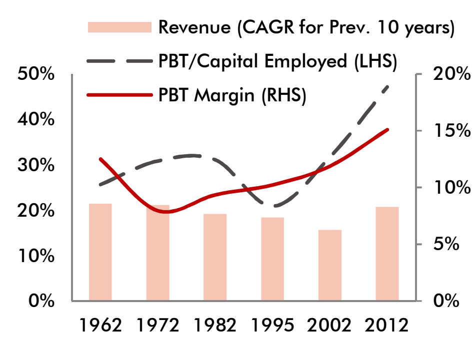
Source: Bloomberg, Ambit Capital

Asian Paints' fundamentals (1994-04)



Source: Company, Ambit Capital

Asian Paints' 70 years of consistency



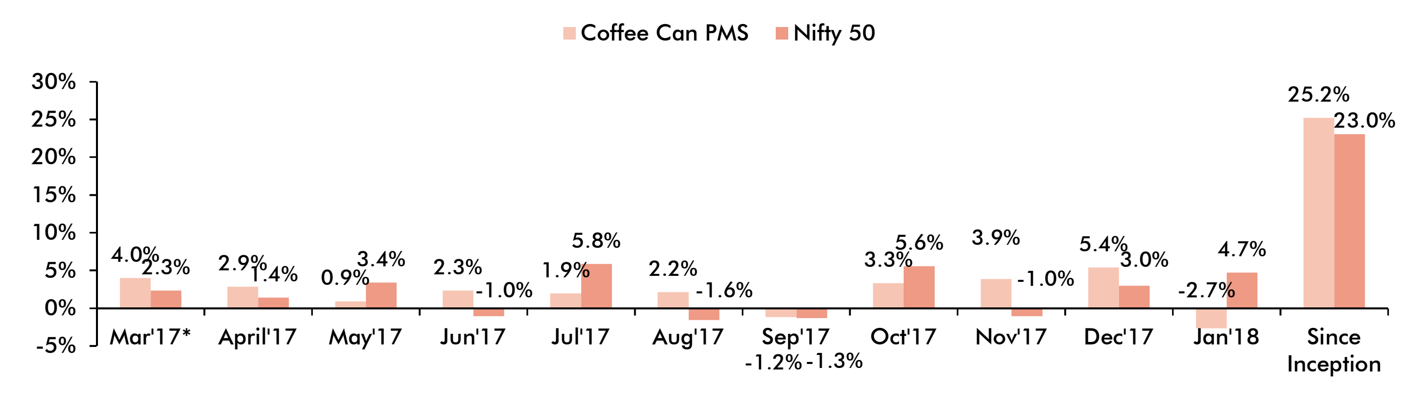
Source: Company, Ambit Capital

Example 2 - Walmart, 1972-1997: On 30th December 1983, well-known retailer Walmart's stock was trading at a P/E multiple of 56x when S&P500 Index was trading at a P/E multiple of 12x. By 30th December 1996, Walmart's P/E had shrunk to only 17x whilst S&P500 Index's P/E had risen to 19x. Despite this de-rating in its P/E multiple, Walmart delivered a share price CAGR of 19% from 1983 to 1996 when S&P500 Index delivered a CAGR of 12% over the same period. This stellar share price performance was delivered by Walmart despite its P/E multiple reducing to a third because the firm maintained an ROCE of 34% whilst reinvesting on average, 87% of its annual cash flows back into the business.

Performance update – Ambit's Coffee Can PMS

Exhibit below shows the performance of Ambit's Coffee Can PMS. The portfolio comprises 11 stocks of high quality companies, spread across Financials, Home Building Materials, Consumer Discretionary and Consumer Staples. There has been no change in the list of holdings (i.e. zero churn) since inception. Since Ambit's Coffee Can Philosophy seeks only great franchises which can sustain their competitive advantages over long time period, our high conviction in the longevity and capital reinvestment requirements of our portfolio companies implies that we continue to advise investors to buy such great franchises even though our view is that fundamentals do NOT fully support current valuations of the broader market.

Ambit's Coffee Can PMS performance update (as on 31st January 2018)



*Source: Ambit Capital, Bloomberg. *Date of inception= 6th March 2017*

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